



Australian Government
Productivity Commission

Superannuation: Assessing Efficiency and Competitiveness

Productivity Commission
Draft Report

April 2018

This is a draft report prepared for further public consultation and input. The Commission will finalise its report after these processes have taken place.

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An appropriate reference for this publication is:

Productivity Commission 2018, *Superannuation: Assessing Efficiency and Competitiveness*, Draft Report, Canberra.

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The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

Opportunity for further comment

The Commission is undertaking this inquiry under the twin (stage 2 and stage 3) terms of reference. This draft report brings together both streams of work to provide an overall assessment of the superannuation system and recommend policy changes.

You are invited to examine this draft and comment on it by written submission to the Productivity Commission, preferably in electronic format, **by 13 July 2018**, by attending a public hearing or submitting a short comment on the inquiry website (<http://www.pc.gov.au/inquiries/current/superannuation/assessment#draft>). Further information on how to provide a submission is included on the inquiry website: <http://www.pc.gov.au/inquiries/current/superannuation/make-submission#lodge>.

The Commission will be holding public hearings in late June 2018, and further details will be made available on the Commission's website in due course.

The final report will be prepared after further submissions have been received and public hearings have been held, and will be forwarded to the Australian Government at a date to be advised.

Commissioners

For the purposes of this inquiry the Commissioners are:

Karen Chester	Deputy Chair
Angela MacRae	Commissioner
Peter Harris	Chairman (stage 2 inquiry draft report)

Terms of reference: Stage 3

I, Scott Morrison, Treasurer, pursuant to Parts 2 and 3 of the Productivity Commission Act 1998, hereby request that the Productivity Commission undertake an inquiry to assess the efficiency and competitiveness of Australia's superannuation system.

Background

Today, superannuation is a \$2 trillion sector. It is important that, given the sheer size of the superannuation system, combined with its compulsory and broad nature, the system is efficient. Competition is also important as it can drive efficient outcomes for price, quality and innovation. Small changes in the system can have a real impact on people's standard of living in retirement.

Following the Government's response to Financial System Inquiry Recommendation 10 on efficiency in superannuation, on 17 February 2016 the Government tasked the Productivity Commission to develop criteria to assess the efficiency and competitiveness of the superannuation system (Stage 1) and to develop alternative models for allocating default fund members to products (Stage 2).

These Terms of Reference task the Commission to review the performance of the superannuation system against the criteria identified through the Commission's Stage 1 report, published in November 2016. This will be the third and final Stage of the review.

Scope

The Commission is to assess the efficiency and competitiveness of Australia's superannuation system and make recommendations to improve outcomes for members and system stability. The Commission is to also identify, and make recommendations to reduce, barriers to the efficiency and competitiveness of the superannuation system.

The assessment should be based on the five system-level objectives, 22 assessment criteria, and 89 corresponding indicators set out in the Commission's Stage 1 report.

In undertaking its assessment the Commission should evaluate the accumulation, transition and retirement phases of superannuation as well as the default, choice (including self-managed) and corporate fund member segments.

Whilst not out of scope, defined benefit funds should not be a key focus of the Commission's assessment.

Without limiting the Commission's assessment on the basis of the framework outlined in its Stage 1 report, the Commission should consider the following matters.

Costs, fees and net returns

The Commission is to focus on assessing system-wide long-term net returns, including by reference to particular segments. Through this assessment, the Commission should have particular regard to:

- whether disclosure practices are resulting in a consistent and comparable basis for meaningful comparisons to be made between products
- whether additional disclosure would improve outcomes for members
- whether the system is minimising costs and fees (including, but not limited to exit fees) for given returns
- what impact costs and fees have on members with low account balances, and what actions could be undertaken- whether by funds or policy changes- to ensure that these balances are not eroded needlessly
- whether tailoring of costs and fees for different member segments would be appropriate.

Default fund members

In relation to default fund members, the Commission should consider:

- whether the current default settings in the system are appropriate, or whether policy changes would be desirable
- whether an alternative default fund allocation mechanism should be introduced that would deliver net benefits.

Insurance in superannuation

The Commission should consider the appropriateness of the insurance arrangements inside superannuation, including:

- the impact of insurance premiums on retirement incomes of both default cover and individually underwritten cover funded inside of superannuation
- the extent to which current policy settings offset costs to government in the form of reduced social security payments
- whether policy changes could improve default cover through superannuation, so that default cover:
 - provides value-for-money
 - does not inappropriately erode the retirement savings of members of all ages
 - delivers consistent outcomes across the system.

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- whether policy changes are needed to ensure that insurance is not a barrier to account consolidation.

The broader financial system

In response to the 2014 Financial System Inquiry, the Government agreed to periodic reviews of competition in the financial sector. Pursuant to this response, the Government has also tasked the Commission to conduct an inquiry into competition in the financial system more broadly.

The two inquiries should not duplicate analysis or reporting.

Process

This review will commence on 1 July 2017.

Surveys involving industry participants should be tested with stakeholders before being implemented, to limit collection costs and ensure respondents consistently interpret data requirements.

The Commission should consult widely and undertake appropriate public consultation processes, including inviting public submissions and holding public hearings.

The Commission should release a draft report in January 2018 and provide its final report to the Government within 12 months of the commencement of the review.

Scott Morrison

Treasurer

[Received 30 June 2017]

Terms of reference: Stage 2

I, Scott Morrison, Treasurer, pursuant to Parts 2, 3 and 4 of the Productivity Commission Act 1998, hereby request that the Productivity Commission conduct: a study to develop criteria to assess the efficiency and competitiveness of the superannuation system; and an inquiry to develop alternative models for a formal competitive process for allocating default fund members to products.

Background

An efficient superannuation system is critical to help Australia meet the economic and fiscal challenges of an ageing population. The superannuation system has accumulated over \$2 trillion in assets. Given the system's size and growth, the system is of central importance to funding the economy and delivering retirement incomes.

MySuper has been a strong step in the right direction but more needs to be done to reduce fees and improve after-fee returns for fund members. The Financial System Inquiry noted that fees have not fallen by as much as would be expected given the substantial increase in the scale of the superannuation system, a major reason for this being the absence of consumer driven competition, particularly in the default fund market.

These Terms of Reference follow from the Government's response to Financial System Inquiry Recommendation 10 on efficiency in superannuation. The Government committed to tasking the Productivity Commission to develop and release criteria to assess the efficiency and competitiveness of the superannuation system, including the choice and default markets and to develop alternative models for allocating default fund members to products.

This work will inform a review of the efficiency and competitiveness of the superannuation system, which the Productivity Commission will be asked to undertake following the full implementation of the MySuper reforms (after 1 July 2017).

Process

The Productivity Commission is to develop criteria to assess the efficiency and competitiveness of the superannuation system and release the criteria within nine months of receiving these Terms of Reference. The release of these criteria is intended to provide transparency and certainty to the superannuation industry about how it will be assessed ahead of the full implementation of MySuper.

The Productivity Commission is to develop alternative models for a formal competitive process for allocating default fund members to products. In developing alternative models, the Productivity Commission should be informed by the criteria it develops to assess the efficiency and competitiveness of the superannuation system. The Productivity Commission should report on alternative models within 18 months of receiving these Terms of Reference.

For both elements, the Productivity Commission should consult widely and undertake appropriate public consultation processes, including inviting public submissions and conducting industry roundtables. The Productivity Commission is to provide both draft and final reports and the reports will be published.

Scope of study: Development of criteria to assess efficiency of super system

The Productivity Commission should develop criteria to assess whether and the extent to which the superannuation system is efficient and competitive and delivers the best outcomes for members and retirees, including optimising risk-adjusted after fee returns.

In determining the criteria to assess the efficiency and competitiveness of the superannuation system, the Productivity Commission may have regard to:

- operational efficiency, where products and services are delivered in a way that minimises costs and maximises value, which can be enhanced by competition and innovation from new entrants and incumbents
- allocative efficiency, where the system allocates resources to the most productive use and optimally allocates risks
- dynamic efficiency, including services to members, where the system induces the optimal balance between consumption and saving over time
- the extent to which the system encourages optimal behaviour on the part of consumers, including consideration of the learnings from behavioural finance.

The Productivity Commission should consider the nature of competition in the superannuation industry, the effect of government policy and regulation on the competitiveness and efficiency of the system and relevant international experience.

Scope of inquiry: Development of alternative models

The Productivity Commission is to examine alternative models for a formal competitive process for allocating default fund members in the superannuation system to products and to develop a workable model, or models, that could be implemented by Government if a new model for allocating default fund members to products is desirable.

These model(s) would provide viable alternatives for the Government's consideration, depending on the outcomes of the review of the efficiency and competitiveness of the superannuation system, which the Productivity Commission will be asked to undertake following the full implementation of the MySuper reforms.

The developed model(s) should enhance efficiency in the superannuation system in order to improve retirement incomes, including through optimising long-term net returns to members, and build trust and confidence in funds regulated by the Australian Prudential Regulation Authority (APRA). The models developed should consider default fund selection across the superannuation system as a whole.

The Productivity Commission may consider auction, tender and other types of competitive processes. The Productivity Commission should consider the merits of different approaches, the metrics for conducting them and their frequency. This should include consideration of:

- the strengths and weaknesses of competitive processes used internationally, such as Chile, New Zealand and Sweden, as well as those used in large corporate tenders by the Northern Territory Government and in other jurisdictions
- the costs and benefits of different mechanisms, including:
 - optimising long-term after fee returns
 - the administrative, fiscal, individual and complexity costs.
- and in examining different processes, consider:
 - the robustness of the process, including against gaming and collusion
 - whether the structure achieves efficient outcomes and facilitates ongoing innovation over the long run
 - the effect on system stability and market concentration
 - who should run the process
 - the extent to which the process promotes the interests of consumers.
- regulatory impediments to optimal competition under the preferred model(s).

Principles for designing a model for a competitive process should include:

- **Best interests:** ensure incentive compatibility with meeting the best interests of members, encourage long-term investing, and encourage a focus on expected after-fee returns based on asset allocation and investment strategy.
- **Competition:** drive pressure on funds to be innovative and efficient, diversify asset allocation and optimise long-term after-fee returns by rewarding best performers. Facilitate new superannuation fund entrants to the market.
- **Feasibility:** ensure the process is low-cost and easy to administer and minimises regulatory costs on industry, including business and employers.

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- **Credibility and transparency:** make relevant information public; avoid room for gaming the process; and ensure metrics are clear, simple, difficult to dispute and difficult to manipulate.
 - **Regular assessment and accountability:** regularly conduct a repeat process that requires default funds to earn their right to receive new default members, and ensure funds are accountable for the outcomes they deliver members.
 - **Fiscal implications:** the extent to which the process can reduce reliance on the Age Pension and/or give rise to other risks or costs to Government.

The Productivity Commission should draw on expertise in the field of competitive models.

Scott Morrison
Treasurer

[Received 17 February 2016]

Inquiry timeline

Due to delays in data collection and consultations, the release of the draft report for the inquiry into the efficiency and competitiveness of Australia's superannuation system was delayed to 30 May 2018. This will result in a consequential delay of the final report, with the timing to be advised.

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Abbreviations

ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ACCI	Australian Chamber of Commerce and Industry
ACTU	Australian Council of Trade Unions
AFCA	Australian Financial Complaints Authority
AIST	Australian Institute of Superannuation Trustees
APRA	Australian Prudential Regulation Authority
ASFA	Association of Superannuation Funds of Australia
ASIC	Australian Securities and Investments Commission
ASU	Australian Services Union
ASX	Australian Stock Exchange
ATO	Australian Tax Office
AUSTRAC	Australian Transaction Reports and Analysis Centre
BP1	Listed benchmark portfolio
BP2	Blended benchmark portfolio
BTFG	BT Financial Group
CEO	Chief Executive Officer
CFMEU	Construction, Forestry, Mining and Energy Union
CFR	Council of Financial Regulators
CGT	Capital Gains Tax
CPI	Consumer Price Index
CTF	Counter-Terrorism Financing
DIY	Do it yourself
DSS	Department of Social Security
EBA	Enterprise Bargaining Agreement
ERF	Eligible Rollover Fund
FOFA	Future of Financial Advice

FSC	Financial Services Council
FSS	First State Super
FUM	Funds Under Management
FWC	Fair Work Commission
GDP	Gross domestic product
GFC	Global financial crisis
HHI	Herfindahl–Hirschman Index
HILDA	Household, Income and Labour Dynamics in Australia
IFS	Industry Fund Services
IP	Income protection
ISA	Industry Super Australia
ISC	Insurance and Superannuation Commission
ISWG	Insurance in Superannuation Working Group
LRBA	Limited Recourse Borrowing Arrangements
LRM	Longevity Risk Management
MOU	Memorandum of understanding
NEST	National Employment Savings Trust (UK)
NZCO	New Zealand Cabinet Office
OAIC	Office of the Australian Information Commissioner
OECD	Organisation for Economic Co-operation and Development
OTE	Ordinary time earnings
PAIRS	Probability and Impact Rating System
PC	Productivity Commission
PDS	Product Disclosure Statement
PJCCFS	Parliamentary Joint Committee on Corporations and Financial Services
RBA	Reserve Bank of Australia
RCTUGC	Royal Commission into Trade Union Governance and Corruption
RSA	Retirement savings account
RSE	Registrable Superannuation Entity
SCT	Superannuation Complaints Tribunal

SG	Superannuation Guarantee
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>
SMSF	Self-managed superannuation fund
SOARS	Supervisory Oversight and Response System
SR	SuperRatings
SRF	Standard reporting framework
STP	Single Touch Payroll
TER	Total Expense Ratio
TFN	Tax File Number
TPD	Total and permanent disability

Glossary

Account-based pension	A regular retirement income stream, purchased with money an individual has accumulated in their superannuation after they have reached the preservation age.
Annuity	A retirement income product that provides a guaranteed stream of fixed payments made at regular intervals.
APRA-regulated fund	Any large or small superannuation fund regulated by the Australian Prudential Regulation Authority (APRA), also known as a Registrable Superannuation Entity.
APRA-regulated institutional fund	Any large (more than four members) superannuation fund regulated by APRA.
Asset allocation	The distribution of funds in an investment portfolio (for a fund or individual member) between different asset classes.
Asset class	A category of assets that a superannuation fund can invest in, such as cash, fixed interest, shares, property or unlisted infrastructure.
Bulk transfer	The process whereby multiple member accounts are transferred to a different superannuation fund without the member's consent. This process follows 'successor fund transfer' rules set out in legislation.
Concessional contributions	Contributions drawn from an individual's pre-tax income that are made into a superannuation fund.
Condition of release	A prescribed event (such as retirement) a person must satisfy to be able to access superannuation payments.
Corporate fund	A superannuation fund sponsored by a single employer or group of usually related employers for the benefit of company employees.
Corporate tender	A tender for the right to become the default superannuation fund of a particular group of employees.
Default fund	A superannuation fund to which an employer's Superannuation Guarantee contributions are paid if the employee does not choose an alternative fund.

Deferred annuity	An annuity where payments commence after a nominated period.
Defined benefit fund	A superannuation fund where contributions are pooled rather than allocated to particular members, and where retirement benefits are determined by a formula based on factors such as salary and duration of employment.
Defined contribution fund	A superannuation fund where the value of the final retirement benefit payable is based on contributions made plus investment returns less any fees and taxes.
Exempt public sector superannuation scheme	A superannuation fund providing benefits for government employees, or schemes established by Commonwealth, State or Territory law, that are not directly subject to the <i>Superannuation Industry (Supervision) Act 1993</i> (Cwlth) and APRA regulation.
Industry fund	Funds originally formed to provide access to superannuation for employees working within a particular industry.
Investment risk	One of a number of risks to the value of an investment, including market, interest rate, inflation, credit, liquidity and asset-specific risk.
Legacy product	A superannuation product (held by some members) that is no longer available for issue to new members.
Lifetime annuity	An annuity payable over a recipient's remaining lifetime.
Longevity risk	The risk of a person outliving their savings.
MySuper product	A default defined contribution superannuation product. Superannuation funds must meet requirements set by APRA to be permitted to offer a MySuper product. All default products are MySuper products since 1 July 2017.
Non-concessional contributions	Contributions drawn from an individual's post-tax income that are made into a superannuation fund.
Outsourcing	The process whereby a superannuation fund trustee contracts another entity to provide services to the fund, such as administration or investment management.
Peer risk	The risk of an individual superannuation fund performing below the market average.

Pooled superannuation trust	A trust in which the assets of a number of superannuation funds, approved deposit funds or other pooled superannuation trusts are invested and managed by a professional manager.
Preservation age	The minimum age prescribed by law at which a member can withdraw their superannuation benefits from the superannuation system.
Product dashboard	Product and performance information (specified by APRA) regarding MySuper products that must be made available on superannuation fund websites.
Registrable superannuation entity	An APRA-regulated superannuation fund, an approved deposit fund or a pooled superannuation trust.
Retail fund	A superannuation fund that offers superannuation products on a commercial ‘for profit’ basis.
Retail level	The level of the superannuation market that provides services directly to members.
Self-managed superannuation fund	A superannuation fund with fewer than five members, all of whom are trustees or are directors of a corporate trustee.
Sequencing risk	The risk of experiencing poor investment returns just prior to drawing on funds in retirement.
Small APRA fund	Any APRA-regulated fund with fewer than five members.
Small fund	Any superannuation fund with fewer than five members.
Superannuation Guarantee	Compulsory superannuation contributions paid by employers on behalf of employees, and equal to a percentage (currently 9.5 per cent per year) of each employee’s ordinary time earnings.
Superannuation system	The collection of participants and activities involved in superannuation, including members, employers, funds, upstream suppliers, ancillary service providers (including insurers) and regulators.
SuperStream	An Australian Government package of measures designed to enhance administrative processes for superannuation, especially the way that Superannuation Guarantee payments are transferred from employers to funds.

Trustee	A person or company holding property on behalf of another party with a fiduciary duty to the beneficiaries.
Unlisted asset	An asset for which there is no public exchange for listing, quotation or trading.
Wholesale level	The level of the superannuation market that involves the interaction between trustees/funds and other service providers.

OVERVIEW

Key points

- Australia's super system needs to adapt to better meet the needs of a modern workforce and a growing pool of retirees. Currently, structural flaws — unintended multiple accounts and entrenched underperformers — harm a significant number of members, and regressively so.
 - Fixing these twin problems could benefit members to the tune of \$3.9 billion each year. Even a 55 year old today could gain \$61 000 by retirement, and lift the balance for a new job entrant today by \$407 000 when they retire in 2064.
- Our unique assessment of the super system reveals mixed performance.
 - While some funds consistently achieve high net returns, a significant number of products (including some defaults) underperform markedly, even after adjusting for differences in investment strategy. Most (but not all) underperforming products are in the retail segment.
 - Fees remain a significant drain on net returns. Reported fees have trended down on average, driven mainly by administration costs in retail funds falling from a high base.
 - A third of accounts (about 10 million) are unintended multiple accounts. These erode members' balances by \$2.6 billion a year in unnecessary fees and insurance.
 - The system offers products and services that meet most members' needs, but members lack access to quality, comparable information to help them find the best products.
 - Not all members get value out of insurance in super. Many see their retirement balances eroded — often by over \$50 000 — by duplicate or unsuitable (even 'zombie') policies.
- Inadequate competition, governance and regulation have led to these outcomes.
 - Rivalry between funds in the default segment is superficial, and there are signs of unhealthy competition in the choice segment (including the proliferation of over 40 000 products).
 - The default segment outperforms the system on average, but the way members are allocated to default products leaves some exposed to the costly risk of being defaulted into an underperforming fund (eroding over 36 per cent of their super balance by retirement).
 - Regulations (and regulators) focus too much on funds rather than members. Subpar data and disclosure inhibit accountability to members and regulators.
- Policy initiatives have chipped away at some of the problems, but more changes are needed.
- A new way of allocating default members to products should make default the exemplar.
 - Members should only ever be allocated to a default product once, upon entering the workforce. They should also be empowered to choose their own super product by being provided a 'best in show' shortlist, set by a competitive and independent process.
 - An elevated threshold for MySuper authorisation (including an enhanced outcomes test) would look after existing default members, and give those who want to get engaged products they can easily and safely choose from (and compare to others in the market).
 - This is superior to other default models — it sidesteps employers and puts decision making back with members in a way that supports them with safer, simpler choice.
- These changes need to be implemented in parallel to other essential improvements.
 - Stronger governance rules are needed, especially for board appointments and mergers.
 - Funds need to do more to provide insurance that is valuable to members. The industry's code of practice is a small first step, but must be strengthened and made enforceable.
 - Regulators need to become member champions — confidently and effectively policing trustee conduct, and collecting and using more comprehensive and member-relevant data.

Overview

Superannuation is a significant financial asset for many Australians. It sits alongside the Age Pension, the family home and other household savings as a pillar of the retirement income system. With super being compulsory for most workers and with nearly 15 million members collectively owning over \$2.6 trillion in assets, it will play a central role in funding Australians' retirement.

The super system's performance therefore matters for the wealth and wellbeing of Australians. The system is both complex and compulsory. Not everyone has the time, inclination or capacity to keep a constant eye on their super. Government plays a role in regulating the system so that people can trust it with a significant portion of their savings (and for many, their primary source of savings).

The system has come a long way since 1992 when compulsory super was introduced. It arose as a de facto pay rise, which tied Australia's retirement savings policy to the workplace relations system. Super funds were inextricably linked to employers and unions, with industrial awards cementing the relationship. The workplace relations system has since changed, and the role of unions has diminished. But vestiges of that old system live on with specification of super funds in awards, and workplace determination of default funds.

Now that the system is well on the way to maturity — with many members retiring with substantial balances after contributing for many years — it is timely to ask whether it suits the needs of its members today. Australians are increasingly likely to move between industries and occupations throughout their careers, women are participating in the labour force in greater numbers than ever before, and the gig economy and technologies such as automation are breaking down some of the industry and occupational boundaries we once had (box 1). Moreover, most Australians are working longer, retiring later and living longer — meaning they have higher super balances but also need to make them last for longer.

This inquiry is examining the efficiency and competitiveness of our super system — and whether better ways to allocate defaults are needed — with an eye to making it work better for all members.

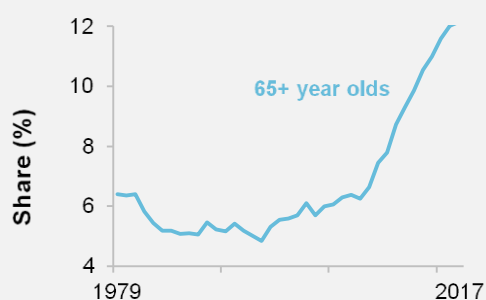
Box 1 Members in the modern workforce

Australia's super system developed in a context quite foreign to current and impending social and workforce dynamics. Maturation of the system, greater female labour force participation, extended working lives, and higher contribution rates mean that the super system will be far more important to members' retirement incomes, and warrants a greater focus on services in the retirement phase.

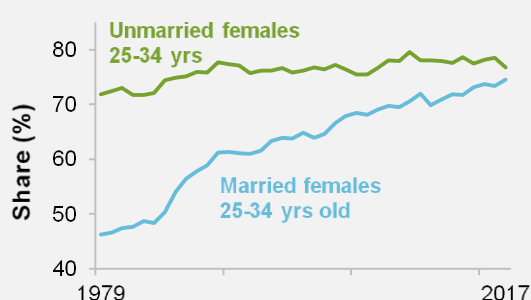
While job tenure has been relatively stable, many people still switch employers, which — combined with multiple job holding and a much greater tendency to move between industries and occupations — suggests that inefficient multiple accounts will be a persistent and costly problem without further reform. Moreover, this inefficiency could be accentuated if technological shifts result in greater job mobility. The current technology for supplying superannuation services and engaging with members — much of which is now digital — gives better opportunities for employees, not employers and employee representatives, to be the most active parties in decision making.

The super system has not kept pace with the needs of its members. Most notably, it has led to the absurdity of unintended multiple accounts in a system anchored to the job or the employer, not the member.

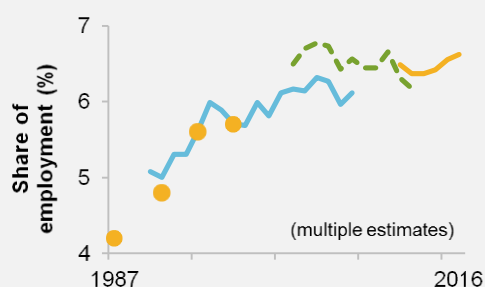
Participation rates by older people are rising steeply



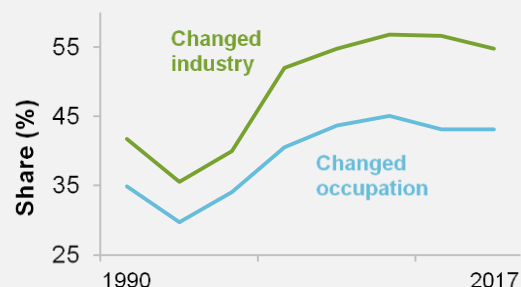
Marriage (and children) place less of a brake on participation



There has been an uptick in multiple job holders



Of those who change jobs, more are moving between industries and occupations



Our approach

This has been a three-stage inquiry process, drawing on two terms of reference (box 2). It is unique in its breadth and use of evidence — indeed, there is little precedent in Australia and internationally for reviewing the efficiency and competitiveness of a superannuation or pension system in its totality.

Box 2 **A three-stage process**

The Australian Government tasked the Commission with three sequential pieces of work on the super system, falling under two terms of reference.

Stage 1 involved developing a framework for assessing the efficiency and competitiveness of the super system. The final study report was released in November 2016 and the framework comprised 5 system-level objectives, 22 assessment criteria and 89 unique indicators (PC 2016a).

Stage 2 entailed developing a set of alternative models for allocating default members to products (PC 2017c). Following publication of the draft report in March 2017 and a round of public hearings, the stage 2 inquiry was rolled into the stage 3 inquiry.

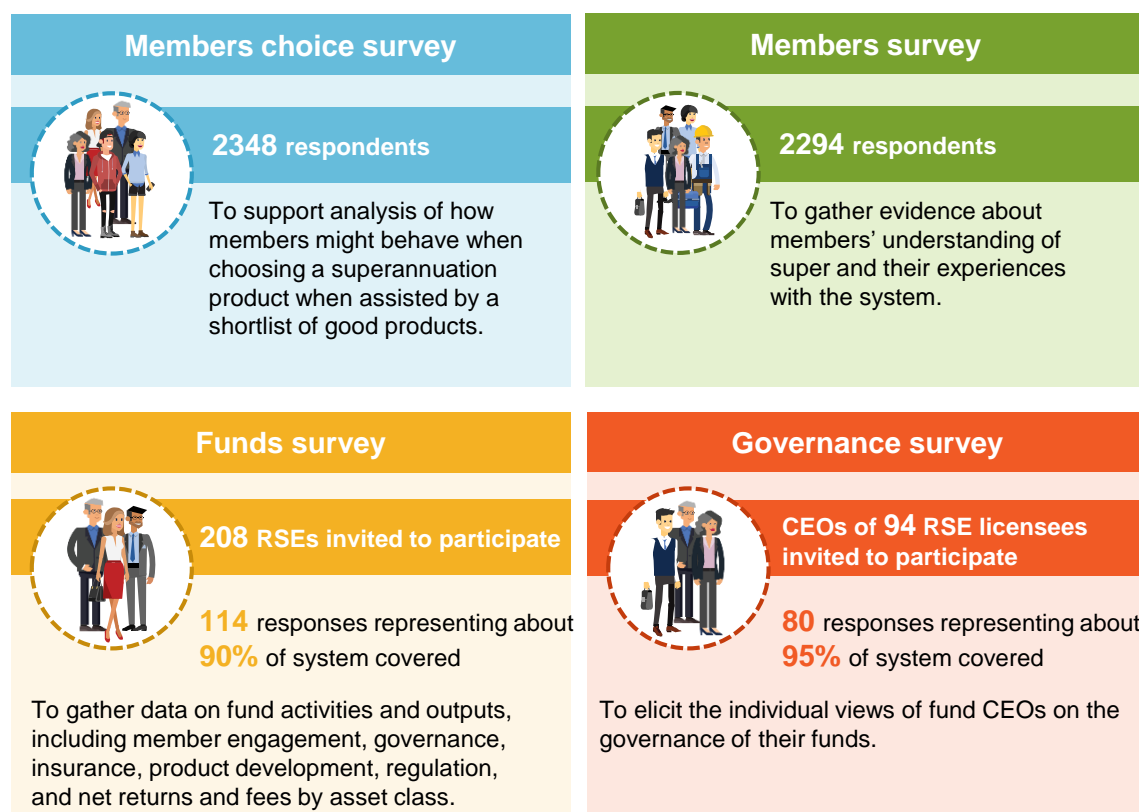
Stage 3, the current inquiry, derives from its own terms of reference. It is assessing the efficiency and competitiveness of the system, drawing on the stage 1 framework, and identifying areas for improvement. It is also providing advice on alternative default models based on feedback on the stage 2 draft report.

This stage 3 inquiry follows the full implementation of the MySuper reforms completed on 1 July 2017. The inquiry originally derives from a recommendation made by the 2014 Financial System Inquiry (Murray et al. 2014). That inquiry found early indications that the MySuper reforms were not leading to a significant improvement in competitive pressure in the super system and recommended introducing a formal competitive process to allocate default members to products, pending a review by the Productivity Commission of the efficiency and competitiveness of the super system.

In this draft report we are asking and answering the questions set out in the assessment criteria we developed in our stage 1 study — which reflect prospective attributes of a competitive and efficient super system, and are within the scope of influence of the system. These criteria cover the system’s contribution to members’ retirement incomes, how it meets members’ needs over their lifetimes, gains in efficiency over time, whether it provides value for money insurance, and how competition drives the outcomes members need.

To do this, we are drawing widely on data and evidence, much of which is already in the public domain or held by regulators and research firms. We have also had to gather new evidence, principally through a quartet of surveys: of super funds (on their operations and performance), of fund CEOs (on governance) and two of members themselves (figure 1). And in using this data and evidence, we have conducted many novel analyses (box 3).

Figure 1 **Our quartet of surveys**



The assessment is not an easy one. Data held by regulators contain many gaps and inconsistencies, especially in relation to funds' investment expenses and related-party relationships. While our surveys were designed to fill some of the gaps, the overall quality of responses to our funds survey was disappointing. Only about half of super funds chose to participate (although notably they represented the overwhelming majority of members and system assets). And of those that did participate, many skipped questions or provided incomplete data (especially on data that matter most to members).

The findings in this draft report are focused on the outcomes for members in the super system, consistent with our remit to make recommendations in the interest of the wellbeing of the Australian community. There are no league tables of individual funds in this report. The task is a system-wide assessment spanning institutional and self-managed super funds, wholesale providers, the regulators and, foremost, members.

Broad as this inquiry is, we are not looking at the overarching retirement income policy architecture. This means we are not examining the Superannuation Guarantee rate, Age Pension or taxation arrangements. And while the purpose of super is to provide income in retirement to substitute or supplement the Age Pension, we are not looking at the adequacy of overall retirement incomes or the impact of super on national savings. Further, we are

conducting this inquiry in parallel with our inquiry into competition in the broader Australian financial system, which complements the analysis undertaken here.

We have consulted widely in preparing this draft report (and the two preceding stages), and will continue to do so as we work on the final report. Public submissions are welcome (by 13 July 2018). We will also be holding public hearings.

Box 3 **What we've done that's new and novel**

We have undertaken several novel analyses for this inquiry. We:

- constructed **investment benchmark portfolios** to compare performance across the system (by segments, funds and products) against the relevant benchmark portfolio, adjusted for investment strategy (asset allocation)
- developed a range of **cameos** to illustrate how retirement balances can be eroded by multiple accounts, unpaid super, insurance premiums, high fees and low net returns
- undertook **econometric analysis of products** to look at impacts of product proliferation on costs and fees, combined with **stochastic analysis** of how these fees affect members' retirement balances
- **simulated sequencing risks** that members might face to evaluate how effective life-cycle products are at managing these risks.

Two further pieces of analysis are well advanced, and will be uploaded on our website as technical supplements following release of this draft report. We are:

- undertaking econometric analysis of **economies of scale** to estimate cost savings that have resulted from scale improvements to date, what scale benefits remain to be realised, and the degree to which the benefits of scale have been passed through to members as lower fees
- modelling the **fiscal effects of insurance** in super, including the impact of insurance payouts on social security payments and the impact of retirement balance erosion caused by insurance premiums on Age Pension liabilities.

What outcomes are members getting?

The super system exists to support its members in retirement. As such, the outcomes delivered to members matter above all else. In the long term, members need strong investment performance and confidence that their balance is not eroded by unnecessarily high fees or insurance premiums. They also need access to products that meet their individual requirements — especially once they have retired — and the right information to make decisions. The system does well in some of these respects, but not all. There is much room for improvement.

The system has delivered mixed returns

Investment returns — net of all fees and taxes — matter most for members' retirement incomes. Even a small difference in annual returns can leave a member substantially worse off at retirement.

To assess investment performance across the super system we have constructed a series of benchmark portfolios. This follows two technical workshops during our stage 1 study and much consultation with industry experts. These portfolios are measures of investment returns across a set of asset classes, with the mix of assets adjusted to match the investment strategy (strategic asset allocation) of the segments of the system we are benchmarking (box 4). This approach is new, and has not been previously applied to gauge the performance of the system as a whole. Importantly, it is agnostic of asset allocation and thus allows for a comparison of performance across the system by segments, funds and investment options (products).

Box 4 **Our two benchmark portfolios**

We have developed benchmark portfolios to assess the system's relative and absolute investment performance. The benchmarks allow comparable performance assessment across funds and products by tailoring for (and thus being agnostic of) asset allocation.

Two main types of benchmark portfolios (BPs) have been constructed for this draft report:

- **BP1** is a listed benchmark portfolio that captures investment performance (net of fees and taxes) of a set of investment strategies across a range of listed asset classes
- **BP2** is a blended benchmark portfolio that captures investment performance (net of fees and taxes) of a set of investment strategies across a range of listed and unlisted asset classes that more closely represents how funds implement asset allocation.

As BP2 is more representative of super funds' exposure to unlisted asset classes — and thus how they would likely implement their asset allocations — it is used in this overview. We define 'underperformance' as falling below BP2 by at least 0.25 percentage points (25 basis points) over the relevant time period. For a typical full-time worker, a difference of this magnitude can reduce their retirement balance by about 6 per cent (or \$54 000).

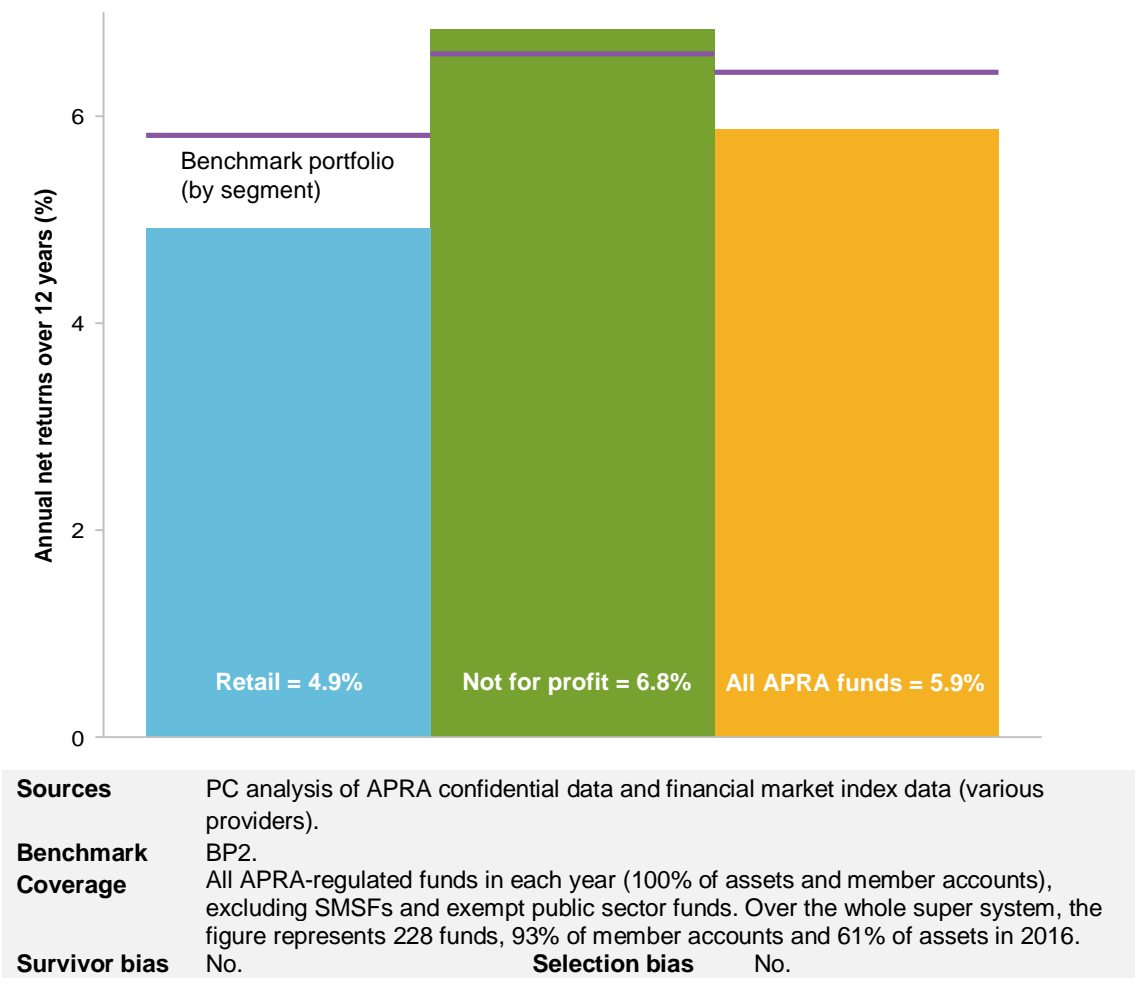
Our benchmarking against BP1 can be found in chapter 2.

Data limitations mean this exercise is challenging and cannot be an exact science — indeed, our benchmarks are sensitive to assumptions (about tax and fees) and adjustments made to reflect funds' asset allocations in earlier years (chapter 2). So we have erred on the side of giving funds the 'benefit of the doubt' in constructing the benchmarks, and have identified 'underperformance' only where funds or products fall short of the relevant benchmark (by at least 0.25 percentage points over the relevant time period).

To take account of risk, we have benchmarked investment performance over the longest time period permitted by the data (in most cases, 12 years). While the results are somewhat influenced by the time horizon, they are broadly consistent over shorter periods.

Over the past 20 years, most institutional super funds (regulated by APRA) have delivered solid returns to their members (net of investment and administration expenses, and taxes), averaging about 5.7 per cent a year in nominal terms — equivalent to about 3.2 percentage points above CPI. But when viewed over the 12 years to 2016, APRA-regulated funds on average delivered average annual net returns just below the system-wide benchmark (figure 2).

Figure 2 Funds by segment: not-for-profit funds outperform retail funds on average
 Benchmark adjusted for asset allocation, 2005–2016



Investment performance varies across the system. As a group, not-for-profit funds delivered returns above the benchmark tailored to their average asset allocation, but retail funds as a group fell below theirs. The tailored benchmarks already take into account that retail funds typically have more conservative asset allocations compared to not-for-profit funds. These

results suggest that while many funds have been delivering solid returns for members, there are also many underperforming products, particularly in retail funds.

This difference between not-for-profit and retail funds is not fully explained by characteristics such as fund size, asset allocation (such as the proportion of growth assets) or reported administration expenses. A performance gap is also apparent (but less pronounced) across fund types when looking at returns to growth and balanced products, which are often a fund's default investment option.

Performance also varies across individual funds and products, again after adjusting for differences in asset allocation (figure 3). Of the 14.6 million accounts in the dataset, about two-thirds are in the funds that performed above their benchmark. However, almost all of the remaining member accounts are in funds that fell short of their fund-specific benchmark portfolio (by at least 0.25 percentage points). Nearly half of these underperformers are retail funds, and about a third are industry funds.

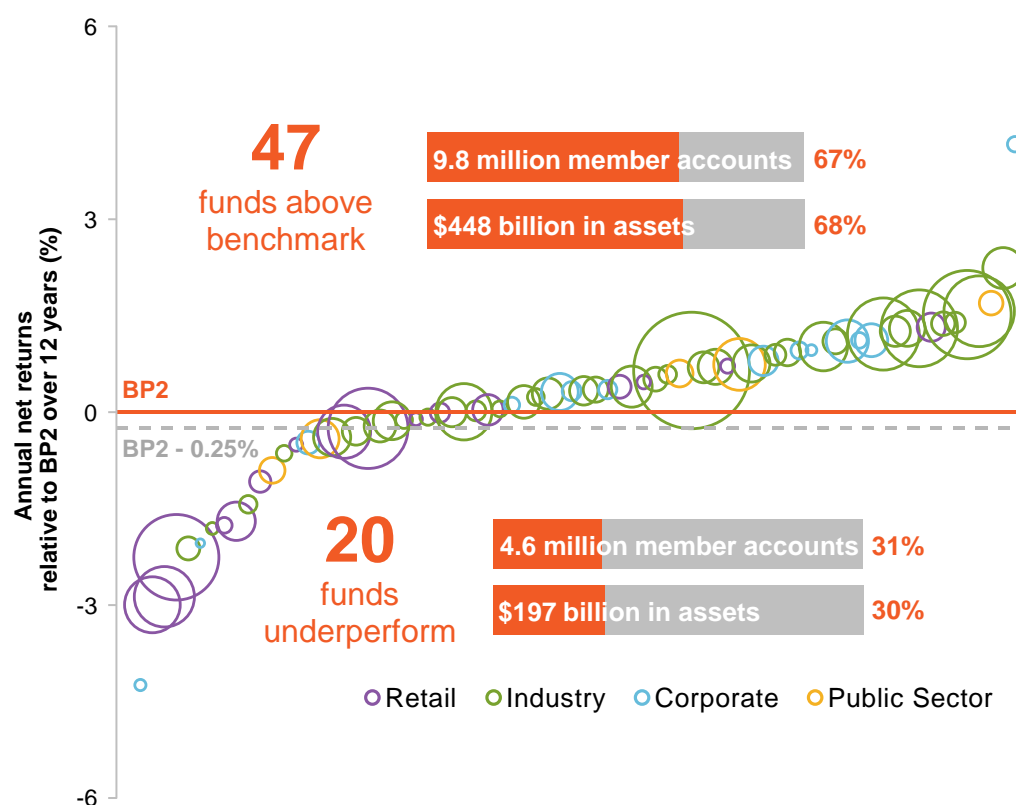
This analysis only covers funds that currently offer a MySuper product, due to data limitations and the need to make assumptions about asset allocations in past years. Using simpler (but likely less accurate) assumptions allows for a broader sample, in which about half of member accounts are in underperforming funds (and of these accounts, over half are in retail funds).

The wide dispersion in fund performance over the long-term has large implications for members' retirement incomes. For example, a typical full-time worker in the median fund in the bottom quartile (in terms of investment performance) over their lifetime would retire with a balance 53 per cent (or \$635 000) lower than if they were in the median top-quartile fund (cameo 1).

Figure 3 **Individual funds (with MySuper products): nearly 5 million accounts are in underperforming funds**

Performance relative to individual funds' benchmark portfolios, 2005–2016

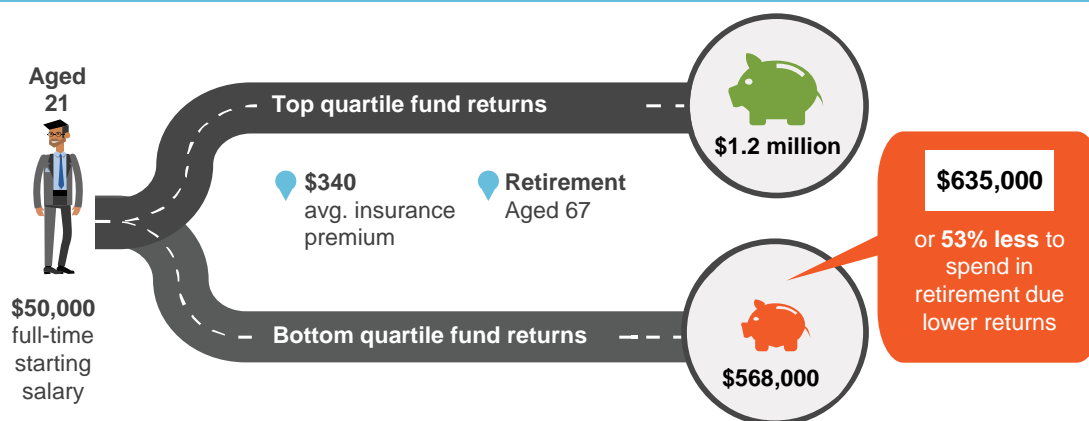
Size of circles indicates the size of each fund's assets under management



Source	PC analysis of APRA confidential data and financial market index data (various providers).
Benchmark	Fund-tailored BP2.
Coverage	All APRA-regulated funds with a MySuper product in the dataset over the full period (52% of assets and 61% of member accounts in all APRA-regulated funds with a MySuper product in 2016). Over the entire super system, the figure represents 74 funds, 32% of assets and 50% of member accounts in 2016.
Survivor bias	Yes.
Further results	Selection bias No. 7 funds performed between BP2 and 0.25 percentage points below BP2 (262 000 member accounts and \$18.8 billion in assets).

Cameo 1 Underperformance compounds to substantially lower retirement balances

Super problem: Underperforming fund = 13 years' lost pay



Outcomes also vary by the type of product. To look at outcomes in the default segment, we tracked products over the past decade by matching current MySuper products to their precursors (figure 4). This revealed significant dispersion in the performance of MySuper products — which collectively hold over 15 million (half of all) member accounts. Many of these accounts are in products that perform well above the average, but a material portion significantly and persistently underperform a benchmark portfolio tailored to the average MySuper asset allocation.

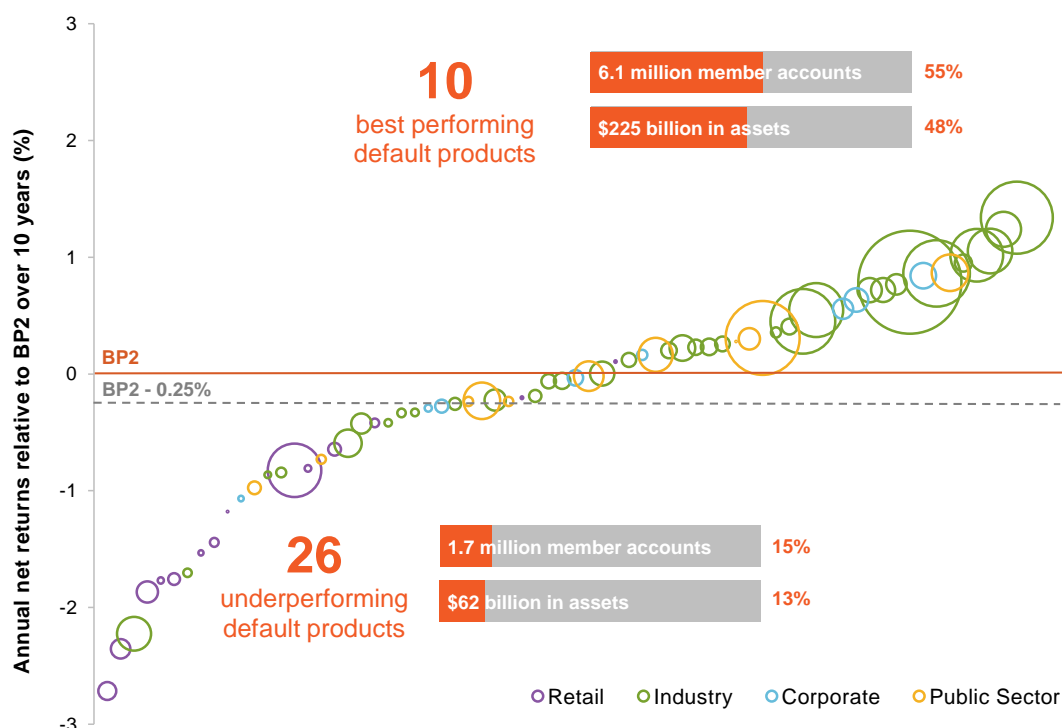
The analysis reveals that:

- in the decade to 2017, the top 10 MySuper products generated a median return of 5.7 per cent a year (which matches system-wide average returns over the past 20 years because of high returns prior to 2008). This is well above the median of 4.7 per cent for all MySuper products in our sample. More than 6 million member accounts and over \$225 billion in assets were in these 10 products, all of which were associated with not-for-profit funds (of varying sizes)
- over the same period, 36 products performed below the benchmark portfolio, of which 26 underperformed by more than 0.25 percentage points and generated a median return of 3.9 per cent a year for their members. About 1.7 million member accounts and \$62 billion in assets were in these 26 underperforming products. The 26 underperforming products were made up of 12 retail, 10 industry, three corporate and one public sector products.

Figure 4 **Default products: vastly different net returns, with 1.7 million default member accounts in underperforming products**

Compared to MySuper average asset allocation, 2008–2017

Size of circles indicates the size of each fund's assets under management



Sources	PC analysis of SuperRatings and APRA data, and financial market index data (various providers).
Benchmark Coverage	BP2. 66 of 108 MySuper products covering 75% of member accounts and 73% of assets in all MySuper products as at December 2017.
Survivor bias	Yes.
Selection bias	Yes.
Further results	22 MySuper products performed above BP2 but not in the top 10 (3 million member accounts and \$150 billion in assets). 10 products performed between BP2 and 0.25 percentage points below BP2 (428 000 member accounts and \$29 billion in assets).

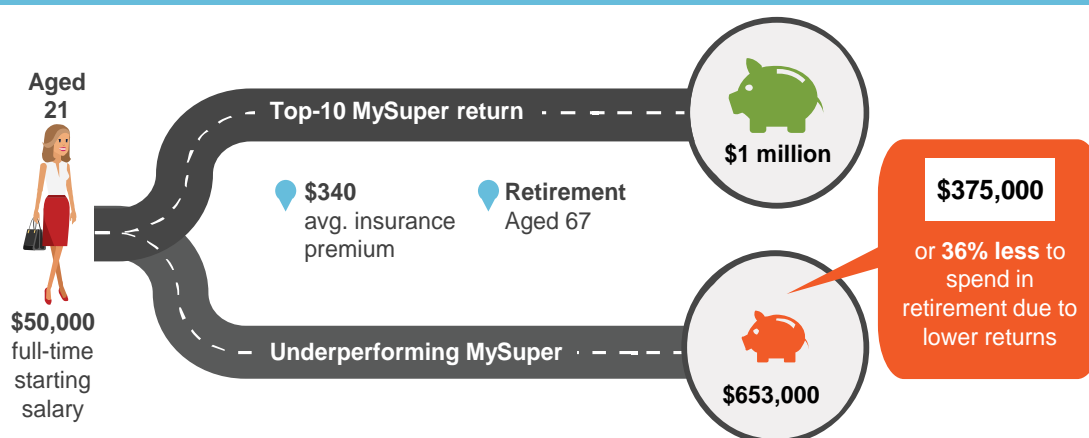
Nearly a third (8) of the underperforming MySuper products are life-cycle products — where members are automatically moved into less risky (and lower-return) asset allocations as they age (represented by a single ‘representative’ life stage in our data). Life-cycle products comprise about a third of member accounts and assets in the MySuper segment.

APRA data on a near complete set of MySuper products — over the first three years since MySuper was introduced — show a similarly large dispersion in investment performance. This suggests that the observed dispersion in net returns is not an historical artefact of the pre-MySuper era.

The large differences in investment performance for MySuper products have enormous implications for members. For example, a typical full-time worker who is in the median underperforming MySuper product in figure 4 would retire with a balance 36 per cent (or \$375 000) lower than if they were in the median top-10 product (cameo 2). And if all members in the underperforming MySuper products had been in the median top 10 product, they would have collectively been better off by over \$1.3 billion annually (or about \$770 each annually, on average).

Cameo 2 MySuper returns can be a lottery for default members

Super problem: Underperforming MySuper = 7.5 years' lost pay



Underperformance appears to be more pronounced for the 11 million members who have chosen their own products within APRA-regulated funds (some may also hold MySuper accounts). The choice segment covers both the accumulation and retirement phases, with assets evenly split between retail and not-for-profit funds. For those accumulation choice products on which we could obtain data, just under half — representing 40 per cent of assets in the data — underperformed benchmarks tailored to their own asset allocation in the 12 years to 2016 by at least 0.25 percentage points (though this is likely a conservative estimate of underperformance in the whole choice segment as our data only cover about 13 per cent of the segment by assets). Some of these differences may be due to a material departure from the average default asset allocation and members' preferences for more costly services, which detract from net returns.

More than one million members have chosen to self-manage their super in an SMSF. Large SMSFs are broadly competitive with institutional funds in terms of net returns. However, smaller ones (with less than \$1 million in assets) perform significantly worse than institutional funds, mainly due to the materially higher average costs they incur due to being small. It is not clear how many of these will perform better in future as they grow in size.

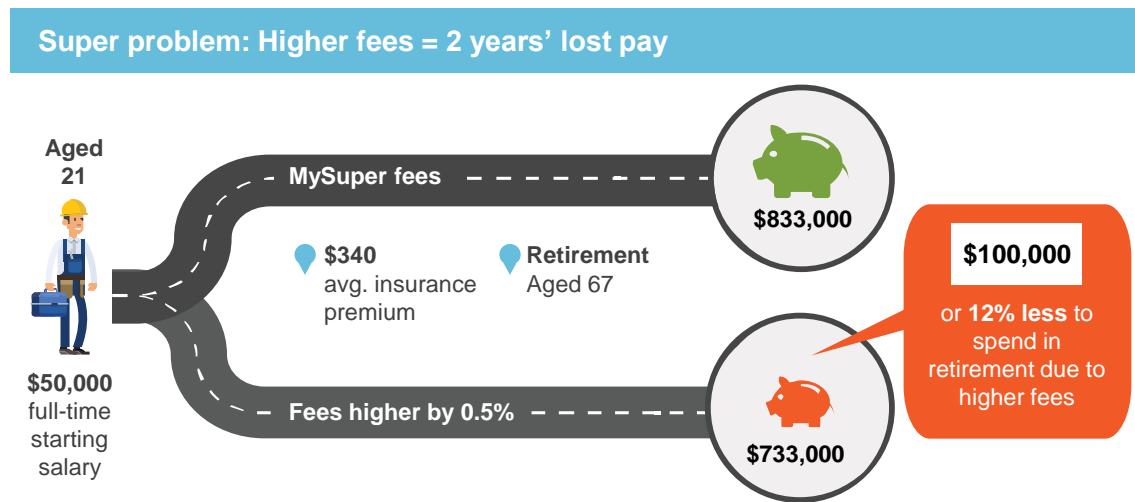
Clearly, some members — in choice as well as default — do well, but many could be doing a lot better.

What drives differences in performance across funds and products is not always easy to discern. An evaluation over the long term by asset class would have provided further insight and afforded an international comparison. Those data apparently exist but were not made available to the Commission. In response to our surveys, about 80 per cent of funds claimed that they regularly undertake performance attribution analysis and their trustee boards assess and fully understand the attribution of investment performance outcomes. Despite this response, relatively few funds provided data to us on net returns by asset class — the data needed to undertake performance attribution.

Fees have come down but remain a drain on net returns

Australians pay over \$30 billion a year in fees on their super (excluding insurance premiums). Fees can have a substantial impact on members — for example, an increase in fees of just 0.5 per cent can cost a typical full-time worker about 12 per cent of their balance (or \$100 000) by the time they reach retirement (cameo 3).

Cameo 3 Higher fees materially erode balances at retirement

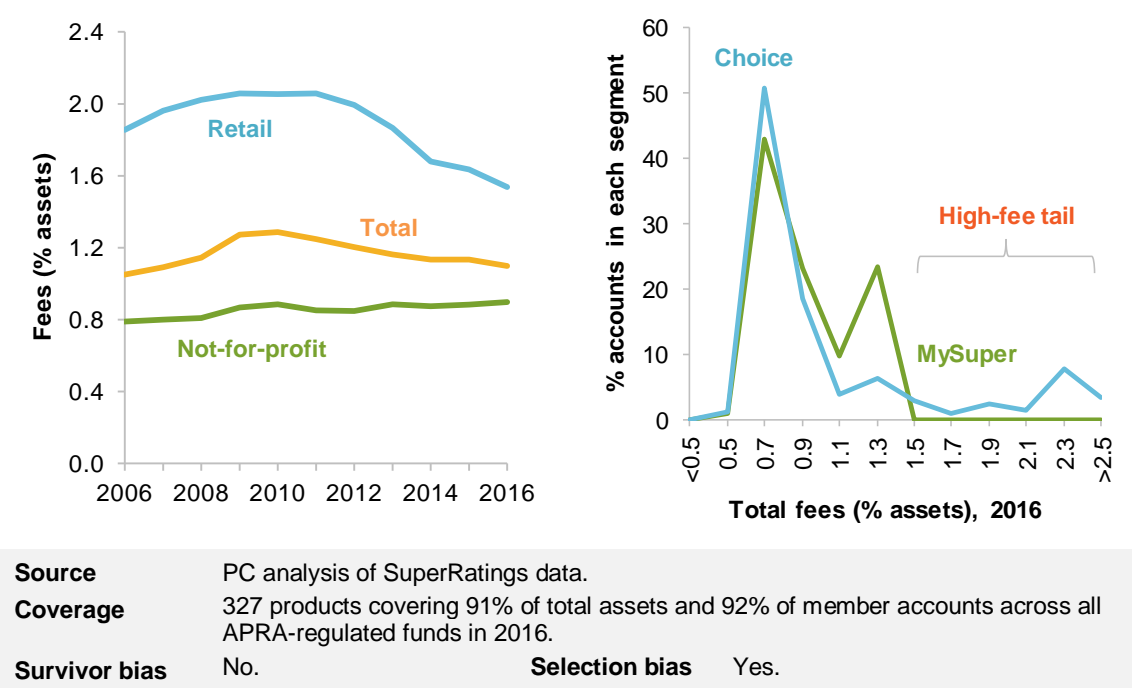


While fees often increase in line with growing balances, average reported fees have fallen in percentage terms since the global financial crisis for APRA-regulated funds (figure 5). This downward trend is observed for both administration and investment fees, and in both the accumulation and retirement segments.

The MySuper and SuperStream reforms appear to have contributed to this fall (although disentangling their impacts from growth in average fund scale and other fee drivers is difficult). In any case, the downward trend at a system level appears to be driven by falling fees in the retail segment, especially administration fees. This may be due to MySuper having limited the types of fees that can be charged for default products. It may also reflect the

competitive pressure being exerted by members opening SMSFs, which could have encouraged retail funds to reduce fees for choice products.

Figure 5 **Products by segment: retail and choice products have materially higher fees**



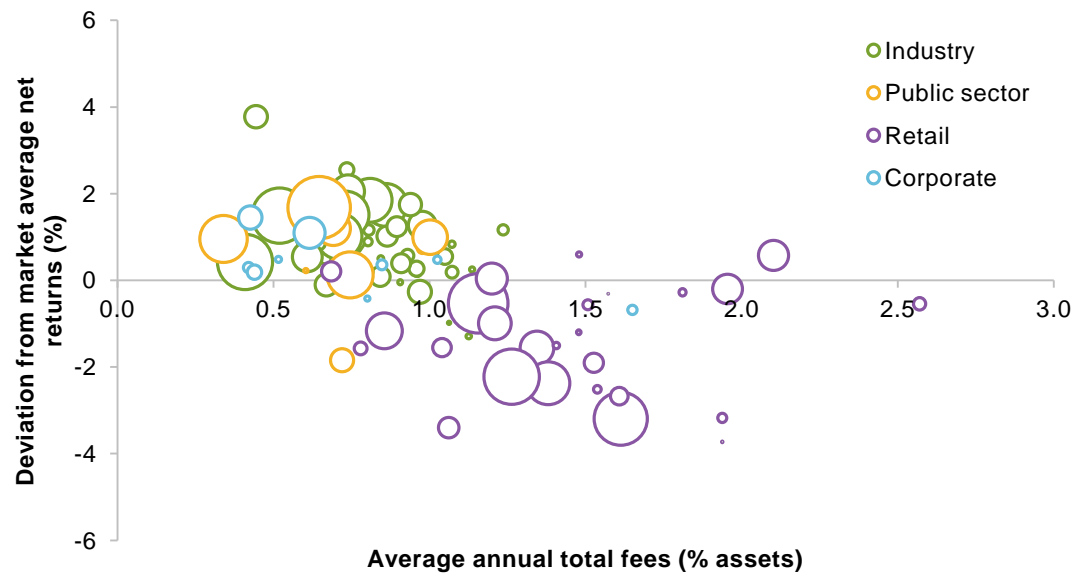
By contrast, fees for not-for-profit funds have been largely flat over time, but on average remain well below the fees charged by retail funds. And fees charged by retail funds remain relatively high, at least for choice products. Roughly 14 per cent of member accounts appear to be paying annual fees in excess of 1.5 per cent of their balances. Fees can explain a significant amount of the variation in net returns across super funds. Funds that charge higher fees tend to deliver lower returns, once both investment and administration fees have been netted off (figure 6). And high-fee funds — which hold about 10 per cent of the system’s assets — tend to have persistently high fees over time. This suggests there is significant potential to lift retirement balances overall by members moving, or being allocated, to a lower-fee and better-performing fund.

Moreover, at least 2 per cent of accounts are still subject to trailing adviser commissions — despite such commissions being banned for new accounts by the Future of Financial Advice laws. Though largely a legacy problem, these commissions can materially erode member balances. In addition, high exit fees in some choice products can create a barrier to member switching, across both the accumulation and retirement phases.

Analysing fees is bedevilled by significant gaps and inconsistencies in how funds report data on fees and costs, despite regulator endeavour to fix this. This lack of fee transparency harms

members by making fee comparability difficult at best, and thus renders cost-based competition largely elusive.

Figure 6 Individual funds: members paying higher fees typically get lower net returns
2007–2016
Size of circles indicates the size of each fund's assets under management



Source	PC analysis of Rainmaker data.
Coverage	All institutional funds (APRA-regulated and exempt public sector) in the dataset over the full period (60% of all assets in institutional funds in 2016).
Survivor bias	Yes.
Selection bias	Yes.

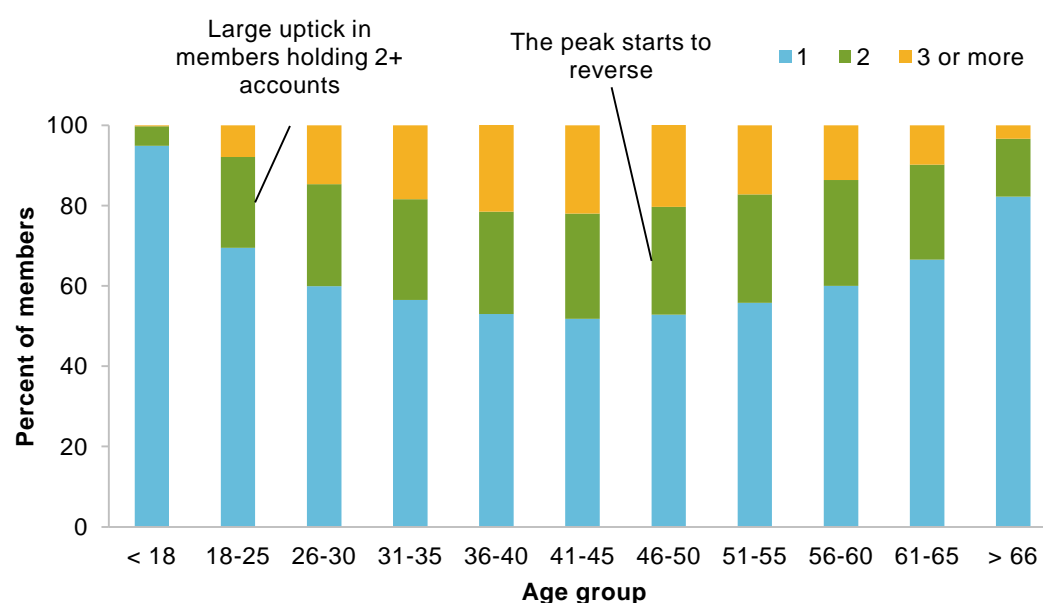
Reported fees in Australia are higher than in many other OECD countries. International comparisons are fraught, mainly due to large differences in asset allocation and tax, so we attempted to collect information from Australian funds on the costs they incur at an asset-class level to inform comparisons with other countries. Again we were hamstrung by poor responses to our funds survey. For example, only 17 per cent of the funds that responded provided any information on investment management costs for Australian listed equities — an asset class that virtually all super funds have exposure to.

Nevertheless, asset-class data from other countries suggest fees are significantly higher in Australia. Applying data on international costs to the aggregate asset allocation in Australia suggests total investment fees should be about 0.4 per cent of assets, substantially less than the observed 0.68 per cent.

There are too many unintended multiple accounts

Over a third of all super accounts are ‘unintended multiples’ — created when a new default account is opened for a member when they change jobs or industries, and the member does not close their old account or rollover their existing balance. Much of this account proliferation appears early in adulthood and persists well into middle age (figure 7).

Figure 7 **Account proliferation happens early, and persists**



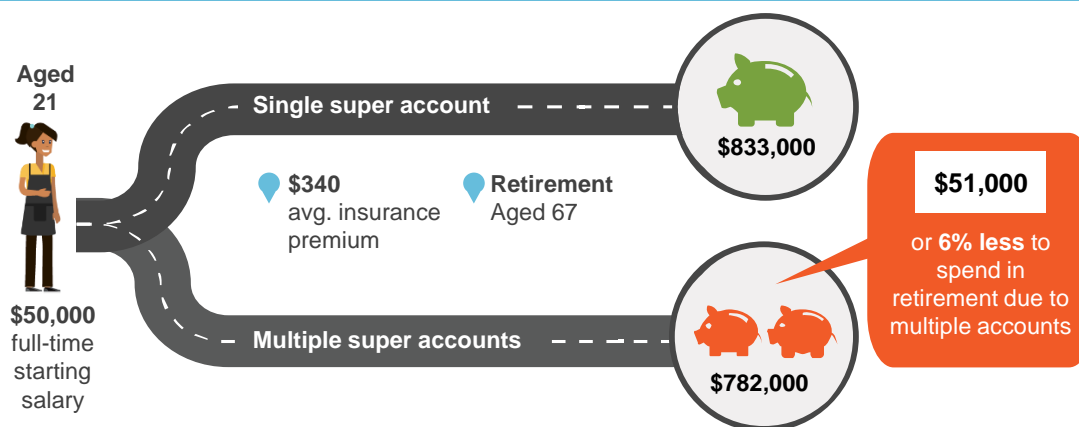
These unintended multiples collectively cost the members who hold them \$1.9 billion a year in excess insurance premiums and \$690 million in excess administration fees. Over time, the foregone returns compound and unnecessarily erode members’ retirement balances, and can leave a typical full-time worker 6 per cent (or \$51 000) worse off at retirement (cameo 4). Even worse, the effects are regressive, with unintended accounts hurting younger and lower-income members the most.

This is an avoidable system failure that has hurt members since the inception of compulsory super. It is a perverse side-effect of the current way default members are allocated to products (discussed below). Recent initiatives have made it easier to find and consolidate accounts in the system, but progress has been slow and a large stock of unintended multiple accounts remains — about 10 million.

Unless systemic changes are made, the problem will only become worse given what we already know of our workforce in the decades to come.

Cameo 4 Multiple accounts reduce retirement balances

Super problem: Multiple accounts = 1 years' lost pay



Members face a bewildering number of products to choose from

An efficient super system would offer members a range of products and services suited to their needs and make sure they can readily access good quality (salient and simple) information to inform their decisions.

But many members struggle to find the right products. The irony of the system is that, if anything, products are most complex during accumulation and most simple in retirement — when the converse constellation is needed for most members.

In the accumulation phase, most members have fundamentally simple needs: high net returns, low fees, meaningful disclosure by funds and transparent product features. These needs can be well served by ‘no-frills’, low-fee products with a balanced growth asset allocation. Many default products have these characteristics, though their insurance offerings are unnecessarily complicated (discussed below). Yet in the choice segment, there has been a proliferation of little used and complex products — over 40 000 in total — which complicates decision making and increases fees without boosting net returns. There are risks that some members who use these products are unwittingly buying a degree of control over their investments at the price of materially lower retirement incomes.

As members approach retirement age, the potential impact of a year of poor returns on their balance at retirement rises. Life-cycle products — which reduce the share of growth assets in a member’s portfolio as they age — are intended to reduce this sequencing risk. But most life-cycle products have a relatively modest impact on sequencing risk, while forgoing the higher returns that come with a larger weighting to growth assets (in some cases, from as early as 30 years of age). While these products will always have a niche in the choice segment, their presence among MySuper products (covering about 30 per cent of MySuper

accounts) is questionable and suggests many members are potentially being defaulted into an unsuitable product that sees them bearing large costs for little benefit.

In retirement, members' needs are no longer as straightforward. The large diversity of household needs, preferences, incomes and other assets means that no single product can meet the needs of everyone. The range of retirement products on offer — including account-based pensions, annuities and new hybrid annuity products — appears sufficient to meet most members' needs. Annuities in particular offer a way to reduce longevity risk, though many are complex and will not suit many members. A default retirement product ('MyRetirement') is not warranted. The goal of policy should be to remove unjustified obstacles to all products, rather than favouring the take-up of specific products. Policy changes in mid-2017 relating to Comprehensive Income Products for Retirement were a good step in this direction.

One of the underlying problems is that members at all stages find the super system too hard to navigate, and do not know where to turn for help. While there is no shortage of information, many find it complex, overwhelming and inconsistent with their needs. Product Disclosure Statements seem more focused on protecting the fund than helping the member. Members get excessive choice at the expense of less comparability, and even highly engaged and financially literate members struggle. Many would like more relevant and simple information to help them compare products and, if necessary, switch.

Some members seek out financial advice, but few know where to look for impartial and affordable advice, or how to judge the quality of the advice that they receive. The Future of Financial Advice laws have helped to reduce biased advice stemming from advisers' conflicts of interest (especially within vertically integrated institutions), but the quality of advice remains variable. In super, all financial advice is arguably personal, and needs to take into account members' individual circumstances. The need for tailored and impartial advice will only grow as the system matures.

Insurance is not delivering value for all members

About 12 million Australians have insurance (life, total and permanent disability and/or income protection cover) through their super. In 2016-17, they paid a total of \$9 billion in premiums (up 35 per cent in three years). But about a quarter of members do not know if they have (and are paying for) a policy.

The inclusion of insurance within super dates back to the 1950s and was cemented by legislation in 2005. Today it accounts for just under half the total life insurance market. Current settings are arguably more a function of history than considered policy design. The suitability of insurance in super relies on trustees balancing insurance cover for members against the erosion of member balances at retirement.

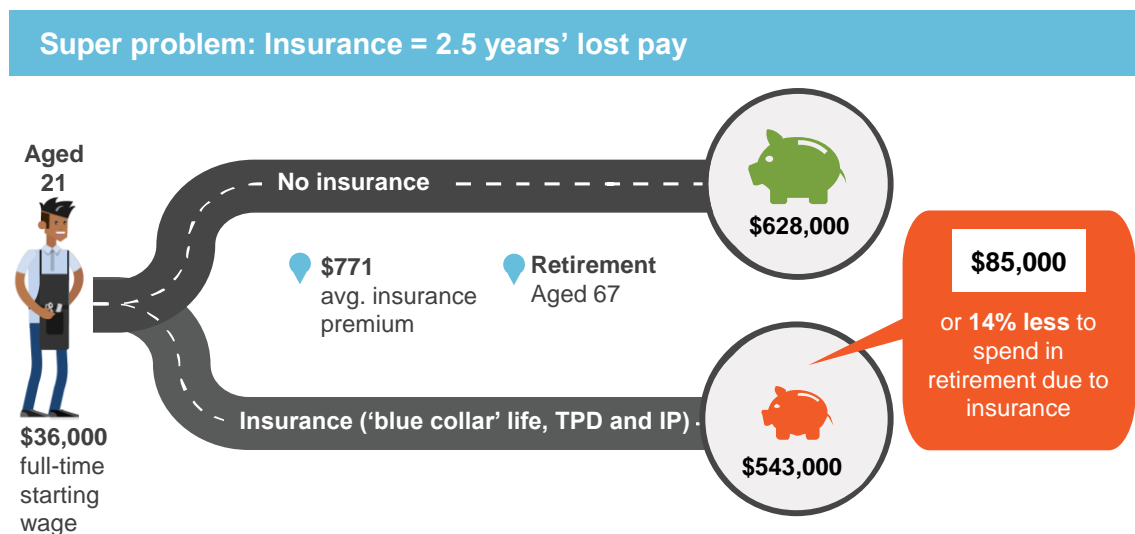
Group insurance arrangements within super deliver many members much more affordable insurance than they would be able to get through individually written cover outside of super

(not least because the latter is often subject to large adviser commissions). Because most of these group policies are provided on an opt-out basis, the large share of low-risk members in the pool acts to keep premiums down for everyone. Some have argued that insurance in super has been a key factor in addressing an underinsurance gap in Australia, but the Commission has not assessed this issue as part of this inquiry.

While insurance in super is good value for many members, it is not for all members. Premiums come out of members' accounts, meaning higher balances at retirement are forgone. The effects on retirement balances are worse for members on low incomes, especially those with intermittent labour force attachment who continue to have premiums deducted from their accounts while not contributing to their super. The retirement balance erosion for these members could reach 14 per cent (\$85 000) (cameo 5), and well over a quarter for some disadvantaged members with duplicate insurance policies (\$125 000).

The focus of this inquiry has been to consider whether changes to the current arrangements are warranted, if the Commission finds that insurance is not providing value for money for all members, without undermining the benefits insurance in super provides.

Cameo 5 Insurance policies erode balances for low-income workers



Some insurance policies are unnecessary for members. An estimated 17 per cent of members have duplicate policies across multiple super accounts — which can erode their retirement balances by over \$50 000. And some members are being defaulted into insurance products they are ineligible to claim on (‘zombie’ policies). The chief and costly culprit for such ‘zombie policies’ is income protection, which can typically be claimed against only one policy and only when members are working. A typical full-time worker can expect insurance to erode their retirement balance by 7 per cent (\$60 000) if they have income protection cover, compared to just 4 per cent (\$35 000) if they only have life and disability cover.

Other questionable practices include:

- extremely complex and incomparable policies, which impede member decision making and have been a stumbling block for account consolidation and fund mergers
- member difficulties in interacting with funds, particularly to opt out of insurance and with respect to complaints handling
- the bundling of life and disability insurance, meaning that members without dependants are unable to opt out of life cover while retaining their disability cover
- poor application of risk premiums, for example, for occupation or smoking status
- inadequate tailoring of policies to the needs of different member cohorts (about 10 per cent of funds that offer MySuper products do not use any member cohort information in framing insurance policies).

These outcomes are hard to reconcile with the legal obligations on super fund trustees to act in their members' best interests and to ensure that insurance does not inappropriately erode their members' balances.

In response to some of these outcomes — and after Government prompting — the industry has developed a voluntary code of practice. This is a small first step at addressing some of the most egregious problems. For example, the premium caps in the code will limit balance erosion for some members, as will the requirement to stop deducting insurance premiums from inactive accounts (in certain conditions).

There are some encouraging early signs of funds adopting the code, but how rigorously they will comply with the rules in practice remains unclear. The code is unenforceable and falls well short of what is needed, and of best practice for an industry code of conduct. Its effectiveness will depend on the extent of voluntary take-up and the strength of its provisions (which are yet to include implementation of standard definitions and a short-form annual insurance statement for members). In its current state, it will only herald modest improvements in member outcomes.

What drives poor member outcomes from super?

Ultimately, and beyond the performance of financial markets, the outcomes that members get from their super are shaped by the behaviour of system participants, the degree of competition in the super system, and the effectiveness of regulation and regulators. Some members do well, as evidenced by the average level of investment performance. Yet structural flaws in the form of inadequate competition, governance and regulation have created problems that drag down the system's performance and lead to very mixed performance across the system — with members footing the bill.

Members are not always going to make good decisions

Some members are highly engaged with the super system, and actively compare products or open SMSFs. But most are not. Many members simply default into a fund and product, and rely on the system to manage their super for them (whether out of trust, a lack of interest or an inability to compare products). Levels of engagement are especially low among the young and members with low balances. Engagement is higher for members approaching retirement or with larger balances, suggesting that many become more engaged at different points in their lives.

The available evidence reflects this. Rates of switching between funds and products are modest — fewer than 10 per cent of members switch funds each year and only a third have ever changed their investment option. Of those who switch funds, around half did so because they either changed jobs or their employer changed funds. Close to 60 per cent of members do not understand their fees and charges, and around 40 per cent lack an understanding of basic investment options (such as growth, balanced and conservative). And about 30 per cent of Australians have rather low levels of financial literacy.

Low member engagement is not necessarily a problem. For many members, it is rational. Engaging takes time and effort, and trustees are charged with acting on members' behalf and in their best interests. And low engagement is to be expected in a compulsory and complex system that covers the bulk of the population. In some cases, disengagement can also be a consequence of cognitive constraints and behavioural biases, such as myopia, loss aversion, and a tendency to procrastinate.

But in many respects the system — and government — has made engagement harder than it ought to be for members. Complexity of products (and oft-changing tax rules), a lack of salient and simple information, and challenges in finding the right financial advice have made it hard for members to engage in a way that gets them to the best outcomes — and greater member engagement has not always led to better outcomes. Ultimately, the extent of informed member engagement has implications for competition.

There is some competition in the system, but it's not always healthy

Competition matters, not for its own sake, but because it is an impetus for improving member outcomes — in terms of maximising net returns, minimising costs and delivering the products and services members need. Robust rivalry between funds is essential for delivering these outcomes, and for stimulating ongoing innovation in the super system.

On some indicators, the system can look competitive. There are many funds, and much rivalry between them, at the retail level. There are no unnecessary barriers to new funds being set up. While some wholesale markets appear relatively concentrated (such as for administration services), this is not necessarily a concern given the benefits of economies of scale and the potential for 'insourcing' to provide competitive pressure.

But there are problems. There is much rivalry between funds in the choice segment, but it does not always deliver the best outcomes to members. Even though the structure of the segment looks broadly competitive with many products and SMSFs adding competitive tension — and reasonably low barriers to entry — *persistent* underperformance by some funds is a symptom of ineffective competition. It appears that funds are competing to provide increasingly tailored products and administrative services (such as smartphone apps), but putting less effort into delivering the highest net returns to members. And muted competitive pressure coming from the demand side (members and their advisers) is not playing the corrective role that it does in other, less complex markets.

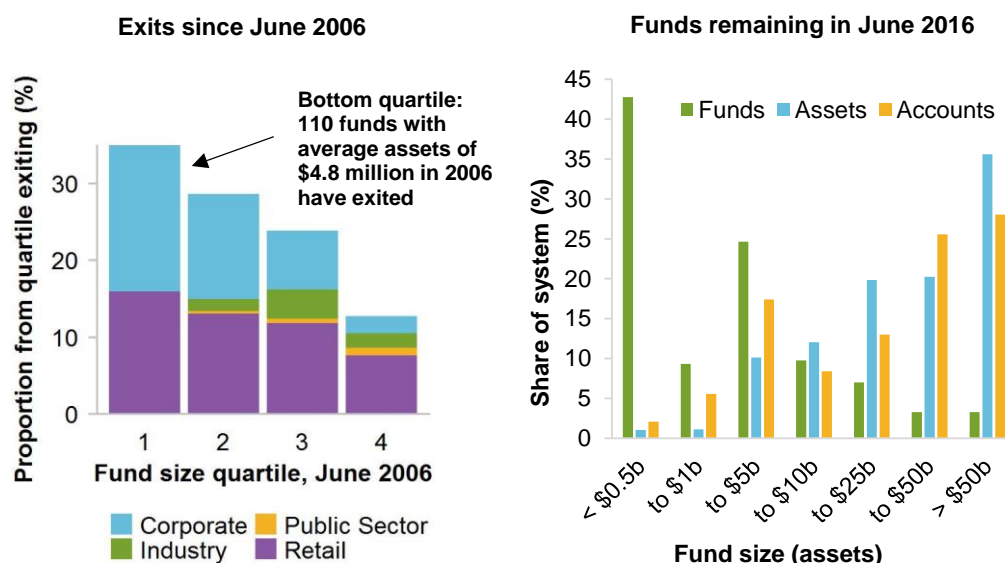
In the default segment, competition is at best superficial. Members who default are typically disengaged and exert no competitive pressure — there is limited or no competition *in* the market. As a result, any competitive pressure within the default segment has to come from competition among the funds authorised to provide default products — competition *for* the market.

This is not happening. The Financial System Inquiry found that a lack of strong price-based competition in the super system has meant that the benefits of scale are not being fully realised or passed on to members as lower fees. It attributed this in part to an absence of member-driven competition, especially in the default segment (Murray et al. 2014).

Default policy settings — comprising workplace determination of default products and a requirement for the funds that provide them to hold MySuper authorisation — mean that competition is muted. While the hurdle for being granted authorisation of a MySuper product is low, the process for listing default funds in modern awards has constituted a high barrier to entry for new entrants to the default segment. A formal process has been legislated but remains dormant — with no process currently in place to remove funds nominated in awards that are not performing well (discussed below). There is no systematic pressure on funds to compete strongly once they gain access to the default market.

Further, the exit of higher-cost subscale funds (many of which were corporate and retail funds) has led to some economies of scale being realised within the super system. But the remaining large tail of small funds (with higher expenses) suggests unrealised scale economies remain, at much cost to members (figure 8). Our preliminary analysis suggests that average costs have come down in about half of incumbent funds — a sign that some funds have not been able to realise cost efficiencies as they have grown in size. The continued presence of subscale and underperforming funds suggests a lack of effective competition and barriers to exit.

Figure 8 **Small funds have been exiting but many remain**



Default allocation is not putting members first

Default arrangements are a necessity in a compulsory super system to protect members who do not make their own investment decisions. Up to two-thirds of members default when starting a new job, and about half the accounts in the super system are in MySuper (default) products — representing 24 per cent (\$635 billion) of system assets. Current arrangements have worked well for many funds and industrial parties (such as employer groups and unions). And many default funds have demonstrated strong investment performance, to the benefit of their members.

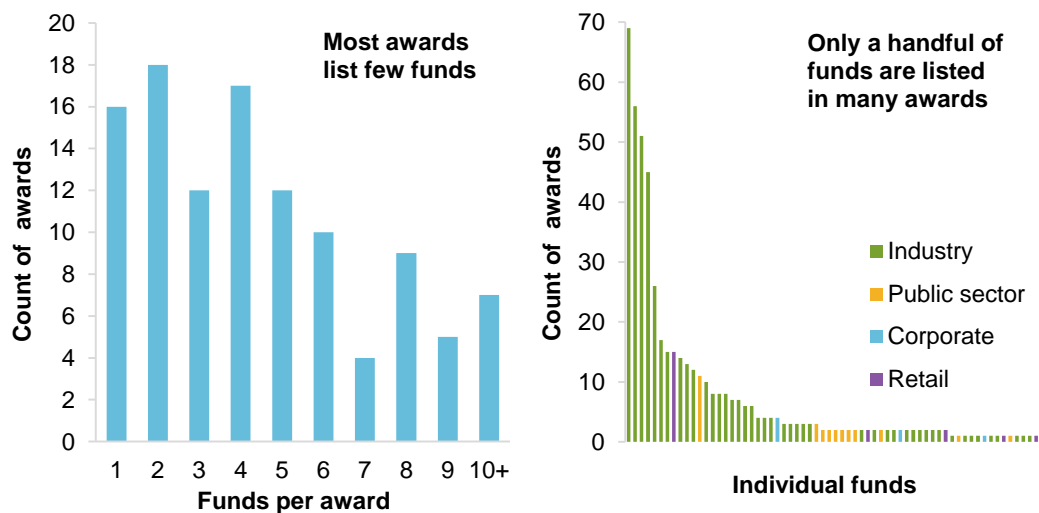
But member outcomes are too variable. Current policy settings fail to ensure members are placed in the very best funds, with significant consequences for members' balances and ultimately their wellbeing in retirement (at the extremes, there are 6 million member accounts in top-performing MySuper products and 1.7 million in funds experiencing serial underperformance). Policy settings have also enabled restrictive clauses in workplace agreements that prevent an estimated one million members from exercising choice even should they want to. A lack of healthy competition *for* the market means poor-performing funds are not being weeded out. And the large number of members accumulating multiple accounts when they change jobs reveals that current arrangements are not putting members first.

One of the main drivers of subpar outcomes is the way default funds are tied to employers and the workplace relations system, with employer choice constrained by lists of funds in modern awards and enterprise bargaining agreements.

Employers are not always well placed to navigate this maze and make decisions on behalf of their workers. Any system in which employers play such a central role in choosing defaults will always be hostage to constraints on employers’ time, expertise and even goodwill to find the best super product for their workers. While some employers are highly capable and make much effort (sometimes using corporate tenders), many others (especially smaller businesses) put in limited effort or struggle to compare products. And there will always be a risk that some funds will offer benefits to influence employers’ choices — a problem that is both hard to observe and regulate.

The listing of funds in modern awards is designed to mitigate some of the risks with employer choice, but is beset by a structure that restricts contestability between funds to obtain default members. Employers could face a choice of anywhere between 1 to 15 funds, depending on which of the 122 awards is relevant (figure 9). Only a handful of funds are listed in more than 10 awards.

Figure 9 **Award listing is concentrated**



In making listing decisions, the Fair Work Commission (FWC) (until it was rendered unable to do so) has historically drawn heavily on precedent, and viewed itself as a dispute solving body — not as an arbiter of the quality or merit of funds put up for inclusion. Members’ interests are a secondary consideration to questions of standing and history.

Only funds backed by employer or employee representatives are generally able to have themselves considered by the FWC — but these industrial parties have themselves sponsored the joint development of funds, and so are not unhindered by conflict when reviewing other funds’ requests to be registered.

Moreover, there is no active FWC process for reviewing and delisting underperforming funds (albeit APRA is now pressuring some poorly performing funds to justify their MySuper authorisation).

The process for listing funds in modern awards was revamped in 2012 following a Productivity Commission inquiry (which was limited by its terms of reference to look only at how funds are listed in awards). Legislation now provides for an Expert Panel within the FWC that all funds may apply to and be considered on merit.

But the process has turned out to be competitive in name only. In 2014, the Federal Court ruled that the Expert Panel that had been set up was not correctly constituted, and the Government has since failed to appoint a replacement. Default allocation is effectively dormant, with no process in place for new funds to be listed in awards, or for existing funds to be removed if they underperform (or even wind up or merge). And even if a new panel was to be appointed, the panel's decisions could be overridden by the full bench of the FWC, to which many funds do not have legal standing.

The introduction of MySuper (also in 2012) was intended to reduce some of the variation in member outcomes in default by requiring all funds to obtain MySuper authorisation to be allowed to offer a default product (and thus chosen by employers). However, the original MySuper hurdle was set too low and significant variation across default products remains — especially in terms of investment strategy (and life-cycle products), performance and fees — and did not lift the constraints the workplace relations system imposes on the ability of funds to compete for employers and members.

In the context of ongoing changes in the workforce (such as multiple jobs and more job mobility across occupations and industries) and the broad terms of reference for this inquiry, the need for fundamental modernisation has become clear. The good member results seen in some default products are owed to a combination of trustee and employer goodwill and benign regulatory intervention. Yet the large variation in performance by both funds and regulators is inevitable, given the large number of funds and current way of allocating defaults. Sustaining a high level of performance, and spreading it to more members, is only achievable by providing incentives to adapt to better ideas or new needs.

Governance falls short of best practice

High quality governance is integral to a system where members rely on others to make decisions on their behalf, especially in an environment of compulsory savings and muted competition. Unlike shareholders in listed companies, super fund members have no voting rights and little if any influence over board appointments. In this context, the regulation of governance standards matters.

Over the past 30 years the governance of super funds has improved greatly due to a tightening of legislative requirements, increasing powers given to regulators, and the introduction of prudential and reporting standards targeted at governance. Yet governance

practices lag contemporary best practice. The evidence suggests that some boards are either not complying with all of their regulatory obligations, or are complying in a ‘tick and flick’ sense without striving to protect and promote members’ best interests.

Best practice governance would require that the trustee boards of *all* super funds have a good mix of knowledge, skills and experience, and are free from potential conflicts of interest. Feedback from our governance survey suggests not all funds employ satisfactory practices for appointing adequately skilled and qualified directors. One in five CEOs either disagreed or only slightly agreed that their funds seek independent review of trustee capabilities to ensure they are optimal, and only three in five strongly agreed that their boards examine and improve their own effectiveness on a regular basis.

Further, some retail fund directors, although considered ‘independent’, are on a number of related-party boards, which raises questions about their independence and fuels perceptions of (and concerns of actual) conflicts of interest. Indeed, one recent study estimated that 78 per cent of directors on retail fund trustee boards are affiliated with related parties.

APRA identified board composition as an ongoing concern in its recent review of the governance of super funds:

Unfortunately, however, very few boards that were part of the thematic review were able to articulate, or had formally documented, what the optimal composition of the board should be now and how this might change into the future in accordance with the strategic direction of their operations. (Rowell 2017c, p. 4)

Evidence of unrealised economies of scale, persistent underperformance and an entrenched large number of small funds — about half of all APRA-regulated funds have less than \$1 billion in assets — raises the question of why there have not been more fund mergers, given the likely benefits for members. Membership of an underperforming fund imposes large costs — as noted earlier (in cameo 1), a typical full-time worker in the median bottom-quartile fund (on investment performance) can expect to retire with a balance less than half the size than if they were in the median top-quartile fund.

Little is known about mergers that have been broached but not completed. Yet anecdotes abound of mergers not proceeding for reasons disparate to members’ interests. At times there appears to be an absence of strategic conduct regulation (discussed below). Some barriers to mergers are still evident, despite recent changes in regulatory guidance to funds (on successor fund transfers). Some directors may be reluctant to countenance mergers that would see them losing their jobs. The temporary nature of capital gains tax relief for funds that merge could also be a factor.

Further, good disclosure of fund practices and decisions is essential, especially where funds are outsourcing to related-party providers. APRA is currently reviewing funds’ practices in this area, and has voiced concerns that some funds may not be achieving value for money in their outsourcing arrangements. Available data and research by others suggest that funds that outsource administration to related parties pay more, but the poor quality of the data makes it challenging to robustly analyse these practices.

We endeavoured to gather data through our funds survey to undertake such an evaluation, but were thwarted by a very low response rate and poor quality responses. Over 70 per cent of funds failed to answer the question and, of the 33 funds that did, only 12 provided data on the proportion of expenses outsourced to related parties. The fact that funds are so unwilling to disclose the information is itself a red flag. These poor survey responses are symptomatic of a concerning disregard (on the part of many funds) for transparency and members' best interests.

Regulators need to focus more on member outcomes

There is no shortage of regulation in the super system. Regulation is essential for a complex system holding large amounts of money and characterised by many disengaged members and potential conflicts of interest. But at times the regulators appear too focused on funds and their interests rather than on what members need.

The key regulators — APRA and ASIC — are doing well in their core duties of prudential regulation (APRA) and financial product and advice regulation (ASIC). There have been improvements over many years, and these will continue with recently proposed reforms to boost each regulator's toolkit. Legislating an 'outcomes test' for MySuper products will give APRA greater scope to lift standards and remove authorisation from funds that are failing to act in the best interests of members (especially on mergers). And ASIC's new product intervention powers will strengthen its ability to guard against upselling.

However, there is some confusion around the two regulators' respective roles, given both have long held powers to police bad behaviour by trustee boards. For example, ASIC has traditionally been responsible for regulating conflicts of interest, but APRA has increasingly encroached on this role through its prudential standard setting. While much of APRA's work is pre-emptive and out of public view, ASIC has traditionally been reactive (responding to misconduct only after the fact) and public. It has become increasingly unclear which regulator has primary responsibility for trustee conduct — with the risk of misconduct falling between the cracks and a lack of clear regulator accountability.

Strategic conduct regulation appears at times to be missing in action. Ideally, this would involve a regulator proactively identifying actual or potential instances of material member harm, investigating the underlying conduct and taking enforcement action in a way that provides a valuable public deterrent to future poor conduct. To date, there has been a deficit of public exposure of poor conduct (and associated penalties) to demonstrably discourage similar behaviour by others — now and in the future.

There are yawning gaps in data

A further area of weakness is how data on the system are collected. The regulators' data collections are largely focused on funds and products, with a deficiency of member-based data. And there are major gaps and inconsistencies in the datasets held by regulators — such

as the returns and fees experienced by members of individual choice products, funds' outsourcing arrangements and details of the insurance members hold through super. Our funds survey was designed to plug some of these gaps, but — as noted above — many responses fell well short of 'best endeavours', which of itself proved revealing (figure 10).

Regulators have done much to improve the breadth and depth of their data holdings in recent years, but this has been off a low base. Major differences in definitions persist across regulators, and poor quality disclosure by funds appears to go unpunished. Progress has been slow in some areas because of industry opposition (largely on the basis of short-term compliance costs) and the lack of a strong member voice to give impetus to change.

The result is poor transparency, which leaves members in the dark as to what they are really paying for and makes it harder for engaged members to compare products and identify the best performing funds. This suppresses competitive pressure on the demand side, and gives rise to the perverse risk of worse outcomes for members who do get engaged. The lack of transparency also makes it hard for regulators to effectively monitor the system and to hold funds to account for the outcomes they are delivering to members. And it is an obstacle for better public policy across the system.

A package of improvements to benefit members

Even though the super system has performed reasonably well for most members, policy settings need to change to make it work better for *all* members. Sub-par system performance can compound to do considerable harm to members' balances at retirement. For example, holding multiple accounts can reduce a typical worker's balance at retirement by about 6 per cent (\$51 000) and an underperforming MySuper product can reduce a typical member's balance by 36 per cent (\$375 000) (figure 11).

The payoffs from fixing some of the worst problems in the super system would be significant. We have estimated that members would have been in the order of \$2.6 billion better off each year if there were no unintended multiple accounts in the system. And members would have collectively gained a further \$1.3 billion each year had all MySuper products delivered returns in line with the top performers. While these figures may appear immaterial across a \$2.6 trillion system, being defaulted into a single top-performing MySuper product would lift the retirement balance of the median 55 year old by up to \$61 000 when they retire, compared to being defaulted into two underperforming products. For a new workforce entrant today, the gain would amount to \$407 000 by the time they retire in 2064.

Figure 10 Responses to our super funds survey: not so super

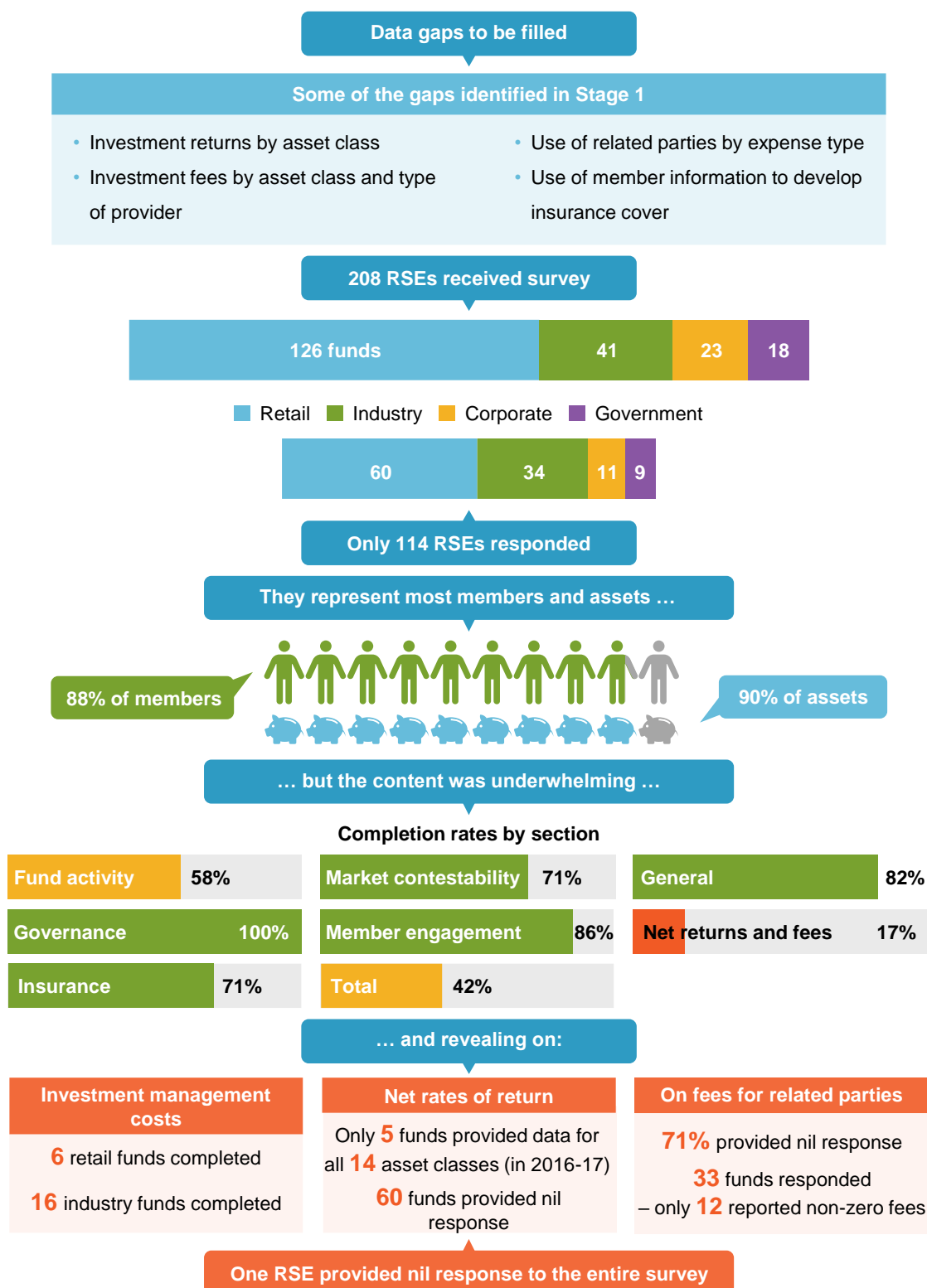
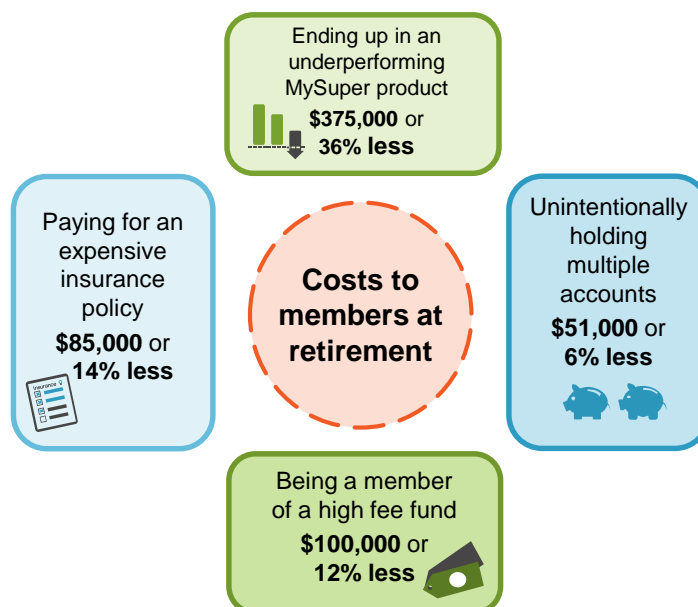


Figure 11 **The character of member harm**

Subpar system performance = much lower member balances



The package of policy improvements in this draft report is designed to lift the overall performance (efficiency and competitiveness) of Australia's super system. A new way to allocate defaults will put the focus squarely on members, and the other components will work with this to address the structural flaws in the current system and put it in good stead to perform strongly in the years to come. Collectively, the improvements will harness healthy competition in the super system and make it work better for all members, bringing it into line with the needs of the modern workforce and diverse retirees.

A new mechanism for allocating defaults

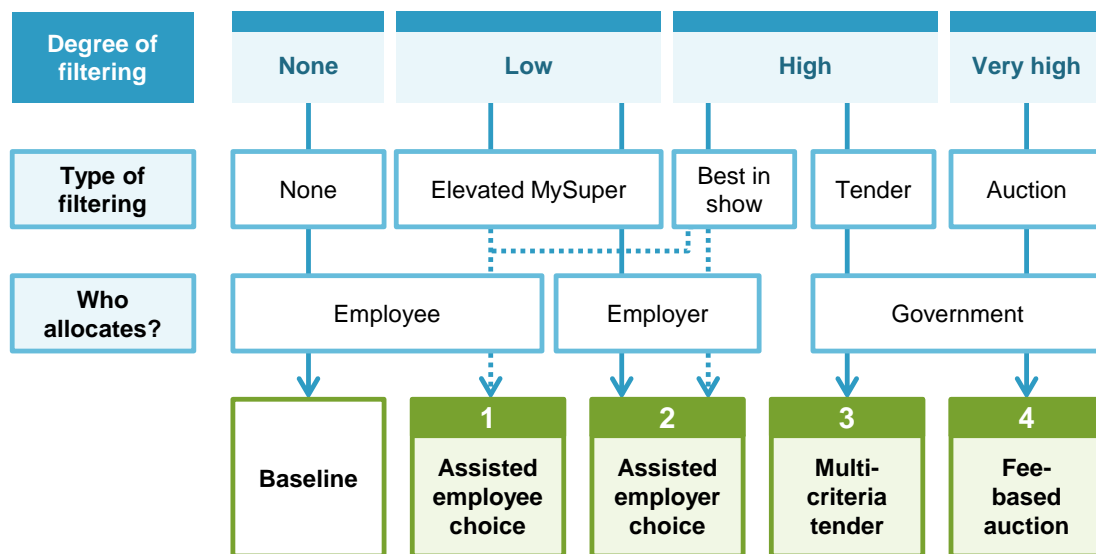
In a world of compulsion the onus is on government to ensure that default super is the system exemplar, mitigating the costly (and highly regressive) twin risks for a default member: defaulting more than once or into an underperforming product.

The starting point should be to stop the re-defaulting of members when they change jobs. Members should only be defaulted once, when they join the workforce. First and foremost, members should only be placed in a default product if they fail to exercise choice and do not have an existing super account. Those who change jobs or re-enter the workforce should have an opportunity to switch to a better super product, but if they do nothing they should stay with their existing (most recently active) account. No existing member of any fund should be made to change their fund.

A best in show shortlist

To assign defaults to members who are new to the workforce (and do not already have a super account), we considered four alternative models (figure 12). These were developed in our stage 2 inquiry and have since been reconsidered in light of feedback from participants on that inquiry's draft report.

Figure 12 **We considered four alternative default models**



After further review, we consider assisted employee choice offers the best outcomes for members. The other three are inferior in crucial ways.

- A fee-based auction would create a risk of funds pursuing low-cost strategies at the expense of net returns that cannot be adequately guarded against.
- A multi-criteria tender allows for a richer consideration of product performance, but the corresponding contractual arrangements would too rigidly lock funds to specific investment strategies.
- Employer choice is the closest to current arrangements — but as with the current system it relies too heavily on employers to choose the best fund for their workers, which not all employers are well equipped to do.

At the heart of our preferred model is a single shortlist of ‘best in show’ products for all members. Members should be empowered to choose their own product, and the shortlist should be designed to make this safe and easy to do.

No-one would be forced to pick from the shortlist, and members would retain the ability to join any fund they choose. They would have access to the full set of MySuper products, which would offer a range of simple and safe products to choose from (once the rules for

MySuper have been elevated, as discussed below), as well as choice products or SMSFs. In essence, the shortlist would ‘nudge’ members towards good products while allowing them to choose something different.

By encouraging members to interact with their super and make an active choice, this model would likely drive member engagement. And the small number of members who do not do anything — likely to be fewer than 5 per cent, by our survey evidence — should simply be allocated on a sequential basis to a product from the shortlist.

The design of this model is inspired and informed by evidence from behavioural economics on how people actually behave, not how they ‘should’ behave. This evidence strongly suggests that the shortlist should be short — with no more than 10 products — and accompanied by simple and comparable metrics on each product’s features in a way that captures members’ attention. Our model is also informed by the substantial body of work of several international pension experts that supports a simple choice environment, where members who do not choose end up in good defaults, and those who do exercise choice are able to do so simply and safely.

Who compiles the list?

The shortlist should be developed by an independent expert panel in a way that makes funds vigorously compete *for* the default market. Every four years, this panel should assess applications from funds (including those already on the shortlist) on the basis of achieving the best outcomes for members. It should particularly consider long-term net returns and fees, as well as each applicant’s investment strategy, intrafund advice, governance and track record on identifying and meeting member needs.

Each fund selected for the shortlist would be required to extend any benefits offered to new default members in the course of competing for and securing the right to act as a default fund to all its existing MySuper members. And choice members who join that fund should also receive the same benefits as existing members.

The panel should be comprised of experts and be independent of — but accountable to — government. The relevant Minister should not have powers to change the decision of the panel. The panel’s decisions would be subject to judicial review (available under general administrative law provisions), but not merits review. Appointed panellists should be free of conflicts of interest, and be seen to be so by the general public. The panel should not sit within the FWC — while the FWC’s independence is a strength as an industrial arbitrator, appointment of experts whose accountability is to the shortlisting process rather than the objectives of the industrial relations system is essential. APRA should not be involved in shortlisting or appointing the panel either, but any fund that loses its MySuper authorisation would also lose its place on the shortlist.

How should it be implemented?

This new default model should be implemented by achieving universal participation by employers and employees in an ATO-run service offering an online version of the ‘standard choice’ form through myGov — the form used by new job starters to choose where their super contributions will go. Members who are new to the workforce would use this centralised online service to choose a super product for themselves (whether from the shortlist or something else), and existing members would be able to use it to consolidate existing accounts or to switch. The ATO should configure the online service in a way that gives a clear nudge to support and encourage member engagement.

In parallel, the legacy stock of existing multiple accounts in the system needs to be cleaned up. The ATO should be empowered to do this, including by more actively reuniting lost balances with members (unless a member actively rejects consolidation) and being the sole operator of a ‘holding account’ for lost super. This would mean replacing the role of Eligible Rollover Funds, which have questionable fee structures and do not appear to be achieving much success at reuniting members with their lost super.

These improvements to default arrangements would result in a small pool of members being defaulted each year — only new workforce entrants who do not make a choice from the shortlist. This would be much less than the number of members being defaulted each year under the current arrangements. This represents a large reduction in ‘churn’ in the system, as members are not being re-defaulted whenever they change jobs. But funds would be competing for more than just defaulters: many more members would voluntarily choose from the shortlist (figure 13). Funds will need to compete for members, not employers — and the best funds will do well.

Some inquiry participants suggested such a change could destabilise the super system. It would not. Modelling by the Commission, and reviewed by APRA, suggests that even if many members chose to switch to a shortlisted fund, and other funds needed to exit or merge in the first few years, this should be manageable for APRA and would advance (not compromise) members’ interests.

How will members benefit?

Our changes to default allocation will immediately benefit new entrants to the workforce by placing most in a fund that is likely to deliver the best outcomes — with a potentially large impact on members’ balances at retirement. Benefits will also spill over to existing members, including by stopping the creation of new unintended accounts (and insurance policies) and providing a simple list for all members to choose from if they wish.

Figure 13 **Where will members go?**



Importantly, the new default allocation would harness competition (and the innovation that flows from it) to deliver for members, not for funds and providers — in other words, competition *for* the market. Over time, the member-friendly nature of the process would also see greater competition *in* the market — a point made by consumer group CHOICE — and this would be reinforced by the effects on financial advisers (discussed below). Funds will have a stronger incentive to lift their performance to retain members, including in the choice segment.

Linking defaults to the member and not the job — and thereby removing employers from the process — will sidestep the potential conflicts of interest that go hand in hand with the current system. But this would not preclude employers or unions from playing a role. Employers will still have scope to bargain with super funds on behalf of their employees to secure group discounts on fees or to develop tailored products or insurance. Corporate funds will remain in the system. And employers and unions could still provide information (as distinct from advice) to their employees if they wish. The difference is that members would

need to actively choose the product (without obligation) rather than having it imposed upon them by default.

Our changes would be a significant improvement on the current way of allocating defaults. And they would also be far superior to a government-owned monopoly fund for default accounts, a model that was put forward by a few participants to this inquiry. A monopoly fund would achieve cost savings (due to economies of scale) and simplify the default process, but at the cost of abandoning any attempt to achieve beneficial member engagement. It could also give the government implied responsibility for the fund's performance, putting at risk a unique virtue of Australia's self-reliant super system.

A government monopoly would also bypass competition in and for the default segment, and with it the benefits that come from providers competing with one another, including higher net returns over time and innovation. This inquiry is looking at how to make competition work better for members, so a government monopoly does not lend itself to ready contemplation. Ultimately, strong default options and safe member choice are better delivered via a best in show process (though top-performing non-incumbents, including government-owned entities, need not be precluded from competing in the process).

An elevated threshold for MySuper

MySuper authorisation plays an essential safety role in the super system by setting strong protections for MySuper members and requiring funds to meet a high standard of disclosure. It functions to make products more comparable, which helps members to make decisions about their super and to exert competitive pressure on funds to meet their needs. At the same time, it acts to reduce some of the material risks to members who want to become engaged and choose their own product.

The Government has already presented legislation to Parliament to strengthen MySuper. This entails the introduction of an outcomes test whereby trustees must annually determine whether their MySuper product is meeting the best interests of their members, and must annually compare their MySuper product against others in the market based on fees, returns, risk and other metrics. APRA will have increased powers to require underperforming funds to transfer their MySuper members to another fund. These reforms are a clear step in the right direction and should be legislated.

To complement and bolster the outcomes test, funds should be required to obtain independent verification — to an audit-level standard — of their outcomes test assessment, comparison against other products in the market, and determination of whether members' financial interests are being promoted, at least every three years. Funds should also be required to report to APRA how many members switch from MySuper to higher-fee choice products each year, and to adopt the insurance code of practice immediately (discussed below).

And funds that fail to meet these elevated standards — or persistently underperform (for five or more years) an investment benchmark tailored to their asset allocation by a material margin, as determined by APRA — should have their MySuper authorisation revoked. Their default members will then be transferred, with APRA oversight, to a better fund.

Following implementation of this enhanced outcomes test, there should be an independent review of the MySuper authorisation rules every five years to ensure they are meeting the intended objectives and are being suitably applied by APRA to remove underperforming MySuper products.

Products and information that meet member needs

Making it easier for members to get engaged and compare products is an essential prerequisite (alongside the other policy improvements) for driving healthier and safer competition in the super system, and ultimately making competition work for members rather than against them.

The spirit of product disclosure needs to be re-oriented from risk aversion to helpfulness, with regulators taking the lead to make disclosure meaningful and digestible. Foremost, clearer, simpler and more widely applied product dashboards are needed to help members compare the returns, fees and risk associated with all super products. Dashboards already exist for MySuper products and have been slated for choice products, but the process of developing these has been beset by industry resistance, missed deadlines and an attempt by the Government to exempt some products from the rules.

Perfection should not be a barrier to the possible, nor an excuse for perpetual delay. Legislation to narrow the scope of dashboards should not be pursued, and ASIC should prioritise full compliance for *all* super products by July 2019. ASIC should seek to revise the content and format of dashboards to simplify them and provide more easily comprehensible metrics. In doing so, it should consult with independent experts and consumer organisations. Behavioural economics research points to the importance of ‘less is more’ in funds competing for the meaningful attention of members.

To make dashboards even more useful, the metrics they contain should be integrated into the new centralised online service for the best in show shortlist. This should include the functionality for a member to compare their current product with those on the shortlist to see how their super is performing and, if desired, to easily switch. And members should be nudged into action by proactive prompting when they log onto the myGov website.

Separately, not all members will need financial advice, but more can be done to help those who do to access financial advice that is impartial, affordable and meets their needs. The best in show shortlist will help by serving as a benchmark both for advisers (in recommending products) and their customers (in putting pressure on advisers to explain why any product advice diverges from the list), as well as regulators (in enforcing advice rules).

In addition, the ATO should guide members to online information on government websites when they reach age 55. In particular, guidance on how to access impartial financial advice is especially important for retiring members before they commit to mostly irreversible longevity risk products.

Renaming the term ‘general advice’ — as the Commission has recommended in its draft report for its parallel inquiry into Competition in the Australian Financial System — is also desirable, so as not to mislead members into thinking they are receiving advice relevant to their personal situation when they are only being provided with product information or marketing material. This is particularly important in the compulsory, complex and highly regulated world of super.

Further, there are clear opportunities for funds to harness data and technology better in designing super and insurance products. Most funds collect little information about their members, and few use the data they do collect to design and price products. Greater use of data — even cost-effective imputed data that are not fund specific — in designing products and providing advice (including digital ‘robo’ advice) would help cater to members’ diverse needs, especially in the transition and retirement phases.

And finally, more remains to be done to stamp out egregious practices in the system. Policy changes are already in train to improve employer compliance with superannuation payment obligations. Trailing commissions have already been banned in super, but where grandfathered commissions are still in place funds should be made to more clearly disclose the costs to members. And the Government needs to require all exit and switching fees to new members and on new products (in both accumulation and retirement) to be limited to cost-recovery levels, with ASIC reviewing whether such fees on existing members are unrelated to the underlying performance of the product or unreasonably impede members switching to better products.

Best practice fund governance

We are recommending a set of amendments to governance rules to lift the performance of boards and make trustees more accountable to their members. Best practice would include the presence of a ‘critical mass’ (to use the Cooper Review’s term) of independent directors — which, in practice, would mean at least one-third of directors. More genuinely independent directors on boards may help in this regard — the Government’s proposed tightening of the definition of ‘independence’ is helpful — but getting the right mix of knowledge, skills and experience is at least as important and arguably matters most.

Trustees of all super funds should be required to have, use and disclose a process to assess, at least annually, their board’s performance relative to its objectives and the performance of individual directors (as required by APRA’s Superannuation Prudential Standard 510). Alongside this, boards should be required to maintain a skills matrix that identifies the skills and experience of each trustee director (and publish a consolidated summary each year), such that new appointments can be selected on the basis of filling identified gaps in expertise.

This would better align super funds with best practice for companies listed on the stock exchange. The ASX recommends that publicly listed companies ‘should have and disclose a board skills matrix setting out the mix of skills and diversity that the board currently has or is looking to achieve’.

Trustees should also be required to engage an external third party to evaluate the performance of the board (including its committees and individual trustee directors) and capability against the skills matrix at least every three years. APRA should be provided with the outcomes of such evaluations as soon as they have been completed.

Stronger disclosure is also needed. APRA should require funds to conduct formal due diligence of their outsourcing arrangements at least every three years, with a copy of the assessment provided to APRA. Funds should also publicly disclose to current and prospective members the proportion of costs paid to service providers that are associated with related-party outsourcing arrangements.

The regulators can do more to facilitate mergers between underperforming or subscale funds. Trustees on both sides of a merger attempt should be required to disclose all such attempts (that reach the memorandum of understanding stage) to APRA, as well as the reasons why a failed merger did not proceed and the assessment of members’ best interests that informed the decision. This will likely assist APRA in applying the outcomes test under elevated MySuper standards (as discussed above), especially where action needs to be taken to facilitate or compel a merger. APRA should report to the Council of Financial Regulators each year on the extent to which the outcomes test is removing obstacles to fund mergers.

ASIC has a role to play too. It should proactively investigate questionable cases where mergers between super funds stalled or did not proceed — which would dovetail with a greater focus on strategic conduct regulation (discussed below).

Finally, the Government should make the current capital gains tax relief provisions permanent for funds that merge.

Insurance that works for members

Much can be done to improve the value that members get from insurance in super. For young members in particular, stopping the creation of unintended super accounts will avoid excessive erosion of balances due to multiple insurance policies. Further to this, insurance should be made opt in for members aged under 25 (rather than opt out, as is currently the case). Many young members work in casual or part-time jobs, and have relatively low financial commitments and/or no dependants to support, meaning life insurance is simply not of value to them.

Another area for improvement is making sure that insurance cover ceases on accounts that have had no contributions for the past 13 months, unless the member explicitly informs the fund that they wish to retain their cover. This would assist in addressing the problems around

unintended multiple policies and reduce the risk of members holding ‘zombie’ insurance policies that they are unable to claim on.

More broadly, super fund trustees need to more clearly explain the trade-offs they are making when entering and designing group insurance arrangements. Trustees should immediately be required to articulate and quantify the balance erosion trade-off they have made for their members and make it available on their website annually, along with a simple calculator that members can use to estimate how insurance premiums would impact their balances at retirement. Funds seeking inclusion on the best in show shortlist should also articulate this trade-off for prospective members.

Finally, the voluntary code of practice for insurance in super needs to be bolstered and turned into a binding and enforceable set of rules with broad industry adoption. To start this process, adoption of the code should immediately become a requirement for funds to retain MySuper authorisation. The code requirements are sufficiently flexible such that there is no apparent reason for funds not to adopt it straight away.

APRA and ASIC should establish a taskforce to monitor and report on adoption and implementation of the code — with ASIC taking the lead — and to advise the industry of the further steps that need to be taken for the code to be strengthened and meet ASIC’s definition of an enforceable code of conduct. Industry should be given two years to get the code to this standard before further regulatory intervention is considered. And as part of this, the code owners need to do more work to enhance the code provisions, particularly the implementation of standard definitions and a short-form annual insurance statement for members.

This inquiry is not asking the broader question of whether insurance *should* be funded through super. That question should be answered by a formal independent review of insurance in super, which should commence within four years from the completion of this current inquiry report (or earlier if the strengthened code of practice is not made enforceable within two years).

Regulators that are member champions

Confident regulators that champion the member are essential in a modern super system.

There has been much recent evolution in the respective roles of APRA and ASIC in superannuation. Revisiting the delineation of regulatory roles is timely. There remain some areas of clear or potential overlap which were not sufficiently addressed in implementing the post-Cooper Review governance reforms. In particular, a clearer articulation of which regulator is responsible for strategic conduct regulation is needed — and in a way that allows for much of this activity to be public and provide a strong demonstration effect to all trustee directors. This would also help to improve the accountability of each regulator.

This inquiry has uncovered several prospective areas for more strategic regulatory action on trustee conduct. As noted, failed mergers should be investigated more proactively, as should the impacts on members of exit and switching fees (and other indirect costs of switching). And there is scope to review fund advertising that is not directly focused on gaining or retaining members. ASIC is well suited to take on these activities.

Clarifying regulator roles will in large part require changes in regulator practices and culture, with the regulators assuming a more confident regulatory practice and being more member focused. The Commission is seeking input on whether (and how) a clearer division of regulators' responsibilities would lead to better strategic conduct regulation and regulator accountabilities. Whatever the specific delineation, it will always be important for APRA and ASIC to work in parallel to share information (including on trustee conduct) and ensure members' interests are protected. A revamped memorandum of understanding between them would be needed.

The regulators also need to collect more data that are relevant for assessing member outcomes — and to make these data public — and the Government needs to give them a clear remit to do so. The main gaps are clear. The centralised online service we have proposed will help address some of these by allowing the ATO to collect data on the choices members make.

Other changes are also needed. APRA, as the system's prudential guardian and main data custodian, should enhance its data reporting framework to collect more data on actual member outcomes on an ongoing basis. This should include collecting and publishing data at the product level (rather than the fund level), similar to what is collected for MySuper products.

Work is also overdue on dealing with inconsistencies between funds in how they report data to the regulator — most importantly for outsourcing arrangements (where related parties are involved or investment costs are being netted off member returns) and the costs of administering insurance. APRA relies heavily on the goodwill of funds to accurately report on these areas in the spirit of the reporting framework, but this alone has proved inadequate — as has now been the experience of the Commission.

More broadly, the regulators can do more to improve their data analytics capabilities and to coordinate their efforts on data collection and reporting. There should be a joint exercise by APRA, ASIC, the ATO, the ABS and the Commonwealth Treasury to improve data collection and analysis across the whole super system, with a strong focus on collecting and publishing consistent data.

How a modernised super system will work better for all members

<i>Current problem</i>	<i>Draft recommendation(s) (numbers)</i>	<i>How members will benefit</i>
Unintended multiple accounts mean balances are eroded by fees and insurance	Members default once and retain existing account for new jobs (1) ATO to clean up stock of lost and unclaimed accounts (8)	In time, all members will pay a single set of fees and insurance premiums (unless they choose otherwise)
Poor outcomes for some existing default members, including subscale funds	A single best in show shortlist of products to assist new workforce entrants (2), selected by a competitive and independent process (3) Elevate MySuper (4) Centralised online service (1)	Better net returns for members of funds that currently underperform Members only default once and to a high-performing product designed to meet the needs of default members Easier for members to engage by choosing their own product, and to compare products and switch Employers no longer pick defaults
Tail of underperforming and/or high-fee products	Simple and comparable dashboards for all products (9), with comparisons to a member's current product (10) Disclose trailing commissions (13)	Easier for members to see how current product is performing and switch to something better, and to benchmark quality of financial advice
High exit and switching fees in some funds	Limit exit and switching fees to cost recovery levels (12)	Greater member switching to better products
Economies of scale are not fully realised	Elevate MySuper (4) Remove impediments to mergers (6, 7)	Better net returns for members of funds that currently underperform
Proliferation of complex products in the choice segment	More meaningful disclosure of product features, including when members switch (9, 10, 21) Best in show shortlist (2, 3) ASIC review of exit fees (21) and APRA review of legacy products (20)	Easier for members and their advisers to evaluate available products and compare to current product
Lack of quality, accessible and comparable information on products	More meaningful product disclosure (21), including better dashboards (9) and comparisons to best in show shortlist (10)	Easier for members to engage with super by comparing options and switching products, and to benchmark quality of financial advice
Lack of impartial and affordable financial advice	Best in show shortlist (2, 3) Guide pre-retirees to online information (11)	Best in show shortlist will act as a benchmark for financial advice Members approaching retirement will be more aware of their options
Unsuitable insurance, including default insurance members cannot claim on	Opt-in insurance for under 25s (14), cease insurance on accounts without contributions (15), clearer articulation of balance erosion trade-offs (16), strengthen and enforce insurance code (17, 18) and future review (19)	Removal of unsuitable insurance policies and providing, over time, greater value for members
Lack of transparency on related-party outsourcing arrangements	Greater disclosure of outsourcing costs to members (21) and formal due diligence by funds (20)	Better value for money will flow through to lower fees and/or higher net returns
Some trustee boards lack sufficient skills, expertise or independence	Lift standards for boards, including independent skills assessments (5)	More capable boards will ultimately deliver higher net returns and products that better meet member needs
Inadequate data impede competition and accountability	Publish product-level data (20) and develop more consistent, member-relevant data across system (22)	Accountability to members that the system is performing in their interests High and low performing funds are clearly identifiable to members

Draft findings, recommendations and information requests

Investment performance

DRAFT FINDING 2.1

APRA-regulated funds have delivered investment returns to members over the past two decades (net of all fees and taxes) of 5.7 per cent a year, on average. The majority of members and assets in the system are in products that have performed reasonably well. But there is significant variation in performance within and across segments of the system which is not fully explained by differences in asset allocation. Not-for-profit funds, as a group, have systematically outperformed for-profit funds. While retail funds dominate the 'tail' of underperformance, industry and corporate funds also reside in the tail.

DRAFT FINDING 2.2

The SMSF segment has broadly tracked the long-term investment performance of the APRA-regulated segment on average, but many smaller SMSFs (those with balances under \$1 million) have delivered materially lower returns on average than larger SMSFs. The difference between returns from the smallest SMSFs (with less than \$50 000) and the largest (with over \$2 million) exceeds 10 percentage points a year.

DRAFT FINDING 2.3

There is wide variation in performance in the default segment that is not fully explained by differences in asset allocation. About 1.7 million member accounts and \$62 billion in assets are in MySuper products that underperformed conservative benchmarks over the 10 years to 2017. This suggests that many members are currently being defaulted into underperforming products and could be doing better.

If all members in these underperforming products received the median return from a top-10 MySuper product, they would collectively be \$1.3 billion a year better off. Being in an underperforming product means that, on retirement, a typical worker (starting work today) is projected to have a balance 36 per cent lower (or \$375 000 less to retire with).

DRAFT FINDING 2.4

There is wide variation in performance in the choice segment that is not fully explained by differences in asset allocation. Over \$50 billion in assets are in investment options that underperformed conservative benchmarks over the 12 years to 2016. Many choice members could be doing a lot better.

INFORMATION REQUEST 2.1

Are the assumptions underpinning the Commission's benchmark portfolios sound? If not, how should they be revised, and what evidence would support any revisions?

INFORMATION REQUEST 2.2

Aside from administration fees, asset allocation and tax, what other factors might explain differences in investment performance against benchmark portfolios of the superannuation system, as well as segments such as for-profit and not-for-profit? What evidence is available to test the influence of such factors?

Fees and costs

DRAFT FINDING 3.1

Despite regulator endeavour, there remain significant gaps and inconsistencies in how funds report data on fees and costs. This harms members by making fee comparability difficult at best, and thus renders cost-based competition largely elusive.

DRAFT FINDING 3.2

Superannuation fees in Australia are higher than those observed in many other OECD countries. In aggregate, total fees — for administration and investment management services, and in both accumulation and retirement — have been trending down as a proportion of assets, from 1.3 per cent in 2010 to 1.1 per cent in 2016. Fees have fallen markedly for retail funds, albeit they remain higher (at least for choice products) than the (largely unchanged) fees for industry funds.

Among APRA-regulated funds, the MySuper and SuperStream reforms have likely acted to reduce fees (including some likely competitive spillover to choice products), albeit this is difficult to attribute directly given growth in average fund scale and the impact of other fee drivers.

While dispersion of product-level fees has decreased over the past decade, there remains a persistent ‘tail’ of relatively high-fee (mainly for-profit) choice products with total fees exceeding 1.5 per cent of assets each year. This tail comprises about 14 per cent of member accounts and 15 per cent of system assets.

DRAFT FINDING 3.3

Reported costs for SMSFs have increased over recent years and, for those with over \$1 million in assets, are broadly comparable with APRA-regulated funds as a percentage of member account balances. By contrast, costs for low-balance SMSFs are particularly high, and significantly more so than APRA-regulated funds. These high costs are the primary cause of the poor net returns experienced by small SMSFs on average. However, the number of new SMSFs with very low balances (under \$100 000) has fallen from 35 per cent of new establishments in 2010 to 23 per cent in 2016.

DRAFT FINDING 3.4

Higher fees are clearly associated with lower net returns over the long term. The material amount of member assets in high-fee funds (about 10 per cent of total system assets), coupled with persistence in fee levels through time, suggests there is significant potential to lift retirement balances overall by members moving, or being allocated, to a lower-fee and better-performing fund.

Fees have a significant impact on retirement balances. For example, an increase of just 0.5 per cent a year in fees would reduce the retirement balance of a typical worker (starting work today) by a projected 12 per cent (or \$100 000).

Members' needs

DRAFT FINDING 4.1

Qualitative judgments by members of superannuation funds suggest that a small share are dissatisfied with the overall performance of their fund. Members who have a poor understanding of the system and less capacity for accurately gauging the performance of their funds tend to report being much less satisfied. However, many more members indicate that the performance of funds, including their service quality, has improved over time than those who feel that performance had flagged.

A sizable minority of members selecting a retirement product express equivocal or negative views about the degree to which funds meet their specific product needs.

DRAFT FINDING 4.2

Many members find it hard to make comparisons between the large numbers of superannuation products available. The substantial proliferation of investment options in the choice segment (some 40 000) complicates decision making and increases member fees, without boosting net returns.

A 'no frills' product with low fees that is allocated to a balanced (or balanced growth) portfolio is likely to meet the retirement needs of most Australians during the accumulation phase. A better designed and modernised default allocation could act as a trusted benchmark for better member decision making across the entire system.

DRAFT FINDING 4.3

The inclusion in MySuper of life-cycle products is questionable given the foregone returns they pose for many members' balances (with some foregoing higher returns by adjusting asset allocation as early as 30 years of age). Life-cycle products comprise around 30 per cent of all MySuper accounts, but are mostly suited to members who want to 'lock in' a lump sum for some immediate purchase after retirement. For other members, maintaining a balanced portfolio before and after retirement would maximise retirement and lifetime income. Life-cycle products are better suited to the choice segment.

DRAFT FINDING 4.4

A 'MyRetirement' default is not warranted. The diversity in household preferences, incomes, and other assets when approaching, and in, retirement means there is no single retirement product that can meet members' needs. The most important task remaining is to improve the quality of financial advice to guide members among the various complex products, especially where members may decide to make the mostly irreversible decision to take up a longevity (risk pooled) income product.

DRAFT FINDING 4.5

Superannuation funds make insufficient use of their own (or imputed) data to develop and price products (including insurance). This is particularly problematic for designing products for the retirement and transition to retirement stages, because this is when different strategies have the biggest payoffs for members.

INFORMATION REQUEST 4.1

Should life-cycle products continue to be allowed as part of MySuper? If so, do they require re-design to better cater for the varying circumstances of members nearing retirement, and how should this be achieved? What information is needed on members to develop a product better suited to managing sequencing risk?

Member engagement

DRAFT FINDING 5.1

Across a range of indicators, member engagement remains low on average, though it is not realistic or desirable for members to be engaged all the time. Engagement tends to be higher among those approaching retirement, those with higher balances and owners of SMSFs. Engagement is lowest for the young and those with relatively low balances.

While many Australians have good broad knowledge of the superannuation system, many lack the detailed understanding necessary for effective engagement. Low financial literacy is observed among a sizable minority (about 30 per cent) of members.

DRAFT FINDING 5.2

Demand-side pressure in the superannuation system is relatively weak.

- Most members in the accumulation phase let the default segment make decisions for them, at least when they enter the workforce.
- A significant minority of members (an estimated 1 million) are barred from exercising choice even if they wanted to.
- Fund and investment switching rates are modest, suggesting that active members (or their intermediaries) have not exerted material competitive pressure on funds.

Proposed legislative changes to prohibit restrictive clauses in workplace agreements on members' choice of fund are much needed.

DRAFT FINDING 5.3

While there is no shortage of information available to members, it is often overwhelming and complex. Dashboards should be a prime mechanism to allow for product comparison and need to be salient, simple and accessible to be effective — but most are not.

DRAFT FINDING 5.4

The quality of financial advice provided to some members — including those with SMSFs — is questionable. Knowledge of the guidance and supports available to pre-retirees is generally lacking. In future, as members retire with higher balances and the diversity of options available expands, the need for tailored advice will grow.

Erosion of member balances

DRAFT FINDING 6.1

Several proposed policy changes will promote Superannuation Guarantee payment compliance:

- Single Touch Payroll being extended to small employers (with less than 20 employees) from 1 July 2019
- funds being required to report contributions to the ATO at least monthly
- the ATO having stronger powers to penalise non-compliant employers and recover unpaid contributions.

DRAFT FINDING 6.2

The superannuation system, primarily due to its policy settings, does not minimise the unnecessary and undesirable erosion of member balances. This erosion is substantial in size and regressive in impact.

- Unintended multiple accounts (one in three of all accounts) are the most egregious driver, directly costing members nearly \$2.6 billion a year in excess insurance premiums and administration fees. For an individual member holding just one unintended multiple account throughout their working life, the projected reduction in their balance at retirement is 6 per cent (or \$51 000).
- Superannuation Guarantee non-compliance is hard to estimate, but may be costing members about \$2.8 billion a year.
- At least 2 per cent of all member accounts (about 636 000) are subject to (grandfathered) trailing adviser commissions. These commissions may cost members in excess of \$214 million a year.

Recent policy initiatives have improved the situation, but current policy settings are inevitably making slow progress by treating the symptoms and not the structural cause.

Market structure, contestability and behaviour

DRAFT FINDING 7.1

The market structure of the superannuation system (as distinct from its policy and regulatory settings) is conducive to rivalry. At the retail level, there are many funds and products. At the wholesale level, while there is concentration in some service provider markets for outsourcing (like administration), a growing ability for larger funds in particular to insource all, or parts, of their service requirements adds to competitive pressure in the system.

DRAFT FINDING 7.2

At the system level, fund-level regulation is a significant cost of entry and there are structural features of the system on the supply and demand side that are likely to create challenges for new entrants (including gaining scale by attracting members). However, these are not necessarily prohibitive or even high barriers to entry.

In the default segment, there are high regulatory barriers to new fund entry, due to policy and regulatory settings that limit access to the market (including difficulty being listed in a modern award). There is also an absence of competition for the default market. Conversely, the choice segment is largely contestable.

While the costs of exit are unlikely to deter new fund entry, barriers to fund mergers are continuing to frustrate much needed consolidation in the system, at great cost to members.

DRAFT FINDING 7.3

There are signs of unhealthy competition in both the choice and default segments of the superannuation system.

- While the choice segment is largely contestable, competition has not always translated to better outcomes for members, and product proliferation (some 40 000 investment options is unhealthy choice) and poor comparability is symptomatic of unhealthy competition.
- In the default segment, the risk of employer inducements (of no benefit to members) remains a concern and can work against the interests of members.

DRAFT FINDING 7.4

There is a high propensity for funds in the system (particularly retail funds) to report using associate service providers — a form of vertical integration. While vertical integration is not in itself a problem, it does raise a potential conflict of interest which needs to be addressed by confident regulators and with greater transparency through disclosure and reporting.

DRAFT FINDING 7.5

Over the past decade, significant economies of scale have been realised in the superannuation system, but this has mainly been driven by the exit of small, high-cost funds. It is not evident that individual funds have been able to realise cost efficiencies as they have grown in size.

INFORMATION REQUEST 7.1

What are the main types and quantum of costs involved in fund mergers? How do these vary depending on the size of funds involved?

INFORMATION REQUEST 7.2

What evidence is there that funds are passing through economies of scale to members in the form of lower fees, or through other channels? Why has the pass-through of scale benefits occurred as it has?

Insurance

DRAFT FINDING 8.1

The deduction of insurance premiums can have a material impact on member balances at retirement. This balance erosion is highly regressive in its impact — it is more costly to members with low incomes. It also has a larger impact on members with intermittent attachment to the labour force, and those with multiple superannuation accounts with insurance (the latter comprise about 17 per cent of members).

Balance erosion for low-income members due to insurance could reach a projected 14 per cent of retirement balances in many cases, and in extreme cases (for low-income members with intermittent work patterns and with multiple income protection policies) could be well over a quarter of a member's retirement balance.

DRAFT FINDING 8.2

In terms of premiums paid, default insurance in superannuation offers good value for many, but not for all, members. For some members, insurance in superannuation is of little or no value — either because it is ill-suited to their needs or because they are not able to claim against the policy. Income protection insurance and unintended multiple insurance policies are the main culprits for policies of low or no value to members.

Younger members and those with intermittent labour force attachment — groups which commonly have lower incomes — are more likely to have policies of low or no value to them.

DRAFT FINDING 8.3

The fiscal effects of insurance in superannuation are complex, and the net effects are uncertain. Existing (public) fiscal estimates overestimate the net fiscal benefits as they do not consider the impact of balance erosion on Age Pension eligibility.

INFORMATION REQUEST 8.1

What is the case for bundling life and total and permanent disability insurance together, as is done by some superannuation funds? Are there funds that offer these separately, and if so, do many members of these funds elect to have one type of cover but not the other?

INFORMATION REQUEST 8.2

What is the value for money case for income protection insurance being provided on an opt-out basis in MySuper products?

Fund governance

DRAFT FINDING 9.1

Although there have been improvements to trustee board appointment processes to better ensure boards have the necessary skills and experience, there is still much room for trustee boards to do better in this area. Use of a skills matrix (informed by external evaluation of board performance, skills, experience and knowledge) to guide the appointment process should be considered best practice by superannuation trustee boards.

DRAFT FINDING 9.2

Best practice governance for superannuation trustee boards would involve a 'critical mass' (at least one third) of independent directors. However, ensuring boards have processes in place to recruit highly skilled and experienced directors is at least as important as the number of independent directors.

DRAFT FINDING 9.3

Despite widespread recognition that evaluation of board performance and capability by external third parties are crucial to identifying skills gaps on boards, many boards fail to undertake such evaluations.

DRAFT FINDING 9.4

Many funds mimic (at least to some degree) the strategy of rival funds for fear they will otherwise exhibit poor short-term performance relative to their peers ('peer risk'). This short-termism is likely to be at the expense of long-term returns to members.

System governance

DRAFT FINDING 10.1

The package of reforms contained in the Treasury Legislation Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill 2017 would improve member outcomes if legislated.

In particular, the proposed MySuper outcomes test should better enable APRA to de-authorise poorly performing products and better promote fund consolidation. Giving APRA more power to deal with ownership changes of superannuation funds would also help.

DRAFT FINDING 10.2

Conduct regulation arrangements for the superannuation system are confusing and opaque, with significant overlap between the roles of APRA and ASIC. These arrangements have the potential to lead to poor accountability and contribute to the lack of strategic conduct regulation, with poor outcomes for members.

DRAFT FINDING 10.3

The formation of the new Australian Financial Complaints Authority should be a positive reform for members, provided it is adequately resourced to deal with the level of complaints received.

DRAFT FINDING 10.4

The relatively small number of SMSFs with some form of limited-recourse borrowing arrangement (about 7 per cent and representing 4 per cent of SMSF assets) means such borrowing is at present unlikely to pose a material systemic risk. However, active monitoring (along with public reporting and discussion by the Council of Financial Regulators) is clearly warranted to ensure that SMSF borrowing does not have the potential to generate systemic risks in the future.

DRAFT FINDING 10.5

The frequency and pace of policy change undoubtedly create real pressures for participants in the superannuation system. However, most of the recent major reforms (such as MySuper and SuperStream) have been overwhelmingly beneficial from a public interest perspective.

INFORMATION REQUEST 10.1

Would a clearer division of responsibilities between APRA and ASIC (for superannuation) lead to better strategic conduct regulation and better regulator accountabilities? Is APRA best placed to specifically focus on ensuring high standards of system and fund performance, and ASIC to specifically focus on the conduct of trustees and the appropriateness of products (including for particular target markets)?

Overall assessment

DRAFT FINDING 11.1

Fixing some of the worst problems in the current superannuation system would bring substantial benefits. If there were no unintended multiple accounts (and the duplicate insurance that goes with them), members would have been collectively better off by about \$2.6 billion a year. If members in underperforming MySuper products had instead been moved to the median of the top-10 performing MySuper products they would collectively have gained an additional \$1.3 billion a year.

DRAFT FINDING 11.2

The superannuation system has not kept pace with the needs of members. Most notably, structural flaws have led to the absurdity of unintended multiple accounts (one in every three accounts is unintended) in a system anchored to the job or the employer, and not the member.

Competing for default members

DRAFT FINDING 12.1

While the default segment has *on average* outperformed the system as a whole, it fails to ensure members are placed in the very best products and places a sizable minority in underperforming products. For example, the top 10 MySuper products generated a median return of 5.7 per cent a year in the decade to 2017, whereas the bottom 26 generated a median return of 3.9 per cent a year (and represent about 1.7 million member accounts and \$62 billion in assets).

Current arrangements also deny some members any ability to choose their own products. Default arrangements need to be modernised and recrafted to harness the benefits of competition *for* default members.

DRAFT FINDING 12.2

Current default arrangements do not promote member engagement. Recent survey evidence reveals that when members are provided with a simple and accessible list of superannuation products, only a small minority would not choose their own product. This evidence aligns with the lessons of behavioural economics.

DRAFT FINDING 12.3

Although a sovereign monopoly default fund would be well placed to realise economies of scale for default members, such a model would run counter to the (desirable) absence of an actual or implied government guarantee in the Australian superannuation system and would fail to harness the benefits stemming from a competitive process. It would also supplant member engagement.

INFORMATION REQUEST 12.1

Are there any material impediments to high-performing non-incumbent funds participating in a 'best in show' selection process? The Commission is particularly thinking about possible claims for participation by funds with no prior local track record but in-principle claims, such as foreign funds or a government-owned fund.

Modernising the super system

DRAFT RECOMMENDATION 1 DEFAULTING ONLY ONCE FOR NEW WORKFORCE ENTRANTS

Default superannuation accounts should only be created for members who are new to the workforce or do not already have a superannuation account (and do not nominate a fund of their own).

To facilitate this, the Australian Government and the ATO should continue work towards establishing a centralised online service for members, employers and the Government that builds on the existing functionality of myGov and Single Touch Payroll. The service should:

- allow members to register online their choice to open, close or consolidate accounts when they are submitting their Tax File Number when starting a new job
- facilitate the carryover of existing member accounts when members change jobs
- collect information about member choices (including on whether they are electing to open a default account) for the Government.

There should be universal participation in this process by employees and employers.

DRAFT RECOMMENDATION 2 'BEST IN SHOW' SHORTLIST FOR NEW MEMBERS

A single shortlist of up to 10 superannuation products should be presented to all members who are new to the workforce (or do not have a superannuation account), from which they can choose a product. Clear and comparable information on the key features of each shortlisted product should also be presented. Members should not be prevented from choosing any other fund (including an SMSF).

Any member who fails to make a choice within 60 days should be defaulted to one of the products on the shortlist, selected via sequential allocation.

The ATO should embed the shortlist and accompanying information into the centralised online service.

DRAFT RECOMMENDATION 3 **INDEPENDENT EXPERT PANEL FOR 'BEST IN SHOW' SELECTION**

The Australian Government should establish an independent expert panel to run a competitive process for listing superannuation products on the online shortlist. This panel should select from products submitted by funds that meet a clear set of criteria (established beforehand by the panel) and are judged to deliver the best outcomes for members, with a high weighting placed on investment strategy and performance.

The panel should have flexibility to select up to 10 products, with the exact number at the discretion of the panel based on the merit of each product and what is most tractable for members, while maintaining a competitive dynamic between funds for inclusion.

The panel should be comprised of independent experts who are appointed through a robust selection process and held accountable to Government through adequate reporting and oversight.

The process should be repeated, and the panel reconstituted, every four years.

DRAFT RECOMMENDATION 4 **MYSUPER AUTHORISATION**

The Australian Government should legislate to allow APRA to apply the MySuper outcomes test.

Authorisation rules for MySuper should be further strengthened to require funds to:

- obtain independent verification — to an audit-level standard — of their outcomes test assessment, comparison against other products in the market, and determination of whether members' best interests are being promoted, at least every three years
- report to APRA annually on how many of their MySuper members switched to a higher-fee choice product within the same fund.

Funds that fail to meet these conditions — or persistently underperform (for five or more years) an investment benchmark tailored to their asset allocation by a material margin, as determined by APRA — should have their MySuper authorisation revoked.

After implementation, the Australian Government should commission an independent review, every five years, of the effectiveness of the MySuper authorisation rules (including the outcomes test) at meeting their objectives.

DRAFT RECOMMENDATION 5 **REGULATION OF TRUSTEE BOARD DIRECTORS**

The Australian Government should legislate to:

- require trustees of all superannuation funds to use and disclose a process to assess, at least annually, their board's performance relative to its objectives and the performance of individual directors
- require all trustee boards to maintain a skills matrix and annually publish a consolidated summary of it, along with the skills of each trustee director
- require trustees to have and disclose a process to seek external third party evaluation of the performance of the board (including its committees and individual trustee directors) and capability (against the skills matrix) at least every three years. The evaluation should consider whether the matrix sufficiently captures the skills that the board needs (and will need in the future) to meet its objectives, and highlight any capability gaps. APRA should be provided with the outcomes of such evaluations as soon as they have been completed
- remove legislative restrictions on the ability of superannuation funds to appoint independent directors to trustee boards (with or without explicit approval from APRA).

DRAFT RECOMMENDATION 6 **REPORTING ON MERGER ACTIVITY**

The Australian Government should require trustee boards of all APRA-regulated superannuation funds to disclose to APRA when they enter a memorandum of understanding with another fund in relation to a merger attempt. For mergers that ultimately do not proceed, the board should be required to disclose to APRA (at the time) the reasons why the merger did not proceed, and the members' best interests assessment that informed the decision.

DRAFT RECOMMENDATION 7 **CAPITAL GAINS TAX RELIEF FOR MERGERS**

The Australian Government should legislate to make permanent the temporary loss relief and asset rollover provisions that provide relief from capital gains tax liabilities to superannuation funds in the event of fund mergers and transfer events.

DRAFT RECOMMENDATION 8 **CLEANING UP LOST ACCOUNTS**

The Australian Government should legislate to:

- ensure that accounts are sent to the ATO once they meet a definition of 'lost'
- empower the ATO to auto-consolidate 'lost' accounts into a member's active account, unless a member actively rejects consolidation
- allow a fund to exempt a 'lost' account from this process only where the member has provided an explicit signal that they want to remain in that fund (prior to the account meeting the definition of 'lost')
- reduce the 'lost inactive' activity threshold from five to two years
- require that all accounts held by Eligible Rollover Funds, regardless of their lost status, are sent to the ATO
- prohibit further accounts being sent to Eligible Rollover Funds.

DRAFT RECOMMENDATION 9 **A MEMBER-FRIENDLY DASHBOARD FOR ALL PRODUCTS**

The Australian Government should require funds to publish simple, single-page product dashboards for all superannuation products.

ASIC should:

- prioritise the implementation of choice product dashboards to achieve full compliance by 1 July 2019
- revise the dashboards to simplify the content and provide more easily comprehensible metrics (drawing on robust consumer testing) by end 2019
- immediately publish all available MySuper and choice product dashboards on a single website, with the information clearly and readily accessible from the area of myGov that allows for consolidation of accounts.

DRAFT RECOMMENDATION 10 **DELIVERING DASHBOARDS TO MEMBERS**

The Australian Government should require the ATO to present the relevant (single page) product dashboard on a member's existing account(s) on its centralised online service.

The Government should also require all superannuation funds to actively provide their members with superannuation product dashboards when a member requests to switch from a MySuper product to a choice product within the fund. This should include:

- the dashboard for the MySuper product
- the dashboard for the choice product the member wants to switch to.

DRAFT RECOMMENDATION 11 **GUIDANCE FOR PRE-RETIREES**

The Australian Government should require the ATO to guide all superannuation members when they reach age 55 to:

- the 'Retirement and Superannuation' section of ASIC's MoneySmart website
- the Department of Human Services' Financial Information Service website.

DRAFT RECOMMENDATION 12 **EXIT FEES AT COST-RECOVERY LEVELS**

The Australian Government should legislate to extend MySuper regulations limiting exit and switching fees to cost-recovery levels to all new members and new accumulation and retirement products.

DRAFT RECOMMENDATION 13 **DISCLOSURE OF TRAILING COMMISSIONS**

The Australian Government should require superannuation funds to clearly inform, on an annual basis, all members who are subject to trailing financial adviser commissions. This information should include the amount of commissions paid and a notice that trailing commissions are now illegal for new members.

All funds should publicly disclose the extent of trailing commissions and number of affected members in their annual reports and provide this information to ASIC.

DRAFT RECOMMENDATION 14 **OPT-IN INSURANCE FOR MEMBERS UNDER 25**

Insurance through superannuation should only be provided to members under the age of 25 on an opt-in basis. The Australian Government should legislate to require trustees to obtain the express permission of younger members before deducting insurance premiums from these members' accounts.

DRAFT RECOMMENDATION 15 **CEASE INSURANCE ON ACCOUNTS WITHOUT CONTRIBUTIONS**

The Australian Government should legislate to require trustees to cease all insurance cover on accounts where no contributions have been obtained for the past 13 months, unless they have obtained the express permission of the member to continue providing the insurance cover.

DRAFT RECOMMENDATION 16 INSURANCE BALANCE EROSION TRADE-OFFS

APRA should immediately require the trustees of all APRA-regulated superannuation funds to articulate and quantify the balance erosion trade-off determination they have made for their members in relation to group insurance, and make it available on their website annually.

As part of this, trustees should clearly articulate in their annual report why the level of default insurance premiums and cover chosen are in members' best interests. Trustees should also be required to provide on their websites a simple calculator that members can use to estimate how insurance premiums impact their balances at retirement.

DRAFT RECOMMENDATION 17 INSURANCE CODE TO BE A MYSUPER CONDITION

Adoption of the *Insurance in Superannuation Voluntary Code of Practice* should be a mandatory requirement of funds to obtain or retain MySuper authorisation.

DRAFT RECOMMENDATION 18 INSURANCE CODE TASKFORCE

The Australian Government should immediately establish a joint regulator taskforce to advance the *Insurance in Superannuation Voluntary Code of Practice* and maximise the benefits of the code in improving member outcomes. The taskforce should:

- monitor and report on adoption and implementation of the code by funds
- provide guidance on and monitor enhancements to strengthen the code, particularly implementation of standard definitions and moving to a short-form annual insurance statement for members
- advise the industry what further steps need to be taken for the code to meet ASIC's definition of an enforceable code of conduct.

The code owners should be given two years to strengthen the code and make it binding and enforceable on signatories before further regulatory intervention is considered.

The taskforce should annually report findings on industry progress on the code.

Both ASIC and APRA should be members of the taskforce, with ASIC taking the lead.

DRAFT RECOMMENDATION 19 **INDEPENDENT REVIEW OF INSURANCE IN SUPER**

The Australian Government should commission a formal independent review of insurance in superannuation. This review should evaluate the effectiveness of initiatives to date, examine the costs and benefits of retaining current insurance arrangements on an opt-out (as opposed to an opt-in) basis, and consider if further regulatory intervention or policy change is required. The review should be initiated within four years from the completion of this inquiry report, or earlier if the strengthened code of practice is not made enforceable within two years.

DRAFT RECOMMENDATION 20 **AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY**

APRA should (in addition to draft recommendations 4 and 16):

- require all APRA-regulated superannuation funds to conduct formal due diligence of their **outsourcing arrangements**, at least every three years, to ensure the arrangements provide value for money. Each fund should provide a copy of the assessment to APRA (including the fees paid and the comparator fees)
- report annually to the Council of Financial Regulators on the progress stemming from the application of the MySuper scale test (and then the outcomes test, once legislated) in bringing about **fund mergers**
- undertake a systematic assessment of the costs to funds of the thousands of **legacy products** in the superannuation system. If the evidence demonstrates that they represent a significant cost in accumulation, APRA should further refine trustees' obligations for member transfers so these products can be rationalised
- embed **product-level reporting** within its reporting framework as soon as practicable (no later than 18 months) to enhance visibility of actual member outcomes across all APRA-regulated funds and to bring reporting for the choice segment into line with the MySuper segment. APRA should also expedite efforts to address inconsistencies in reporting practices.

DRAFT RECOMMENDATION 21 AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

ASIC should (in addition to draft recommendation 9):

- proactively set and enforce standards for the meaningful disclosure of information to members on superannuation products and insurance policies (in addition to product dashboards). Information should be simple, comparable and easy for members to understand
- require all superannuation funds to publicly disclose to current and prospective members the proportion of costs paid to service providers that are associated with related-party outsourcing arrangements
- proactively investigate (questionable) cases where mergers between superannuation funds stalled or did not proceed
- review exit and switching fees faced by existing members, with a focus on whether these fees are related to the underlying performance of the product, and whether they unreasonably impede members moving to products that better meet their needs.

DRAFT RECOMMENDATION 22 SUPERANNUATION DATA WORKING GROUP

The Australian Government should establish a superannuation data working group, comprised of APRA, ASIC, the ATO, the ABS and the Commonwealth Treasury (with Treasury taking the lead). This group should:

- identify ways to improve the consistency and scope of data collection and release across the system, with a focus on member outcomes
- evaluate the costs and benefits of reporting changes, including strategies for implementation
- identify areas where legislative or regulatory change may be necessary to support better data collection
- report annually to the Council of Financial Regulators on its progress, and on the data analytics capabilities of each regulator.

1 Setting the scene

Most Australians have superannuation. With very few exceptions, super is compulsory when participating in the workforce. The latest statistics show that total balances exceed \$2.6 trillion — a substantial portion of national wealth — and, at least by one projection, may reach \$9.5 trillion by 2035 (in nominal terms) (Deloitte 2015, p. 2). The sheer size of the super system, combined with its compulsory nature and the role it plays in funding retirement, means that the system’s performance is crucial for the wealth and wellbeing of Australians.

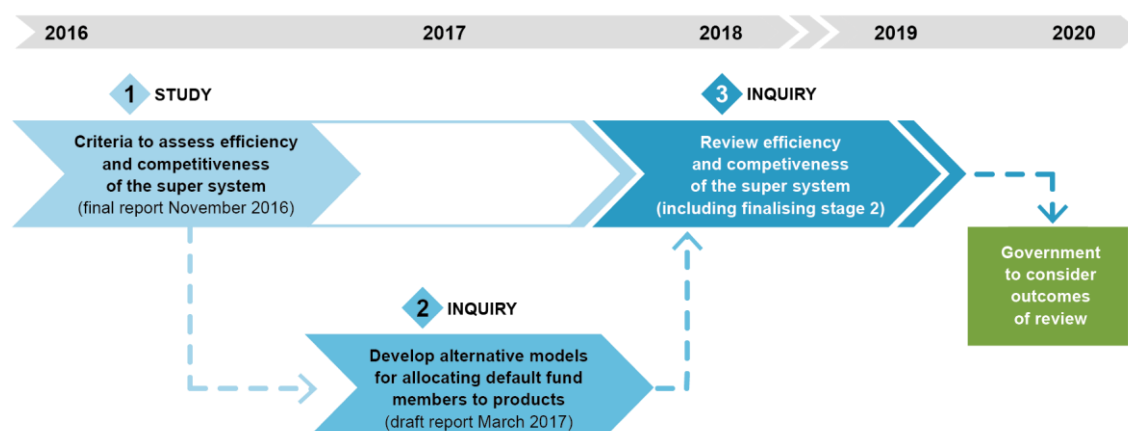
The super system was developed in a context quite foreign to current and impending social and workforce dynamics. Maturation of the system, greater female labour force participation, longer working lives, and higher contribution rates will mean that the super system will be far more important to people’s retirement incomes, and that there will need to be a greater focus on services in the retirement phase.

While job tenure has been relatively stable, many people still switch employers. Combined with multiple job holding and a much greater tendency to move between industries and occupations, this suggests that inefficiencies that arise from members having multiple accounts will become more persistent and costly in future without policy change. This inefficiency could be accentuated due to technological shifts, especially if this results in greater job mobility. At the same time, the technology for supplying superannuation services and engaging with members has shifted in ways that give better opportunities for employees, not employers and employee representatives, to be the most active parties in decision making.

This inquiry assesses the performance of the super system. It does so through the twin lenses of efficiency and competitiveness, and from the perspective of members’ best interests. In essence, the Commission is measuring how well the system as a whole is performing in terms of meeting member needs, providing for Australians in their retirement and keeping costs down.

The inquiry is the culmination of a three-stage process spanning almost three years (figure 1.1). Stage 1 involved setting the framework for assessing efficiency and competitiveness, by way of a suite of criteria and indicators (the final report was released in November 2016) (PC 2016a). Stage 2 entailed developing alternative models for allocating default members to products (with a draft report in March 2017) (PC 2017c).

Figure 1.1 A three-stage investigation



This stage 3 report is bringing both streams of work together to provide an overall assessment of the super system and recommend policy changes. It encompasses finalising the stage 2 inquiry. As such, the Commission is undertaking this inquiry under the twin (stage 2 and stage 3) terms of reference.

The Australian Government tasked the Commission with these three sequential pieces of work following a recommendation made by the 2014 Financial System Inquiry (Murray et al. 2014). The current stage 3 inquiry follows the full implementation of the MySuper reforms by 1 July 2017 (box 1.1).

Competition is a key part of the Commission’s assessment, not because it is a goal in itself, but because it is a means to an end. Competition is needed to drive better performance, keep costs low, stimulate innovation and ultimately promote members’ best interests (box 1.2).

This inquiry is being undertaken against an evolving backdrop. The Government is in the process of implementing changes to regulation, the regulators and fund governance. While the assessment framework used in this inquiry takes broad policy settings as given, there is an evaluation of whether system performance is being constrained by policy or regulatory impediments. Following prompting by the Government, the industry has recently developed a voluntary code of conduct to improve the operation of insurance through super. And several other inquiries and reviews are underway — including a Royal Commission into Financial Services and a concurrent Productivity Commission inquiry into Competition in the Australian Financial System. These are discussed below.

The Commission’s initial assessment of the super system’s performance — its efficiency and competitiveness — is contained within this draft report. Feedback is sought on the data and methods used, as well as on the draft findings, recommendations and information requests.

Box 1.1 **The MySuper reforms**

The MySuper reforms came into effect in July 2013, following a recommendation of the Cooper Review. These reforms put in place a set of regulatory standards for all default accumulation products. The intention was to provide a low-cost, transparent and comparable set of products that achieve better outcomes for default members — members who do not choose their own fund or investment strategy.

MySuper products have been designed to ensure members do not pay for any unnecessary features they do not need or use. Funds are required to provide a single diversified investment strategy (or a life-cycle strategy), with a single fee structure applying to all members. There are limits on the types of fees that can be charged. Funds must offer insurance but give members the ability to opt out. Funds are subject to governance standards set by the Australian Prudential Regulation Authority, and must regularly determine whether the scale of the fund is disadvantaging members.

Superannuation funds have been required to place new default members into a MySuper product since January 2014. Funds had until July 2017 to transfer the balances of existing default members into a MySuper product.

Though the MySuper reforms are now fully implemented, concerns have been aired that the original intentions of the reforms have not been fully realised. In 2014, the Financial System Inquiry questioned whether the reforms would significantly improve competitive pressure and realise the full benefits of scale for members, based on early indications that fees for MySuper products varied widely and had not fallen as much as anticipated (Murray et al. 2014, p. 107).

That inquiry recommended the introduction of a formal competitive process to allocate new default fund members to MySuper products unless a Productivity Commission review (the current inquiry) concludes that the MySuper and other reforms had been effective in improving competition and efficiency in the superannuation system.

Sources: ASIC (2017f); Australian Government (2011); Cooper et al. (2010a); Murray et al. (2014).

1.1 **How does the super system work?**

To a large extent, the super system is a product of government regulation. Employers must pay contributions equivalent to a minimum percentage of their employees' wages — currently 9.5 per cent of ordinary time earnings — into a super account. Most members cannot take this money out of the system until they retire (or are close to retirement age). In return, super receives favourable tax treatment, and members have a wide range of choice in who manages their money and where it is invested. Members who do not actively choose their own fund upon starting a new job — roughly two-thirds of members — are placed into default (MySuper) products (PC 2017a, p. 20).

The Australian super system has grown rapidly since the introduction of the Superannuation Guarantee in 1992, both in terms of funds under management and coverage, and in parallel to major structural shifts in the composition and form of the Australian workforce (discussed below). Collectively, Australians now have over \$2.6 trillion of assets in super funds (APRA 2018f), comprising almost 20 per cent of total household assets and equivalent to

over 140 per cent of GDP (figure 1.2). Superannuation will continue to increase in relative importance as the system matures by the 2040s.

Box 1.2 Why does competition matter for members?

Competition can be an impetus for driving better outcomes for members. In a competitive environment, funds and other service providers in the system would have incentives to deliver the products and services that members want at prices which reflect their costs of supply, and to continually innovate over time to improve their products and attract and retain members.

Healthy competition leads to efficient outcomes, and does not necessarily require a lot of funds in the market. Well-performing (efficient) providers not yet in the market will enter, efficient providers already in the market gain market share over time, and inefficient providers face pressure to improve or exit. Both not-for-profit and for-profit funds will coexist in the market. Experience suggests that no one type of fund has a monopoly over delivering good outcomes. Each kind of fund has had its share of successes and failures, both domestically and internationally.

However, it is critical to distinguish between healthy and unhealthy competition. If fund members are not well informed or engaged, or have limited influence on fund governance and direction, providers within the system could potentially compete on irrelevant product features that add little value to members. Product proliferation, high advertising expenditure and high search costs can be symptoms of unhealthy and wasteful competition. Competition is healthy only where it drives good member outcomes.

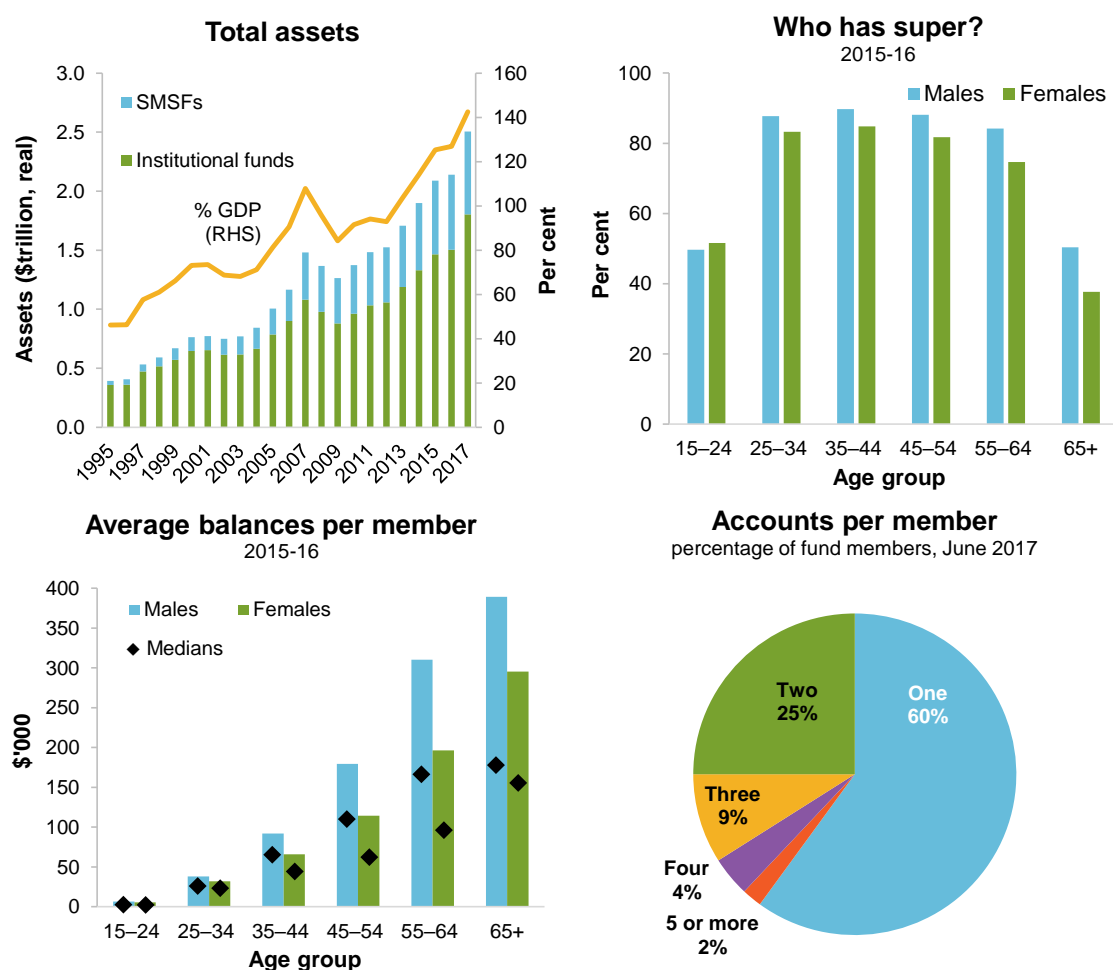
Another key distinction is between competition *in* the market and competition *for* the market. Competition in the market would involve trustees responding to member preferences and members switching funds when they can get a better deal. By contrast, competition *for* the market would involve funds competing for the right to access a particular segment of members, such as default members. This would involve funds being subjected to some kind of comparative evaluation based on merit (such as a tender or administrative filter), as assessed by experts.

Sources: PC (2016a, 2017c).

Over 80 per cent of both men and women in their prime working years (aged 25 to 54) hold a super account (figure 1.2). But there are some stark disparities across members. Average balances rise significantly with age — from \$6100 among young people to \$345 000 for those of retirement age, in 2015-16 — with a large and persistent gender gap across all age cohorts (ABS 2017b). There is also a wide distribution of balances within age cohorts, with medians much lower than averages. Overall, the median balance in 2015-16 (\$48 000) was only about a third of the average (\$128 000).

While most members hold a single account, four in ten have multiple accounts (figure 1.2). Sometimes this will be an explicit choice made by members — survey evidence suggests just over a fifth of members deliberately hold multiple accounts (chapter 5) — but in other cases it will be unintended and come at a high cost in terms of duplicate fees and forgone returns (chapter 6).

Figure 1.2 Member balances are rising but unevenly spread^a



^a Figures include both accumulation and retirement phases. Figures for SMSFs include small APRA funds (the latter comprised 0.3 per cent of assets in this category in 2017).

Sources: ABS (*Household Income and Wealth, Australia 2015-16*, Cat. no. 6253.0); APRA (2005, 2007, 2017h, 2018c); ATO (2017e).

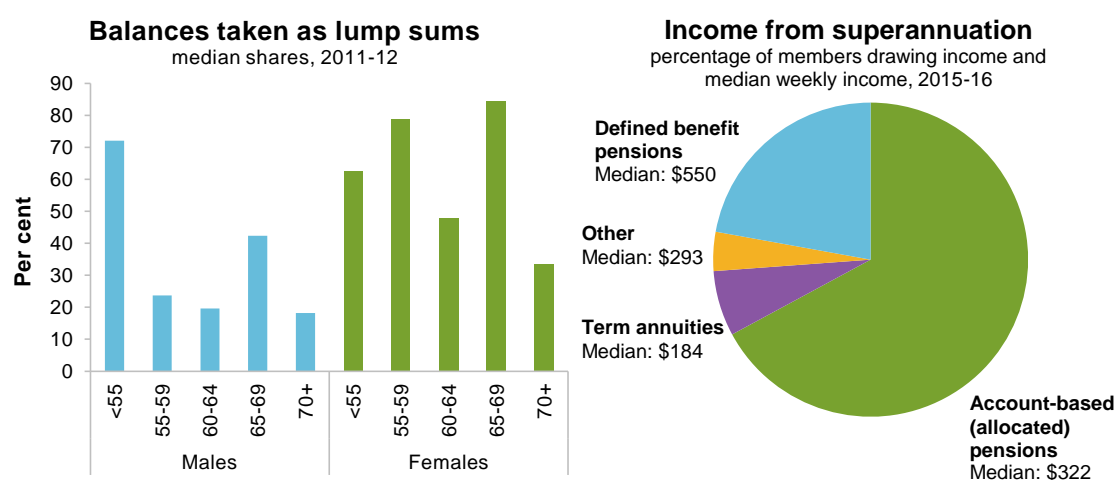
Over 90 per cent of member accounts are in the accumulation phase, with the remainder in retirement and holding a quarter of the system's assets (ABS 2017b; APRA 2018c). However, some members withdraw their balances as lump sums when they reach retirement and effectively exit the super system. For example, in 2011-12, nearly 3 per cent of the population aged 55 and over withdrew more than 90 per cent of their super balance as a lump sum (PC 2015a, p. 84). These are usually members with smaller balances. In general, females withdraw a higher proportion of their balances as lump sums than males (figure 1.3).

Of retirement age members who remain in the system and receive regular income from their super, the median income was \$391 per week in 2015-16, though the median for the typical account-based pension (which excludes members receiving defined benefit pensions) was lower, at \$322 per week (figure 1.3).

Overall, a third of Australians aged 65 years and over rely on government pensions and allowances for over half of their total income, and only about one-fifth rely on government payments for less than one per cent of their income (ABS 2017b).

The significance of the retirement phase will only grow as the system continues to mature. By one projection, assets in the retirement phase may grow from about \$400 billion today to over \$1.5 trillion by 2035 (Deloitte 2015, p. 6).

Figure 1.3 Balances are drawn down in diverse ways



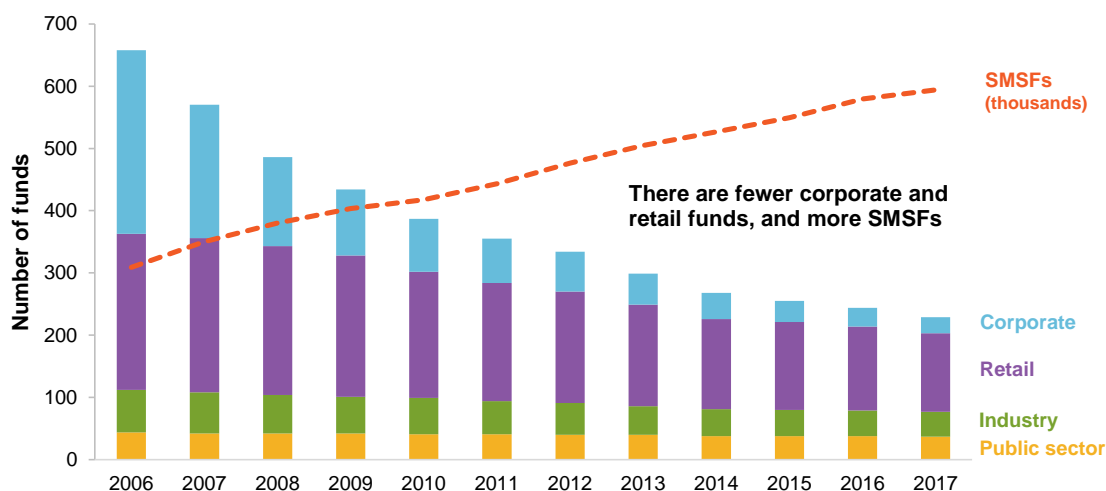
Sources: ABS (*Household Income and Wealth, Australia 2015-16*, Cat. no. 6253.0); PC (2015a, p. 85).

Who is in 'the system'?

Super funds are key players in the system. As of June 2017, there were 228 institutional funds, which are categorised as industry, retail, corporate and public sector funds (figure 1.4). This is down from over 650 funds in 2006 due to consolidation in the industry (especially among corporate and retail funds). At the same time, the number of self-managed super funds (SMSFs) has nearly doubled, from about 315 000 to 594 000.

Institutional funds come in two main types: defined benefit and defined contribution. Among those regulated by the Australian Prudential Regulation Authority (APRA), less than a quarter (23 per cent) of members benefits are defined benefits, with the remainder in defined contribution (APRA 2018c). Defined benefit funds were once common in Australia — especially for high-income workers prior to the Superannuation Guarantee — but are in long-term decline. These funds pool contributions and set retirement benefits according to a formula, with most financial risks borne by the sponsoring employer. By contrast, in defined contribution funds, most risks (in relation to investment performance, fees and retirement benefits) reside with the member.

Figure 1.4 There are fewer institutional funds than in the past^a
June 2017

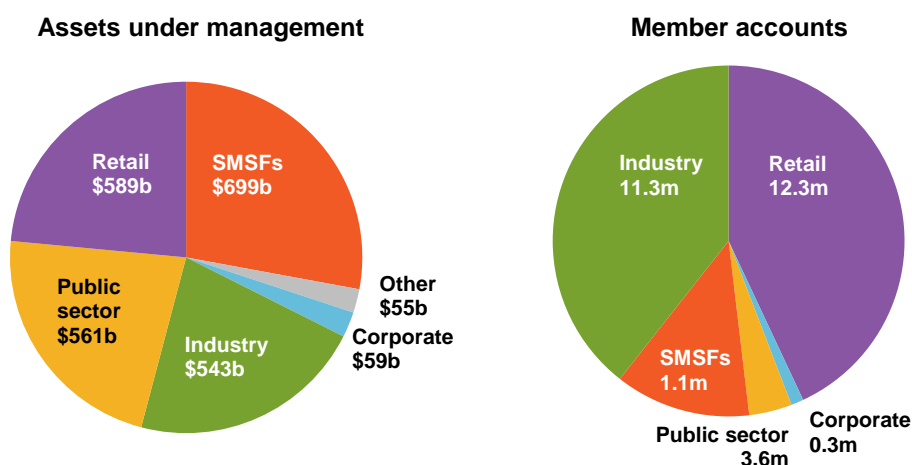


^a Figures for SMSFs include small APRA funds, and figures for public sector funds include State and Territory Government funds exempt from regulation by APRA.

Sources: APRA (2017h, 2018c).

In terms of assets under management, retail funds, industry funds, public sector funds and SMSFs each hold close to a quarter of the total, with most of the small remainder in corporate funds (figure 1.5). The number of member accounts is spread much more unevenly, with the bulk (82 per cent) residing in industry and retail funds.

Figure 1.5 Most accounts are in industry and retail funds
June 2017



^a Figures for SMSFs include small APRA funds, and figures for public sector funds include State and Territory Government funds exempt from regulation by APRA.

Source: APRA (2018c).

There are some key differences across the main segments of the system (box 1.3 provides some definitions). Over half of all accounts are in MySuper products (mostly with not-for-profit funds), though these products only account for a quarter of assets in APRA-regulated funds (figure 1.6). Average balances for choice accounts are over twice those of MySuper accounts, and accounts in SMSFs are about seven times as large again (the figures for choice accounts and SMSFs include the pension phase). Collectively, APRA-regulated funds offer over 40 000 products in which members can choose to invest their super (APRA 2018g).

Box 1.3 What are the ‘segments’ of the super system?

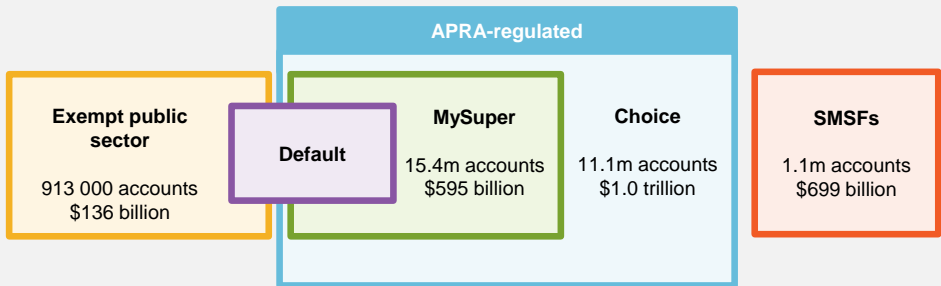
The superannuation system can be divided into segments in various ways, and many of these overlap (see diagram below). In this report, the Commission has adopted the following definitions:

- **APRA-regulated funds** are institutional funds (with more than 4 members) subject to regulation by the Australian Prudential Regulation Authority
- **Default members** are those accumulation members who did not nominate an existing account to their most recent employer, and thus were placed in the employer’s choice of fund. Since 2013, most of these members have been in **MySuper products**, though some default members remain in public sector funds that are exempt from APRA regulation.
- **Choice members** are those who are in a non-MySuper product in an APRA-regulated fund, and generally have chosen the specific product (or investment option) themselves, including members in the retirement phase. This definition is much narrower than the set of all members who make active choices in the system, which also includes **SMSF members** and those who choose their own investment option within exempt public-sector funds.

There are no official statistics available on the number of unique members in each segment (since one member may hold multiple accounts, including across segments). It is also unknown how many members truly ‘default’ by holding a MySuper (or exempt) default product without having chosen to go with that product. Inevitably, many members will have actively chosen to open a MySuper product, or will have deliberately let their employer place them in a specific fund.

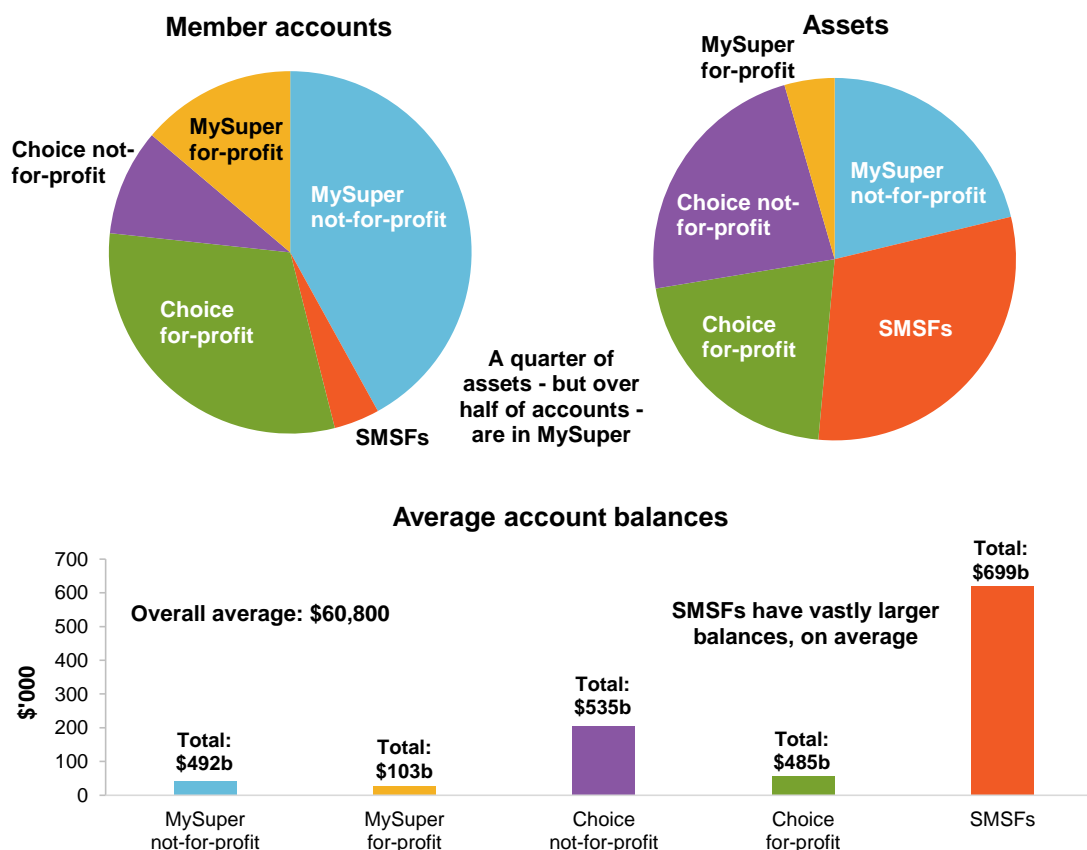
Members can also be in the accumulation segment (if they are still contributing to their balances), the retirement segment (if they have started drawing down their balance), or both.

Finally, it can sometimes be useful to analyse the system by looking at the main fund types: industry, retail, corporate, public sector, and SMSFs. In this report, the Commission has used the terms ‘for-profit’ to denote retail funds, and ‘not-for-profit’ to denote industry, corporate and public sector funds. This follows industry convention. Though fund trustees cannot extract profits (by law), there is scope for trustees that are part of a vertically integrated entity to outsource some functions to related-party providers who can make a profit.



Source: APRA (2018c).

Figure 1.6 **Choice and SMSF members have higher average balances^a**
June 2017

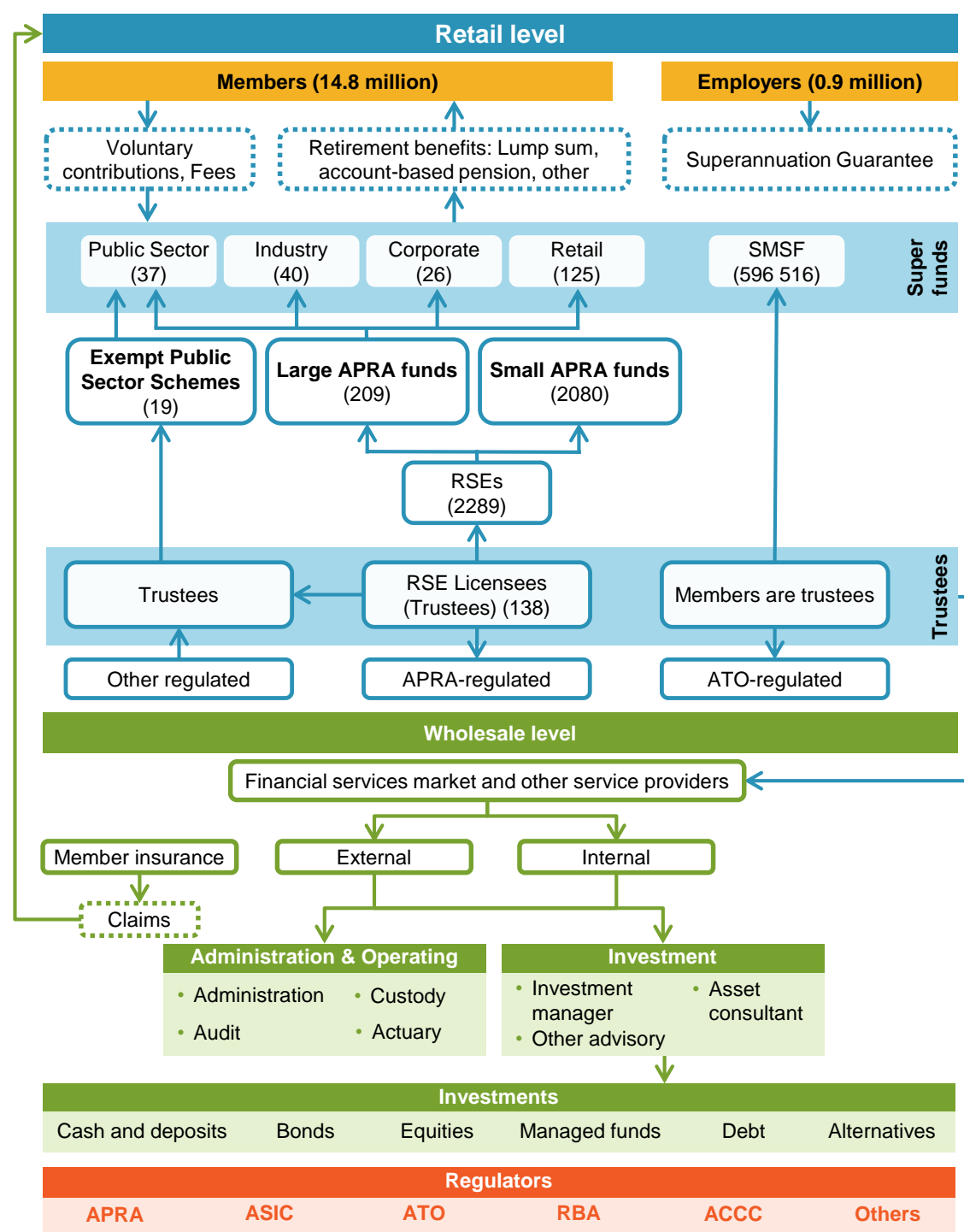


^a Figures include both accumulation and pension phases, unless otherwise indicated. Figures for SMSFs include small APRA funds. Figures for institutional funds only include APRA-regulated funds.

Source: APRA (2018c).

The super system extends well beyond funds and the members it provides for (see below). It encompasses many horizontal and vertical relationships on the supply side at the wholesale and retail levels, member intermediaries on the demand side (such as employers), and the actions of regulators on both the supply and demand sides (figure 1.7). These other parts of the system are assessed in this inquiry only where materially relevant — that is, where there is evidence of potential problems that bear on the efficiency and competitiveness of the system.

Figure 1.7 An overview of the super system^a



^a Figures in parentheses indicate number of entities as at June 2017.

Sources: ABS (*Counts of Australian Businesses including Entries and Exits, Jun 2013 to Jun 2017*, Cat. no. 8165.0); ATO (2017e); APRA (2017h).

Members in the modern workforce

Members are central to the super system — indeed, the system itself exists to meet its members’ needs. Some members have large super balances; others have very little. Some are still working — or between jobs — whereas others have already retired. Many members are passive and disengaged, and many more would like to be more involved with their super but find it too complex or time consuming. Others are sophisticated investors. The system needs to accommodate all this diversity.

But the economic and social environment that gave rise to Australia’s super system was quite different to that of 2018. Those differences will be accentuated over time.

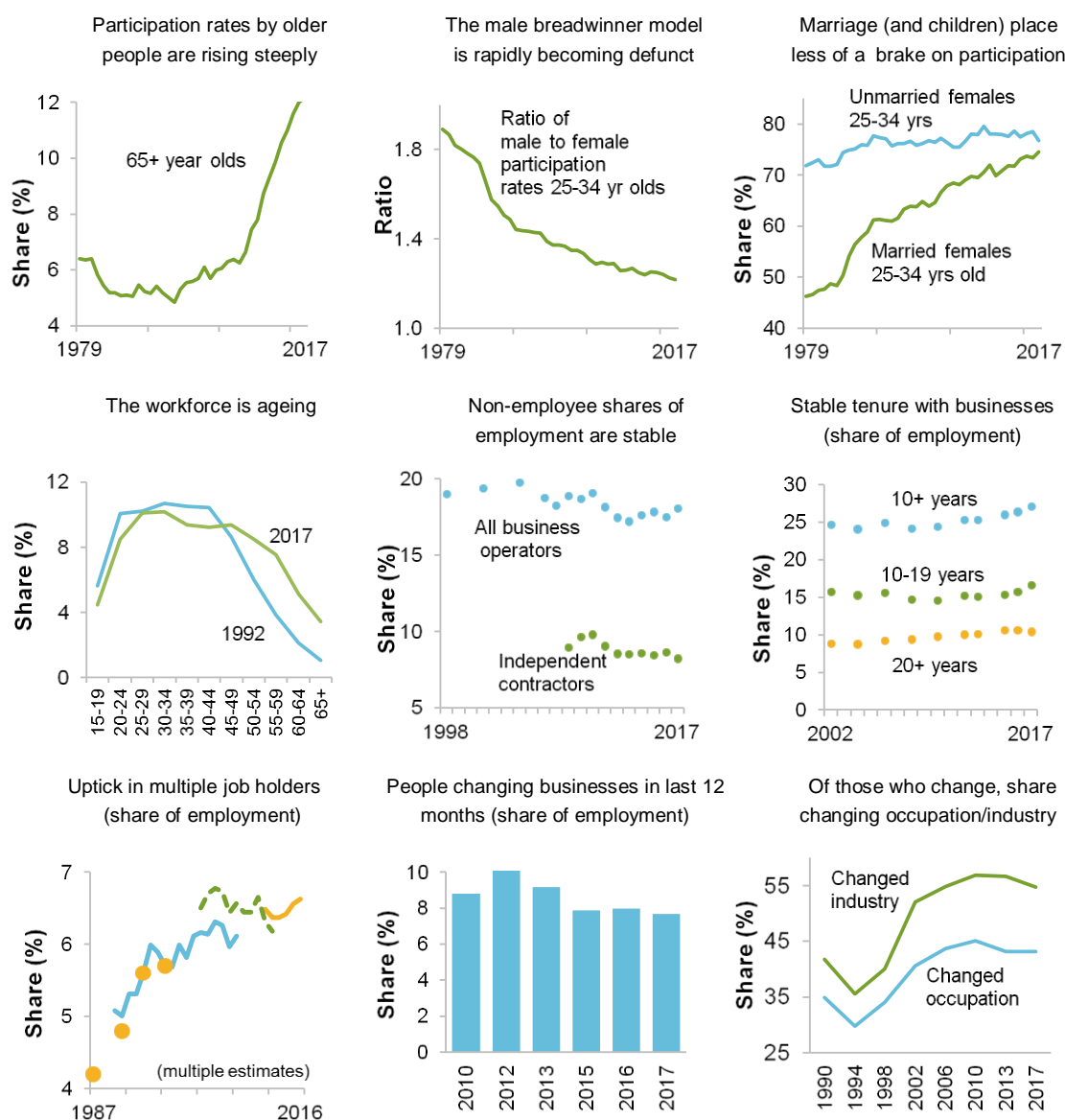
At the time of the introduction of the Superannuation Guarantee, super was not a major source of financing the retirement of most older cohorts. This was because Age Pension eligibility ages were less than now, contribution rates were low in the early years of the system, the working age population was younger, and the remaining lifetime income before retirement for many was modest.

While it will still be some time (just over another 20 years) before the retirement of the first cohorts to have experienced their full working life under superannuation, many members have now been in the system for several decades. Moreover, the portion of a member’s lifetime spent in work is rising given a shift to later retirement ages. In 2004-05, around 28 per cent of males (and 17 per cent of females) aged 45-49 years expected to retire after age 65. The comparable figures in 2016-17 were 38 and 30 per cent respectively (ABS 2006, 2017d). Labour force participation rates of those aged over 65 have risen strongly, albeit from a low base (figure 1.8), while reductions in labour force participation for young people (aged 15–19 and 20–24 years) have abated. Consequently, the expected number of lifetime years in the labour force (‘work expectancy’) for the current cohort of young people is projected to increase (Hunter 2017, pp. 241–242; PC 2013, p. 183).

As the system has matured, mandatory minimum superannuation contribution rates have risen significantly, which has added further momentum to the accumulation of funds (with rates to rise even further to 12 per cent by 2025). The threshold for mandated contributions (at \$450 before tax per calendar month) has also not changed with wage growth, pushing more younger and lower-income people into the super system. Maintaining the \$450 threshold meant that roughly half a million more employees were covered by the system in 2016-17 than would have been the case had the threshold been indexed to inflation (when its value would be more than \$1000 a month).

The combination of all these factors means that much more is at stake in financial terms than at the system’s inception, and its performance is therefore of greater importance to members. Equally, the gains from acquiring knowledge about the performance of funds and the available retirement options are also greater.

Figure 1.8 Trends in the Australian labour market



Sources: ABS (*Labour Force, Australia: Labour Force Status and Other Characteristics of Families, June 2005*, Cat. no. 6224.0.55.001; *Labour Force Status and Other Characteristics of Families, June 2017*, Cat. no. 6224.0.55.001).

These aggregate trends have parallels for some sub-groups of members, and particularly women. Female participation rates for workers aged 25-34 years are now approaching that of males (figure 1.8), with a similar trend apparent for the rates for partnered women compared with single women (ABS 2005, 2017c). While hours worked and wage rates are lower for females, the super system will be increasingly important for them as a source of retirement funding, noting that around 37 per cent of female retirees currently rely on their partner's income as the main source of funding for meeting living costs (ABS 2017d).

Maturation of the system has also made its focus broader. Twenty-six years after its inception, many people have transitioned into retirement, and with that, the system's orientation to retirement products and risk management of post-retirement incomes has become far more prominent. Notwithstanding trends towards delayed retirement, life expectancy improvements are likely to outpace increases in work expectancy, so that people's retirement income must last for longer (PC 2013, p. 182).

Superannuation arose as a de facto pay rise, and this tied Australia's retirement savings policy to the workplace relations system. Super funds were inextricably linked to employers and unions, with industrial awards cementing the relationship. The workplace relations system has since changed, and the role of unions has diminished, but vestiges of that old system live on with specification of super funds in awards, and workplace determination of default fund choices. Nearly all defined benefit schemes have closed, severing another link between employers and retirement savings.

Little is known with certainty about future labour markets and how this might shape people's retirement savings choices. It is not clear that people will face degrees of job interruption much greater than those evident now. For around the past decade, Australian labour markets have shown few changes in trends to contracting rates or job tenure despite significant technological change. Nevertheless, each year around one in every 12 people employed change their employer, and when they do, there appears to be a greater trend (for more than half) towards changing industries and occupations (figure 1.8) — which, absent further policy change, will inevitably entail unintended multiple default super accounts. And the incidence of workers holding multiple jobs has also seen a more than material uptick.

Nevertheless, the past is not necessarily a guide to future labour market conditions. Some expansion of the gig economy will occur, and even if digital disruption does not have net displacement effects, it could increase shifts of people between businesses, occupations and industries — which again reinforces the need to avoid the balance erosion that arises with multiple accounts. Moreover, people will face greater uncertainty about their likely future retirement balances, which will require more retirement income planning and engagement with super funds.

The likelihood that fewer people will be able to own their own dwellings also means that retirement asset portfolios will look quite different from today, with a reduced weighting on equity in people's own homes. People will increasingly have to consider lifetime savings from outside the prism of just buying a house and compulsory super.

At inception of the Superannuation Guarantee, the technologies for managing super accounts, communicating with members and achieving compliance with businesses' legal obligations were primitive by contemporary standards. Statements were always in paper, and neither the internet nor smart phones existed as avenues for member interaction. Although computers were used to manage accounts, the capacity to use data for product development and advice in the retirement phase was limited, and is only now being developed (chapter 4). Testing compliance by small business with the requirements of the Superannuation Guarantee was costly. A modern super system can take advantage of technological

developments and internet diffusion to enable cost-effective Single Touch Payroll for all enterprise sizes, which would address problems of underpayment (a move that is now underway). It also gives better opportunities for employees, not employers and employee representatives, to be the most active parties in decision making.

1.2 What is this inquiry doing?

There is little precedent in Australia and internationally for reviewing the efficiency and competitiveness of a superannuation or pension system in its totality. The broader efficiency and system-wide perspectives are unique to this inquiry and make it a challenging task.

Australia's system has been compared to its peers overseas on many occasions. Prominent examples include the Melbourne Mercer Global Pension Index and Allianz Pension Sustainability Index (PC 2016a). Both of these rank Australia very highly, and have been used by some stakeholders to claim that Australia's system is already performing at a high standard. However, these indexes predominantly consist of measures of the adequacy and sustainability of retirement income systems — both of which are largely determined by government policy — rather than of the efficiency and competitiveness of the non-government parts of those systems.

The terms of reference for this inquiry request the Commission to base its assessment on the framework developed in stage 1. This framework for assessing efficiency and competitiveness was developed through extensive consultation with participants, including through meetings, submissions and roundtables, and was broadly supported by participants and international observers. It was also framed in terms of the overarching purpose of superannuation 'to provide income in retirement to substitute or supplement the Age Pension', as proposed by the Financial System Inquiry (Murray et al. 2014, p. 95).

The framework is comprehensive and comprises three elements (table 1.1):

- five system-level objectives that are within the scope of influence of the super system and specific to the principles of efficiency and competitiveness
- 22 assessment criteria, linked to the objectives, that reflect attributes that a competitive and efficient super system would be expected to have
- 89 unique indicators that set out specific and measurable aspects of the system's performance.

Table 1.1 System-level objectives and assessment criteria

<i>Assessment criteria</i>		<i>Number of indicators^a</i>
System-level objective #1: The superannuation system contributes to retirement incomes by maximising long-term net returns on member contributions and balances over the member's lifetime, taking risk into account		
E1	Are long-term net investment returns being maximised over members' lifetimes, taking account of risk?	4
E2	Are costs incurred by funds and fees charged to members being minimised, taking account of service features provided to members?	10
E3	Do all types of funds have opportunities to invest efficiently in upstream capital markets?	4
E4	Is the system effectively managing tax for members, including in transition?	3
E5	Are other leakages from members' accounts being minimised?	5
System-level objective #2: The superannuation system meets member needs, in relation to information, products and risk management, over the member's lifetime		
E6	Is the system providing high-quality information and intrafund financial advice to help members make decisions?	7
E7	Is the system providing products to help members manage risks over their life cycles and optimally consume their retirement incomes?	7
E8	Are principal-agent problems being minimised?	7
System-level objective #3: The efficiency of the superannuation system improves over time		
E9	Does the system overcome impediments to improving long-term outcomes for members?	6
E10	Are there material systemic risks in the superannuation system?	3
System-level objective #4: The superannuation system provides value for money insurance cover without unduly eroding member balances		
E11	Do funds offer value for money insurance products to members?	10
E12	Are the costs of insurance being minimised for the level and quality of cover?	7
System-level objective #5: Competition in the superannuation system should drive efficient outcomes for members		
<i>Market structure</i>		
C1	Is there informed member engagement?	8
C2	Are active members and member intermediaries able to exert material competitive pressure?	7
C3	Is the market structure conducive to rivalry?	2
C4	Is the market contestable at the retail level?	3
C5	Are there material anticompetitive effects of vertical and horizontal integration?	6
<i>Conduct and outcomes</i>		
C6	Do funds compete on costs/price?	6
C7	Are economies of scale realised and the benefits passed through to members?	5
C8	Do funds compete on member-relevant non-price dimensions?	5
C9	Is there innovation and quality improvement in the system?	3
C10	Are outcomes improving at the system level?	2

^a Many indicators are used multiple times. In total there are 89 unique indicators.

The framework has been designed from the perspective of members' best interests. It spans the accumulation, transition and retirement phases of super, as well as the default, choice, self-managed and corporate fund member segments, as required by the terms of reference. Defined benefit funds — as well as State and Territory Government funds exempt from

regulation by APRA — are not out of scope, but are not a key focus of the assessment. In the case of defined benefit funds, as noted in stage 1, this is largely because these funds are collectively small and declining (outside the public sector), investment risk does not reside with members, and many aspects of competitiveness do not apply because accounts are not portable (PC 2016a).

The system-level objectives and criteria collectively form the questions that this inquiry is asking and answering. The indicators reflect the evidence base the Commission is drawing on to evaluate each criterion. Some indicators are quantitative, whereas others are more qualitative. Most are being benchmarked in some way, whether against others, against stipulated objectives, or over time.

The Commission's analysis (and ultimately whether the system-level objectives are being met) requires interpretation of the available evidence base (including the indicators) and judgment. Most indicators cannot be interpreted in isolation — to do so would inevitably result in ambiguity. Others cannot support robust conclusions in isolation, due to problems of data quality or availability. And in some areas we have drawn on broader forms of evidence than just the indicators, where this offers insights into system performance and the interpretation of indicators. The overall assessment — and the draft findings and recommendations that flow from it — is thus based on a collective interpretation of the indicators and evidence.

The assessment framework was designed in stage 1 to reflect factors that are within the control of the system. This meant that broad policy settings were taken as given. However, this inquiry includes evaluation of the extent to which there are material policy or regulatory impediments that constrain system performance, and uses this to inform the policy recommendations.

Moreover, the terms of reference set out specific policy areas that are to be considered by the inquiry. These include:

- costs, fees and returns — whether additional disclosure would improve outcomes for members, and what actions could be taken to ensure that low member balances are not needlessly eroded
- default fund members — whether policy changes to current default settings would be desirable, including whether an alternative allocation model would deliver net benefits
- insurance in super — the impact of insurance on retirement incomes and costs to governments (through social security payments), and whether policy changes could improve default insurance cover.

Finally, there are a large number of policy initiatives that have recently been announced, both by the Government and industry bodies (box 1.4). Some of these are in the process of being implemented. In undertaking its assessment and developing recommendations, the Commission is endeavouring to take this constantly evolving backdrop into account.

Box 1.4 Policy initiatives already underway

Australian Government measures

In September 2017, the Government announced a package of legislative changes intended to:

- require APRA-regulated funds to hold Annual Member Meetings
- require that trustee boards be comprised of one-third independent directors and an independent chair
- strengthen rules for reporting of fund expenses and portfolio holdings
- give APRA stronger powers to take preventative or corrective action where a fund is not acting in the best interests of members, including through the application of an 'outcomes test' to all MySuper and choice products
- extend choice of fund to all members, including those currently excluded by an enterprise bargaining agreement or workplace determination.

Australian Securities and Investments Commission (ASIC)

ASIC is in the process of introducing requirements for improved disclosure of superannuation fees and charges in Product Disclosure Statements. These requirements (known as Regulatory Guide 97) are intended to improve consistency across the industry and reduce under-reporting. They are currently scheduled to be fully in place by 30 September 2018.

ASIC has also developed requirements for funds to provide consumers with information on the performance and costs of choice products in a simple format (known as product dashboards), as well as to disclose their total portfolio holdings. These were both scheduled to apply from 2017, but were recently extended to 1 July 2019 and 31 December 2019, respectively.

Insurance in Superannuation Working Group

In December 2017, the Insurance in Superannuation Working Group (comprising industry peak bodies that collectively represent the majority of Australia's superannuation funds) released a Voluntary Code of Practice. Under this code:

- trustees must assess the appropriateness and affordability of insurance cover for different segments of their membership when designing insurance benefits
- automatic insurance will cease for members where a contribution has not been received for 13 months for income protection cover (and for life and total and permanent disability cover where the account balance is \$6000 or less), and the member has not responded to communication from the fund
- premiums for automatic insurance must not exceed 1 per cent of estimated ordinary time earnings for the membership generally (or particular segments of the membership), unless particular circumstances warranting a higher premium have been identified
- trustees are required to communicate with members in a clear and timely manner about their insurance cover, the process of any claims and the handling of complaints.

The Code will commence on 1 July 2018, with funds able to adopt transition plans delaying full compliance to no later than 30 June 2021 in order to meet existing contractual arrangements. The code is to be independently reviewed no later than every three years.

Sources: ASIC (2017a, 2017h); ISWG (2017); O'Dwyer (2017c).

What is this inquiry not doing?

There are no league tables of individual funds in this report. The task is a system-wide assessment, with the overarching focus on how the system is performing for *members*. The Commission's analysis will, at times, examine the performance of specific segments of the super system — such as the default, SMSF and retirement segments — where this will meaningfully inform the inquiry task.

On the whole, factors beyond the system's control are also largely (but not entirely) out of scope. Among other things, these include overarching policy settings such as the Superannuation Guarantee rate, the Age Pension level and eligibility requirements, taxation arrangements and government compensation schemes. This inquiry is not looking at the adequacy of retirement incomes or the impact of super on national savings and thus overall community wellbeing (the policy question that ought be asked and answered before further increasing the Superannuation Guarantee rate). As complaints handling has recently been reviewed, the Commission has drawn on the findings of that inquiry without undertaking further analysis of its own (Ramsay, Abramson and Kirkland 2017).

This inquiry is assessing how well current arrangements for insurance within super are working for members. However, it is not tackling the broader policy issue of whether insurance *should* continue to be bundled with super. That is an inquiry in itself, and would (amongst other things) need to analyse what the extent and form of underinsurance in Australia would be in the absence of government intervention. In keeping with our terms of reference, the Commission is focusing on how the current policy of providing insurance in super could be improved from a member's perspective.

In undertaking this inquiry, the Commission has sought to avoid overlap with its concurrent inquiry into Competition in the Australian Financial System. While there are many and varied linkages between the super system and the broader financial system, some relevant elements of the assessment are being covered in the parallel inquiry and are not duplicated here.

Further, the Government has commenced a Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, the first half of which will run in parallel with this inquiry.

The Commission's approach

In keeping with the *Productivity Commission Act 1998* (Cwlth), the Commission has conducted this inquiry using transparent and public processes, with an overarching concern for the wellbeing of the Australian community as a whole. In the superannuation context, this means consistently focusing on outcomes for members.

As part of the stage 3 inquiry, the Commission published an issues paper in July 2017, and has received 100 submissions in response. Over 40 meetings were held with key stakeholders

and relevant experts. This inquiry has also drawn on a significant amount of prior consultation across stages 1 and 2. This encompasses 217 submissions, four technical roundtables and meetings with over 80 parties in both Australia and overseas, including industry bodies, specialist firms, individual super funds, academics and government officials. It also includes public hearings conducted in May 2017 after the release of the stage 2 inquiry draft report.

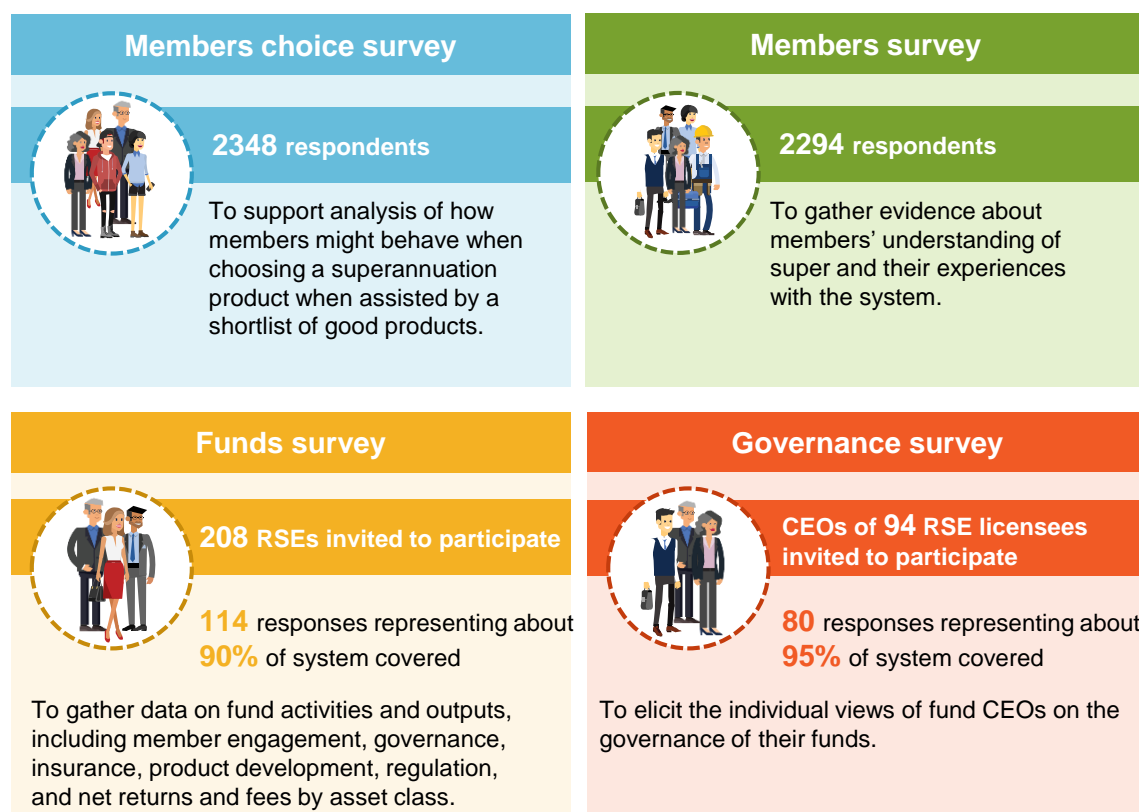
In developing this draft report, the Commission has examined all assessment criteria and indicators for which evidence is available. As far as possible, this has involved drawing on existing data. As noted in the stage 1 study, the bulk of data is already in the public domain, or held by regulators or research firms. The Commission entered into contractual arrangements with several research firms to obtain data. Some of the data provided by regulators and research firms are confidential, and thus are only being reported in the aggregate.

However, new evidence was required in some areas, especially in relation to members' outcomes and needs. Most existing datasets — including those compiled by regulators — are oriented around funds and products. This reflects that much of the regulation and oversight of the system is focused on the supply side. The evidence base for members, on the demand side, is comparatively sparse. To give one example, there are no official datasets of the distribution of total balances across members (aside from some one-off surveys).

To address data gaps, the Commission ran four surveys. An experimental survey that focused on member choice was conducted in the course of the stage 2 inquiry. And for this stage 3 inquiry, the Commission conducted a survey of members (to better understand their experiences with the system), a survey of super funds (to gather data on fund inputs, operations and behaviour) and a survey of fund Chief Executive Officers on fund governance (figure 1.9; box 1.5). The surveys focused on relevant evidence gaps for the inquiry, and were designed to minimise the compliance burden on participants. The results have been de-identified to protect the confidentiality of respondents.

The response rate to the funds survey was disappointing in terms of fund numbers, but high when assessed by the assets and member accounts that the respondent funds represented. The other surveys received much higher response rates. A high response rate was achieved for the governance survey, and a diverse range of Australians completed the two members surveys. The Commission thanks participants in all four surveys for their input.

Figure 1.9 The four surveys to address data gaps



To provide further insight into the impact of fees, returns, multiple accounts and insurance policies, the Commission has also developed a series of ‘cameos’ (box 1.6). These are illustrative calculations, based on a range of assumptions, that quantify how various factors can affect a member’s balance at retirement (such as multiple accounts, poor returns, high fees and high insurance premiums). In all cases, these factors compound over a member’s lifetime.

The Commission also held a technical workshop on measuring economies of scale with selected experts in September 2017.

Appendix A includes a list of all inquiry participants and submissions (including for the stage 2 inquiry), as well as a list of (non-member) survey recipients and respondents. Appendix B outlines the data sources used, and appendix C provides further detail on the surveys.

Box 1.5 The four surveys

Four online surveys were undertaken by the Commission as part of this inquiry. Appendix C provides further details about each survey. Summary statistics and supporting results are available as technical supplements on the Commission's website.

Members choice survey (stage 2)

As part of its work on alternative default allocation models, the Commission undertook an experimental choice survey of member behaviour. Respondents were surveyed on their past and present experiences and attitudes towards superannuation, and also asked to complete some experimental tasks to enable the Commission to better understand how members make their decisions. The survey was primarily designed to gather evidence relevant to understanding how people would likely behave if they had to choose a superannuation fund without any assistance (unassisted choice), as well as in the presence of a shortlist of superannuation products (assisted choice). The survey was designed and conducted by Insight Analytics, in conjunction with a third-party panel provider.

Members survey

The members survey gathered new evidence to better understand members' experiences with the superannuation system. Among other things, the questions covered superannuation and insurance literacy; retirement; satisfaction, member services and information on funds; use of advisers, account monitoring, intrafund advice and beneficiary nominations; changing and claiming on insurance; fund and product switching; and financial literacy. The survey was conducted by Roy Morgan Research between 28 September and 20 October 2017. The final survey data have been weighted to be more representative of the broader population.

Funds survey

The funds survey gathered data on a range of fund activities and outputs, including general information about each fund, member engagement, governance, insurance, market contestability, fund activity and product development, regulation, and net returns and fees by asset class. The survey was conducted by Roy Morgan Research between 18 September and 22 December 2017.

Governance survey

The governance survey was designed to elicit the personal views of fund CEOs on the governance of the funds for which they are responsible. It was based on a longstanding international survey on fund governance (Ambachtsheer, Capelle and Lum 2008), with several additional questions to address the evidence needs of this inquiry. Broad areas covered by the survey comprised general information about the respondent and the structure of the trustee board, as well as subjective questions concerning governance quality and challenges faced by the board. The survey was conducted by the Commission itself between 4 December 2017 and 15 January 2018.

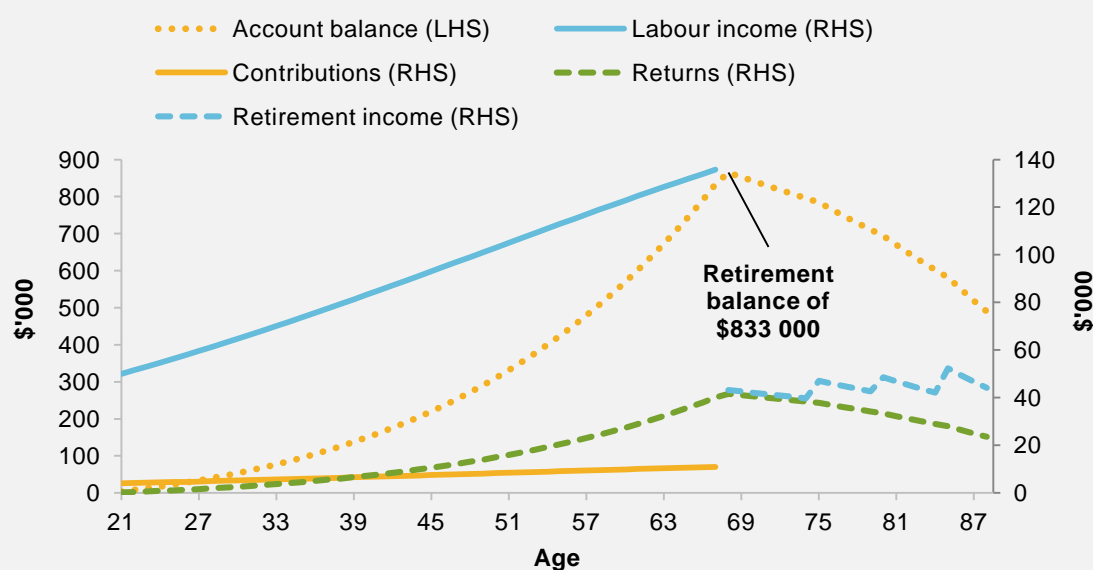
Box 1.6 The Commission's cameos

The Commission developed a cameo model to simulate the effect of changes in different variables on a hypothetical member's superannuation balance, either at or during retirement.

The model is premised on a representative member who enters the superannuation system at age 21, retires at age 67 and dies at age 88. The member starts with an annual salary of \$50 000, which grows over time due to economy-wide labour productivity growth (1.5 per cent a year, consistent with Treasury and Reserve Bank analysis), and an experience curve (that increases at a decreasing rate, based on previous Commission analysis). Superannuation contributions are 9.5 per cent of income (taxed at 15 per cent). In retirement, the member draws down their balance at the minimum required rates.

In the base case, the member's fund delivers an after-tax (but before fees) investment return of 5 per cent a year (adjusted for inflation), consistent with OECD analysis. Investment fees are 0.82 per cent of the account balance in accumulation and 0.87 per cent in retirement, and administration fees are \$69 per year in accumulation (plus 0.16 per cent of balance) and \$64 per year (plus 0.32 per cent of balance) in retirement. These values are based on APRA MySuper and SuperRatings data. The member is also charged 'light blue collar' death and disability insurance premiums, which vary by age (calibrated from Rice Warner data) and average \$340 a year over the member's lifetime.

The figure below shows how these parameters evolve over time in the base case. The cameos throughout this draft report model divergences in selected parameters.



Sources: APRA (2018e); ATO (2016d); D'Arcy and Gustafsson (2012); Forbes et. al. (2010); OECD (2015); PC (2016c); Treasury (2015); PC analysis of SuperRatings and Rice Warner data.

The default allocation mechanism

The stage 2 inquiry on alternative competitive models to allocate default members to products commenced in September 2016. The intention of that inquiry was to develop

workable alternative models for the Government’s consideration, and to be an input to this current inquiry.

In the context of issuing the terms of reference for stage 3, the Treasurer agreed with the Commission’s request (itself reflecting the overwhelming preference of inquiry participants) that the stage 2 work be incorporated into and finalised as part of the broader review of the efficiency and competitiveness of the super system. As a result, no standalone final inquiry report was issued for stage 2. Instead, final advice on alternative default models will be provided in the final report for this stage 3 inquiry.

The current inquiry is assessing the default segment in two ways. First, the efficiency and competitiveness of the default segment as a whole — as it currently stands — are assessed throughout this draft report. This is because the default segment (with half of member accounts) is a major part of the system and represents those members who have not exercised an active choice (about two-thirds of people default when starting a new job). This reality, coupled with the compulsory nature of super in Australia, suggests that the performance of default super should be held to a high standard — the system exemplar — for member outcomes. The default segment also cuts across many of the criteria and indicators.

Second, there is an assessment of the current default allocation model, both as it stands in practice and as currently legislated (but not fully implemented). This is done with reference to the criteria for assessing alternative models set out in the stage 2 inquiry draft report (member benefits, competition, integrity, stability and system-wide costs).

This further assessment serves the purpose of allowing the Commission’s alternative models to be compared to the existing model, and to make recommendations on policy changes. In making such recommendations, transitional costs and options have also been considered.

How can you contribute?

The Commission is now seeking submissions and comments on the draft report, including in response to information requests and the draft findings and recommendations. Additional evidence to inform the assessment is welcomed. The Commission is also especially interested to hear from members (including owners of SMSFs) on their experiences with the super system.

Submissions are to be received **no later than 13 July 2018**. Further information on how to make a submission can be found online at www.pc.gov.au/inquiries/current/superannuation/make-submission.

The next step will be public hearings, which will be held in selected locations from 20 to 22 June 2018 (locations and the number of days will be determined by the level of interest from inquiry participants). Further details will be available on the inquiry website.

Feedback and input from inquiry participants will be taken into account as the Commission finalises its report. The final report will be provided to the Government, with the timing to be advised.

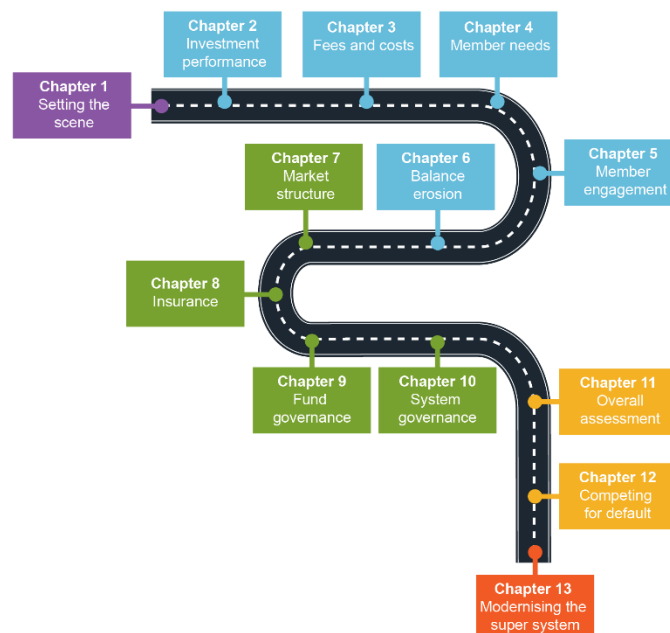
1.3 How is this report organised?

The remaining chapters in this draft report collectively provide the assessment against the criteria and indicators, with the results of the analysis presented as draft findings that are both material and policy relevant.

Figure 1.10 shows the roadmap for the draft report. The following five chapters (2 to 6) provide an overview of the system’s performance, with a focus on its outputs and outcomes. The subsequent four chapters (7 to 10) look more closely at market structure, insurance and governance. Chapter 11 provides a summary against the assessment framework, then the default chapter (12) looks at policy options for the default allocation. The final chapter (13) sets out draft recommendations for modernising the system to work better for all members.

The chapters of this draft report are supported by a suite of appendixes that explain how the Commission has sourced, analysed and applied data to its assessment. Some material is also being made available on the Commission’s website in the form of technical supplements.

Figure 1.10 **Superannuation system inquiry: report roadmap**



2 Investment performance

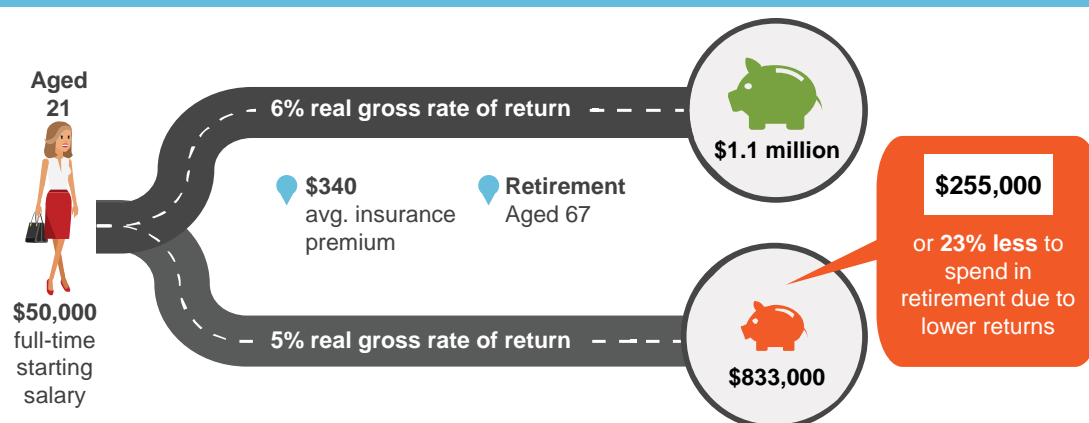
Key points

- The size of, and variation in, net returns is critical to members' retirement incomes. But assessing the system's investment performance is challenging. The Commission's focus is on long-term performance, compared to benchmark portfolios that control for asset allocation. While the assessment is not an exact science, given data limitations, the Commission has erred on the side of giving funds the 'benefit of the doubt' in constructing the benchmarks.
- Overall, the system has delivered mixed investment performance for members.
 - Over the decade to 2016, both APRA-regulated funds and SMSFs have delivered net returns of about 5.6 per cent a year (although smaller SMSFs delivered significantly less).
 - Many members are in 'growth' and 'balanced' products, which delivered around 6.8 per cent a year on average in the 12 years to 2016, beating their tailored benchmarks.
 - The default segment generated average net returns of about 7 per cent a year over the 12 years to 2016. Top performers were typically (but not always) larger, not-for-profit funds.
 - For-profit funds as a group, have delivered returns below several benchmarks and significantly below not-for-profit funds. These differences do not appear to be fully explained by fund size, asset allocation or reported administration expenses.
- Investment performance varies widely across funds and products, and this variation in performance best captures the real experience of members. Many members, in choice as well as default, could be doing a lot better.
- Over the 12 years to 2016, APRA-regulated funds generated net returns below the benchmark (adjusted for average asset allocation). Further, 20 funds (with 4.6 million member accounts) underperformed a benchmark tailored to their own asset allocation by more than 0.25 percentage points.
- 26 of today's MySuper products — that can be tracked back over 10 years — underperformed, and represent 13 per cent (\$62 billion) of MySuper assets and 15 per cent (1.7 million) of member accounts in the sample. There is a material gap between top and bottom performers.
 - A member entering the system today into the median underperforming MySuper product is projected to retire with 36 per cent less (\$375 000) in retirement than if they entered one in the median top-10 product.
- While product heterogeneity in the choice segment makes product-level comparisons challenging, there is revealing evidence of material underperformance within this segment, even when benchmarks are tailored to individual products' asset allocation.
- The Commission's evidentiary need to analyse long-term investment performance by asset class — to afford an international investment performance comparison and a more robust system assessment — was thwarted by the unwillingness of most funds to disclose these data through the funds survey. The survey results for those funds that provided adequate responses (which are likely to be better performing funds) reveal mixed performance in asset class returns relative to indexes and the performance of pension funds in other countries.

Delivering investment returns to members (net of all fees and taxes) is the most important way the system contributes to delivering the best possible retirement incomes. Persistently below par returns can lead to large foregone retirement balances. For example, the difference between a 5 and 6 per cent return¹ can amount to a projected 23 per cent (\$255 000) difference in retirement balances for a typical full-time worker (cameo 2.1).

Cameo 2.1 A small difference in returns matters a lot^a

Super problem: Lower returns = 5 years' lost pay



^a The assumptions underpinning this cameo are set out in chapter 1.

An assessment of whether the system is maximising long-term net returns to members is the key indicator of system efficiency. It also provides insights into whether and how competition in the system is promoting the best outcomes for members. For example, a wide dispersion of returns in default products that persists over an extended time period would suggest insufficient competitive pressure.

To assess investment performance, the Commission has constructed a series of portfolios to benchmark the system and its segments. These are constructed using data on market returns across varying asset classes, and take account of differences in asset allocation within the superannuation system (section 2.1).

The assessment is not an exact science, but performance that consistently exceeds the benchmark is likely to reflect good outcomes being delivered to members. Conversely, performance that persistently resides below the benchmark is likely to reflect that the system is not delivering competitive or efficient outcomes. And the results in this chapter need to be considered alongside other assessments (as brought together in chapter 11), because past returns can never be a perfect predictor of future returns.

¹ In this chapter, returns are always annual rates of return, unless otherwise specified.

In some ways, a system-level assessment is unique. Research and commentary often focuses on types of products within the system (such as ‘balanced’ or ‘growth’ products), but all too often is limited by the available data along with the classic ‘comparing apples and oranges’ adage due to disparate asset allocation. The Commission’s analysis, while also limited by data, affords a view across the entire system and its segments in terms of the investment returns ultimately being delivered to its members.

With regards to the Commission’s stage 1 framework (PC 2016b), the following criterion is assessed in this chapter.

- Are long-term net investment returns being maximised over members’ lifetimes, taking account of risk? (E1)

This chapter starts with an overview of how this assessment is being conducted (section 2.1). It then examines performance at a system level (section 2.2), by product type (section 2.3) and by the main segments of the system (section 2.4). Finally, as system and segment averages can mask dispersion of outcomes, section 2.5 delves below averages to consider the distribution of performance within the system and segments.

2.1 How is the system being assessed?

A focus on returns delivered to members

The Commission’s overriding focus is on member outcomes. The most relevant outcome for members is the returns they receive after taxes and fees are netted out. In most cases, the analysis in this chapter is net of both investment and administration fees, and taxes (though in some instances it is net of just investment fees and taxes). Insurance premiums are considered separately in chapter 8.

Returns are calculated as a geometric average (to take account of compounding returns over time), in line with the approach used by the Australian Prudential Regulation Authority (APRA) and others. In most cases, average returns (across funds or products) are weighted by total assets, meaning larger funds have a larger impact on segment- and system-level performance. This is to reflect the outcome realised by a member in the system. The Commission has also explored using member-account weighted returns, though this approach encountered greater data limitations (tech. supp. 4).

In the stage 1 study, the Commission flagged that the returns analysis would be done over 5, 10 and 20 year periods. The Commission has been limited by the time series of data available, and has sought to use the longest time spans for which comparable returns data exist and for which benchmark portfolios can be constructed — in most cases, 12 years. Both APRA and research firm data have been used, though both come with limitations and trade-offs (box 2.1).

Box 2.1 **Some data limitations and trade-offs: mind the gaps**

APRA data offers the most complete system coverage. However comparable fund-level data is only available back to 2004, and aspects of the reporting framework only commenced in 2013 (including MySuper product data). Further, fund-level data aggregates a range of investment products (or options) offered by funds.

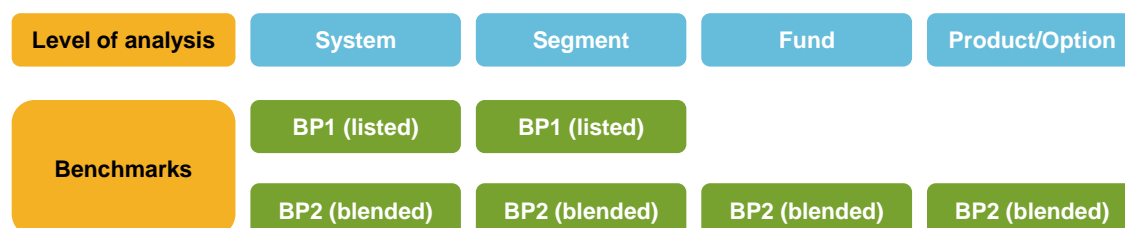
Research firm data offers more granular insights into products and investment options in the system, which is closer to the member experience, as well as a longer historical time series for some products and options. However, these datasets only cover a subset of products in the system (albeit, often the popular ones) which raises the prospect of selection bias — that is, the likelihood that many smaller and poorer performing products and options are not being covered. The difference in estimated long-term (2005–2016) returns to APRA-regulated funds using APRA data compared to SuperRatings data is approximately 0.7 per cent per year less, for example. This could lead to upwards biased results when using SuperRatings data. Changing product and option names makes it challenging to examine trends in products and options over time.

Multiple benchmarks are used to inform an overall view

The analysis in this chapter primarily consists of benchmarking long-term investment performance to a series of benchmark portfolios (PC 2016b). These portfolios are measures of net returns across a set of asset classes, with the mix of assets adjusted to match the strategic asset allocation of the segments or products being benchmarked.

Figure 2.1 shows the two benchmark portfolios (BPs) used in this chapter: BP1 (a benchmark portfolio based on listed assets) and BP2 (a benchmark portfolio which is based on a blend of listed and unlisted assets). Box 2.2 sets out the key inputs and assumptions behind them. These and other benchmarks were constructed following two technical workshops during the stage 1 study and much consultation with industry experts.

Figure 2.1 **Benchmark portfolios used in this chapter**



Box 2.2 The types of benchmarks explained

Benchmark portfolios provide the primary counterfactual used in the Commission's analysis to evaluate the system and segment performance. They aim to account for many influences on investment markets which are beyond funds' control, while providing insights into the efficiency by which funds add value for members.

The benchmark portfolios are weighted averages of financial market indexes, with weights determined by asset allocation and indexes chosen as representative of their corresponding asset classes. The Commission has used index data from several providers, including Bloomberg, FTSE Russell, MSCI and S&P.

Two types of benchmark portfolios (BPs) have been constructed for this draft report.

- A listed benchmark portfolio (**BP1**) that captures investment performance (net of fees and taxes) of a set of investment strategies across a range of listed asset classes.
- A blended benchmark portfolio (**BP2**) that captures investment performance (net of fees and taxes) of a set of investment strategies across a range of listed and unlisted asset classes that more closely represents how funds implement asset allocation.

BP2 is more representative of funds' exposure to unlisted asset classes, and thus how they would likely implement their asset allocations. The Commission defines 'underperformance' as performance which falls below BP2 by at least 0.25 percentage points over the relevant time period.

A CPI + X benchmark based on the median MySuper returns target is also applied for some analyses in this chapter. Further benchmark calculations are provided in the technical supplement, including a benchmark portfolio with a fixed 70 per cent allocation to growth assets.

Adjustments have been made to the benchmark portfolios (where relevant) to account for taxes, investment costs and administration fees. In some cases, assumptions were used to address gaps in the publicly-available evidence and data.

- **Taxes** on investment earnings have been deducted from the benchmarks using the median tax paid at a fund level, as reported to APRA (with individual funds' median tax rates used for fund-level analysis). This may mean that benchmark net returns are overestimated for product-level analysis, as product-level returns may embed some accrued tax liabilities that have not been realised within the time period of analysis. However, the Commission considers APRA data on tax paid as the most reliable source of information. Further, the potential disparity between tax paid and tax liabilities accrued and not yet realised are much lower over a longer period of time. (The results presented in this chapter do not materially differ under the alternative assumptions of 5 and 7.5 per cent annual tax rates.)
- **Investment costs** have been deducted in two ways. Fees charged on exchange-traded funds (investments which track indexes) have been used as a proxy for direct investment costs, with fees assumed to have declined by 5 per cent per year. A further amount is added to reflect indirect costs, including custodian, valuation and search costs. (Benchmark net returns are not overly sensitive to these assumptions, but may be under-estimated as a result.)
- **Administration costs** have been deducted using the median administration expense ratios that superannuation funds report to APRA. In most cases, this is tailored to the median for the relevant system segment (such as choice or MySuper) or to the specific fund type (industry, retail, corporate and public sector).

The assumptions that underpin these adjustments, and sensitivity testing, are fully documented in technical supplement (tech. supp.) 4.

A full description of data sources, assumptions applied and sensitivity tests are provided in a technical supplement, which includes detail on:

- data sources used in the analysis, their limitations, and how the Commission has dealt with those limitations
- the methodology used to estimate net returns, including discussion about alternative methods such as account-weighted and money-weighted returns
- the construction of benchmark portfolios, including assumptions made, the evidence supporting those assumptions and limitations
- sensitivity testing of key inputs and assumptions.

Participant feedback on these is welcome. The Commission will likely hold a technical workshop on investment benchmarking following release of this draft report, noting the broad methodology was subject to consultation with technical experts in stage 1.

Developing these benchmarks has not been straightforward — different approaches have their strengths, weaknesses and interpretive limits. Weaknesses have been exacerbated by a lack of data, and even where data are available, quality issues have required assumptions to be made. In doing so, the Commission has endeavoured to be transparent and conservative in making assumptions, interpreting the analysis and implementing the methodology — affording funds the ‘benefit of the doubt’.

INFORMATION REQUEST 2.1

Are the assumptions underpinning the Commission’s benchmark portfolios sound? If not, how should they be revised, and what evidence would support any revisions?

The benchmark portfolios utilised in this chapter are intended to inform the Commission’s one-off analysis of historical returns, and should not be misconstrued as an optimal investment strategy that any individual fund should pursue in future (including the use of active or passive management), which would depend on a broader range of factors not considered in the Commission’s analysis (PC 2016b, p. 120).

The arbitrary nature of benchmarks means that the Commission has identified ‘underperformance’ only where funds or products fall short of the relevant benchmark by at least 0.25 percentage points over the relevant time period. In the Commission’s judgment, this is a reasonable threshold, as over a sufficiently long period (at least 10 years) funds should be expected to broadly match the benchmark portfolio. And a difference of even 0.25 percentage points can make a significant difference to member’s retirement balances — for a typical full-time worker, moving up to the benchmark can amount to a projected 6.7 per cent (or \$54 000) improvement in their retirement balance.

Results are most sensitive to the asset class indexes used

The Commission has undertaken sensitivity testing on results. Three points are worth highlighting. First, the results are sensitive to indexes used, including the degree of hedging assumed over the period examined. The Commission has endeavoured to use indexes that have been endorsed by participants in submissions (albeit there was relatively limited feedback on this issue) and are those which it understands are commonly used in the market. Alternative assumptions have also been considered, including by adjusting the proportion of asset class domestic and international investments, and using hedged and non-hedged versions of particular indexes.

In most cases, the results are somewhat less sensitive to adjustments to the benchmark portfolios to account for tax (box 2.2). This is a complex area due to concessional tax treatment, imputation credits, different rates for the accumulation and retirement phases and the carry-over of losses. However, the disparity between tax paid and tax liabilities accrued and not yet realised through tax payments are less over a longer period of time.

Finally, the analysis is constrained by the reality that APRA fund-level asset allocation in the years prior to 2014 is only reported for a fund's default investment option. To address this issue, the Commission has made reasonable adjustments to fund-level asset allocation as outlined below and detailed in the technical supplement. To the extent that some funds may have more conservative whole-of-fund asset allocations, this adjustment is in line with the Commission's conservative approach to the analysis. Importantly, the Commission has also tested different approaches to address this issue, none of which fundamentally change the overall results.

It is also worth noting that, more broadly, the precise share of each asset class in the benchmark (and associated assumptions) plays a limited role in many of the results. Index returns for most asset classes over 12 years have been consistently high relative to many comparisons with actual returns (tech. supp. 4).

The analysis controls for risk

The stage 1 study canvassed the pros and cons of various approaches for dealing with risk in investment benchmarking, with the distinction between volatility and risk being particularly important (PC 2016b). In the benchmarking analysis, the Commission is accounting for risk in two ways. First, and primarily, by controlling for differences in asset allocation across parts of the superannuation system. A separate analysis of volatility is also provided. Second, returns are being benchmarked over the long term, meaning that a lot of short-term volatility is expected to 'wash out'. However, the time periods used are restricted by the available data.

This means there is modest sensitivity in the results to the specific time horizon chosen, which to some extent reflects a balanced business cycle. High returns prior to the global financial crisis (GFC), and low returns thereafter, mean that there are some differences in

investment performance across the system over the 10 year period of 2008–2017 versus the 12 year period of 2005–2016, with the latter including an extra two years of pre-GFC high returns.

2.2 How has the system performed?

Ideally, the starting point for a system-level analysis would take an aggregated view across the diverse range of funds in the system (chapter 1), or at least APRA-regulated funds (with 4 or more members) and self-managed superannuation funds (SMSFs) combined, which account for about 94 per cent of total system assets (APRA 2017b). However, the data from these two segments are not directly comparable and this form of aggregation is not desirable (ATO 2015b; Dixon Advisory, sub. 61, p. 4).

As such, APRA-regulated funds and SMSFs are considered separately as the two major components of the broader ‘system’. Further, a rough sense of the performance of the system as a whole can be gleaned by consideration of the two components.

System returns have broadly tracked benchmark portfolios

Over the past 20 years, APRA-regulated funds have generated long-term annual net returns (net of fees² and tax) of 5.7 per cent on an asset-weighted basis (figure 2.2). In real terms, this is equivalent to 3.2 percentage points above CPI. Net returns broadly tracked the benchmark portfolios over the past 12 years and reflect marked dips in performance (in 2008–2009) coinciding with broader economic factors.

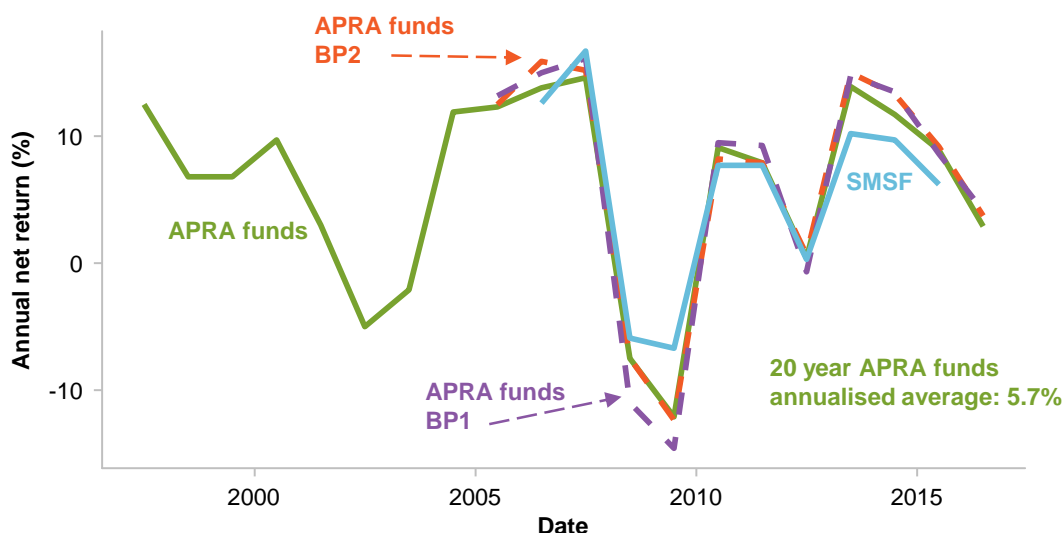
Although the blended (listed and unlisted) benchmark (BP2) generates higher long-term net returns than the listed benchmark (BP1) (figure 2.2), in large part this appears to be attributable to a lower fall in returns during the GFC.

Over the period 2006 to 2015, SMSFs, on average, performed favourably against APRA-regulated funds (and BP1) before and during the GFC, but less favourably since. This is broadly consistent with analysis of APRA-regulated funds and SMSF returns by the Australian Taxation Office (ATO) (2016c) and Rice Warner (2017e). However, caution is needed in comparing returns from the APRA-regulated and SMSF segments, for the reasons set out below.

² APRA returns data is net of reported *expenses* as opposed to fees.

Figure 2.2 **System trends: the system has broadly tracked benchmarks over 12 years^{a,b}**

Benchmarks adjusted for asset allocation, 1997–2016



Sources	PC analysis of APRA (2007, 2017b) data, ATO confidential data and financial market index data (various providers).		
Benchmark Coverage	BP1 and BP2. All APRA-regulated funds after 2004, and only funds with over \$100 million in assets prior to that. SMSFs only for 2006 to 2015.		
Survivor Bias	No.	Selection Bias	No.

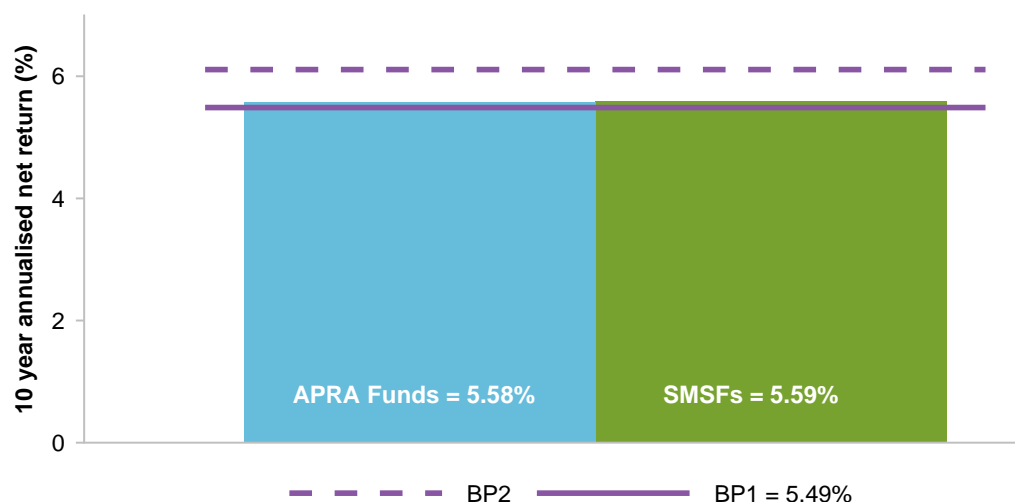
^a In this figure, 'APRA funds' means APRA-regulated funds. ^b Observations pre-2004 are based on APRA's return on assets method. Observations from 2004 are based on APRA's rate of return method. APRA and ATO returns data are not directly comparable as they use different calculations and different data. Attempts to align the calculation methods appear to reduce returns from APRA-regulated funds. Further, ATO asset allocation data does not map to typically used asset classes, and thus does not allow the construction of a benchmark portfolio for the SMSF segment.

Long-term system returns fall below BP2

The performance of the system can also be assessed by measuring the long-term net returns that have been delivered to members (estimated as a long-term geometric weighted average). As illustrated below (figure 2.3), APRA-regulated funds delivered average annual returns (less fees and taxes) of about 5.6 per cent over the 10-year period to 2015 (returns are below the 20-year period discussed above, largely because they exclude more high-return years prior to the GFC). The performance of APRA-regulated funds over this period was commensurate to BP1 and moderately below BP2.

Figure 2.3 Funds in the system: the system delivered returns below BP2 over the past decade, on average^a

Benchmark adjusted for asset allocation, 2006–2015



Sources	PC analysis of APRA confidential data, ATO confidential data and financial market index data (various providers).		
Benchmark Coverage	BP1 and BP2. All APRA-regulated funds and SMSFs. Excludes exempt public sector superannuation schemes, eligible rollover funds and insurance-only superannuation funds.		
Survivor Bias	No.	Selection Bias	No.

^a APRA and ATO returns data are not directly comparable as they use different calculations and different data. ATO asset allocation data does not map to typically used asset classes, and thus does not allow the construction of a benchmark portfolio for the SMSF segment.

Some industry practitioners report fund investment performance over such time horizons gross of administration expenses, arguing this better captures investment performance as administration fees are for a service provided by the fund. The result that APRA-regulated funds deliver returns just under a listed benchmark is not sensitive to assumptions made about reported administration expenses captured in the APRA reporting framework. A gross of reported administration expenses analysis yields a similar result, although with a slightly larger gap between APRA-regulated fund returns and BP1.

The result that APRA-regulated funds, on average, delivered returns below BP2 is consistent across different time periods (including 2008-2015, 2011-2015 and 2005-2016), albeit with small differences subject to the period examined.

SMSFs deliver returns similar to a proxy benchmark

As a whole, SMSFs delivered annual returns (less fees and taxes) of about 5.6 per cent over 2006-2015, similar to an equivalent benchmark used for the APRA-regulated segment for the same 10 year period.

There are differences in asset allocation between these segments, with SMSFs holding a higher proportion in domestic equities, and less in international equities and fixed income products (chapter 7). In part, this may reflect that SMSFs have a greater proportion of assets and members in retirement (chapter 1).

However, in the absence of sufficiently comparable asset allocation data it was not possible to construct a tailored benchmark portfolio for SMSFs. The comparison of SMSF and APRA-fund returns is further complicated by differences in the method used to estimate rates of return in each segment (ATO nd).

Notwithstanding these caveats, the similar performance of SMSFs to APRA-regulated funds over the 10-year period is notable, particularly as some participants examining returns over a shorter time period (such as 7 years) have indicated that SMSFs have significantly underperformed APRA-regulated funds (for example, ISA, sub. 5). The system as a whole is estimated to have delivered net returns of around 5.6 per cent over 2006–2015, though a strong positive relationship between fund size and performance is apparent in the SMSF segment (section 2.4).

The volatility of returns varies

Abnormally low annual returns for even a single year can, through compounding over time, substantially reduce long-term net returns and thus members' balances on retirement. The Commission has thus examined volatility over the long term, which can be a proxy for risk.

There can, however, be challenges in interpreting volatility measures, including across asset classes. For example, the less frequent valuation of unlisted assets in particular (such as unlisted infrastructure and property) may mean that measured volatility for this asset class does not provide a comparable indication of the underlying level of risk in these assets (AMP, stage 1, sub. DR90, p. 4; Chant West 2017).

Both APRA-regulated funds and SMSFs delivered long-term volatility which was lower than the system average asset allocation benchmark portfolios (tech. supp. 4).

Fund-level data have limitations

APRA fund-level data provide a useful starting point for evaluating system-level performance, particularly because they offer full coverage of the APRA-regulated system (and all investment options members are in), unlike any other dataset. Adjusting for asset

allocation and weighting fund-level returns by assets makes use of these data more insightful as a proxy for fund (and system) performance.

Some participants contest the usability of fund-level data. A fund-level return represents an amalgamation of different products and investment options offered by a fund, and is therefore not necessarily reflective of the member experience in a particular product (such as a balanced or growth option). Fund-level data also do not allow for separate consideration of investment performance in the accumulation and retirement segments, which have very different characteristics (APRA 2017c; Chant West 2014). While the Commission has assessed the member-level experience using more granular data, fund-level data is certainly useful when undertaking a system-wide assessment, as the Commission is.

Nonetheless, fund-level returns are a weighted average of product and option-level returns. While no option or member earns the fund-level returns, it is likely that many members earn returns close to the weighted average of option-level returns. Recent research shows that option-level returns are highly correlated with fund-level returns (ISA 2018).

To address some of these issues, the Commission has also drawn on product and investment option-level data that is collected by research firms. However, these data do not have full coverage of the system and are often reliant on voluntary reporting by funds. As such, they are likely to be subject to selection bias (because it is expected that poorer-performing products and options are less likely to be captured in research firms' datasets).

2.3 How have options and asset classes performed?

Members in balanced and growth options are doing well

While option categorisations (asset bands) vary, many members in the system are in some form of diversified investment option categorised as a 'growth' or 'balanced' option, partly because these are commonly the default option offered by funds (Chant West 2017; SuperRatings data) — although the precise number of members in these products is elusive (research firms do not collect these data).

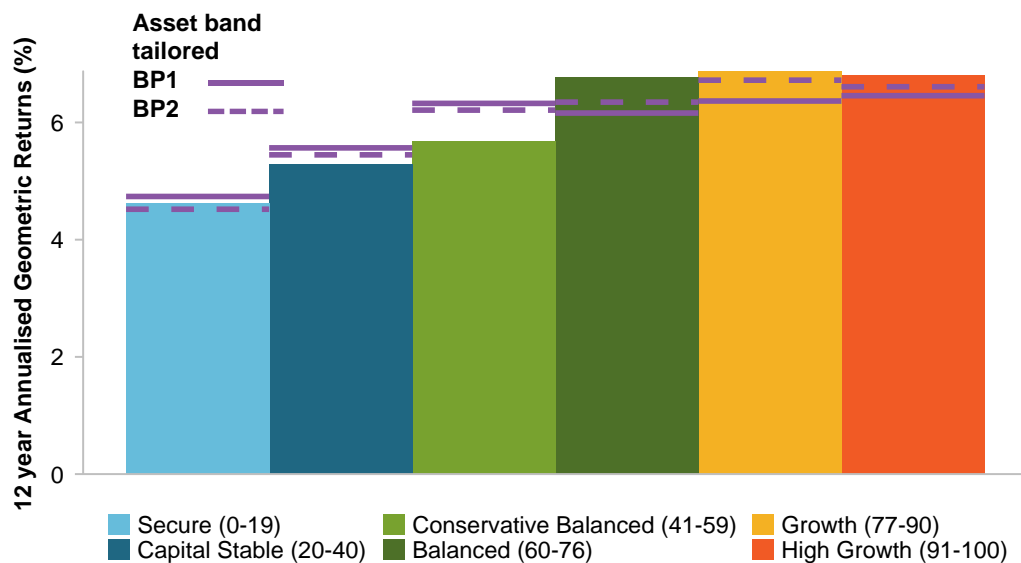
Figure 2.4 shows net returns to a range of types of investment options over 12 years, categorised by their allocations to growth and defensive assets (2005–2016). The similarity in returns for balanced, growth and high growth options likely reflects the time period used. An alternative 5-year view (2012–2016) reveals the expected relationship between risk and return — that is, options with a higher weighting to 'growth assets' yielded higher returns over this shorter time period.

When compared to benchmarks, balanced, growth and high-growth options in the system delivered returns above their asset band tailored BP1 and BP2 on average over the period examined (with much variation across funds and products (section 2.5)). However, the performance of conservative options was not as favourable. Secure options performed above their asset band tailored BP2 (but not BP1), while the returns of capital stable and

conservative balanced options fell below both their asset band tailored benchmarks. To some extent these weaker results may reflect higher implied tax rates for these products (due to lower exposure to imputation credits) and the way taxation has been incorporated into the benchmarks (tech. supp. 4).

Figure 2.4 Options by asset band: balanced and growth options beat benchmarks^{a,b}

Benchmark adjusted for asset allocation, 2005–2016



Sources	PC analysis of APRA confidential data, financial market index data (various providers) and SuperRatings data.
Benchmark	Asset-band tailored BP1, BP2.
Coverage^c	Accumulation options from APRA-regulated funds. In 2004-05, the figure represents up to 61% of total assets and 64% of member accounts of APRA-regulated funds. In 2015-16, the figure represents up to 91% of total assets and 92% of member accounts of APRA-regulated funds.
Survivor Bias	No.
Selection Bias	Yes.

^a Net returns are estimated less investment fees, taxes and implicit asset based administration fees. This means that some options may be reported gross of asset based administration fees. To be conservative the Commission's benchmark portfolios are adjusted assuming all options are net of asset based administration fees. ^b The option type categories have been taken as given from SuperRatings data. ^c These coverage estimates are likely to be overestimates due to the estimation method (tech. supp. 4).

These results are somewhat sensitive to the time period considered, with most option types (including balanced, growth and high growth options) performing under their benchmarks over the shorter 5-year period.

Nevertheless, these results generally paint a more positive picture of average system performance than the fund-level results in section 2.2, where the system of APRA-regulated funds delivered returns below both benchmarks. To some extent, this can be explained by

the presence of selection bias (as options reported in research firm data would tend to be from larger, better performing funds). The results may also be driven by differences in how option-level and fund-level returns data are calculated. Nevertheless, the results support the view that many members are doing *relatively* well in the superannuation system if they are in a diversified investment option.

That said, there can be limitations with categorising options based on their split between growth and defensive assets as individual assets within an asset class could have quite different risk-return profiles. For example, some assets classed as ‘defensive’, such as fixed income products, could in fact have risk-return properties more typically associated with a growth asset (NAB wealth, sub. 63, p. 27). In the absence of an agreed industry standard on the categorisation of particular assets, these decisions are typically left to trustees. Moreover, options listed within the same asset allocation ‘band’ could be quite dispersed across the growth–defensive spectrum.

Overall, the volatility of returns to each option category is broadly in line with expectations. That is, options with higher allocations to growth assets (such as ‘high growth’ options) exhibit higher levels of volatility. On the downside, investment options with higher volatility create additional risks for some members, depending on how close they are to retirement, while missed opportunities on the upside can leave growth ‘on the table’. These issues, and how they are balanced in product design, are explored in chapter 4. Notably, the returns delivered to most types of options exhibited less volatility than returns to both benchmarks (BP1 and BP2).

Analysis by asset class was not possible

Another way of examining the performance of the system, or at least of APRA-regulated funds, is to consider returns at the asset-class level, as anticipated in the Commission’s stage 1 study. Asset-class comparisons offer the most ‘like-for-like’ comparisons with benchmarks. Further, examining index returns of asset classes allows for an understanding of the outcomes of benchmarks and some of the drivers of the Commission’s results, and importantly affords an assessment using international comparisons.

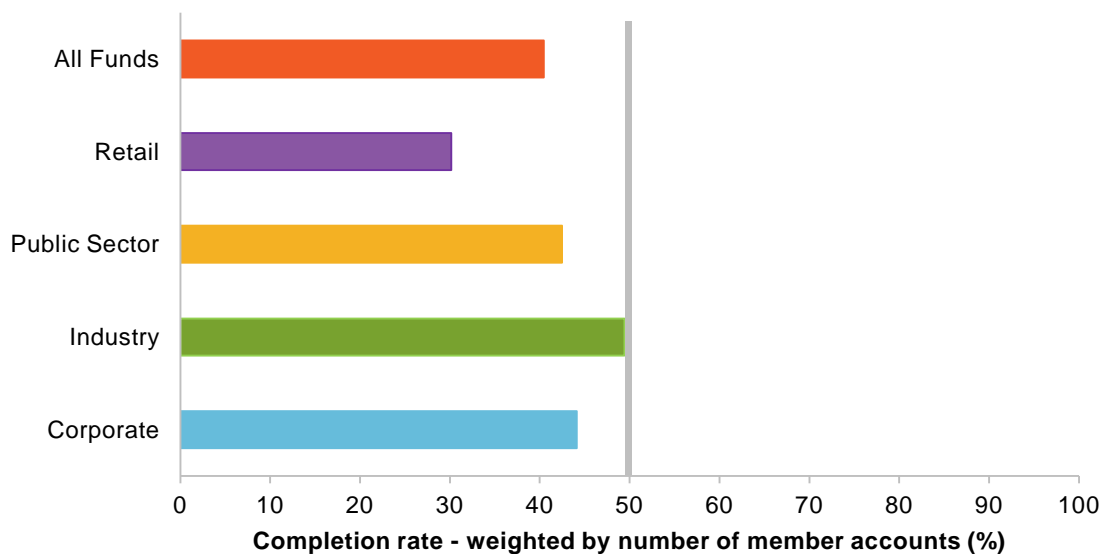
In the stage 1 consultation process, some participants such as Mercer (stage 1, sub. DR104, p. 61) and APRA (stage 1, sub. DR111, p. 5) noted that the lack of data would make asset-class benchmarking difficult to implement. There was, however, some support for this approach at a conceptual level. AIST (sub. 39, p. 68) indicated that asset class benchmarking is commonly undertaken by industry, and PWC (sub. 62, p. 4) even suggested more value should be placed on this analysis than a system or segment level view. The Commission concurs that there is much interpretive value to be gleaned from comparing net investment returns by asset class across the system, and then internationally.

The main difficulty in implementing this comparison is that asset class-level returns are typically not publicly available across the system. The Commission’s funds survey (appendix C) sought to collect these data from funds to allow for a comparison of the

system’s performance at an asset-class level against the indexes used to construct the benchmarks, as well as against returns achieved by pension funds in other countries at an asset-class level.

But this was not possible due to poor response rates to the funds survey. Disappointingly, most funds surveyed did not provide asset class returns, and in many cases those who did only covered relatively short time periods. Only five funds provided data for all 14 asset classes in 2016-17, and 60 funds provided nil responses. The overall completion rate (by year–asset class cells) was only 25 per cent, and when funds are weighted by number of member accounts, about 40 per cent (figure 2.5). The completion rate was materially lower for retail funds, with only a 30 per cent completion rate when weighted by member accounts (no fund provided data across all asset classes), compared to almost 50 per cent for industry funds.

Figure 2.5 Investment returns by asset class: survey weighted completion rates



Nonetheless, the survey results for those funds that did provide adequate responses are presented in the technical supplement. These results suggest that funds delivered mixed performance in asset class returns relative to indexes and the performance of pension funds in other countries.

2.4 How have different segments performed?

While system-level analysis provides useful context, it potentially masks significant differences in outcomes across segments — such as the default, choice, accumulation and

retirement segments — which have distinct characteristics (PC 2016, p. 80; ASFA, sub. 47, p. 7; SMSF Association, sub. 67, p. 8; AIST, sub. 39, p. 29). This section considers the performance of particular segments of the superannuation system.

The default and choice segments have different asset allocation profiles, with typically higher allocations in the default segment to ‘growth’ assets. Similarly, asset allocation in the retirement segment is also typically more conservative than the accumulation segment, and the taxation arrangements that apply to earnings are different in these phases.

To account for these differences, the Commission has tailored benchmark portfolios to reflect the average asset allocation in each segment, in each relevant annual period. This is designed to, as far as possible (data limitations notwithstanding), mitigate the effects of systematic differences in performance across segments due to differences in asset allocation. As such, a segment’s performance should be compared to its respective tailored benchmark portfolios.

Analysis of default, choice, accumulation and retirement segment performance relies on research firm data (APRA data do not provide returns for these segments in isolation, with the exception of MySuper products since 2013). Given the potential for (positive) selection bias in research firm data (reflecting incomplete coverage), this means that the results do not necessarily accord with analysis based on APRA data.

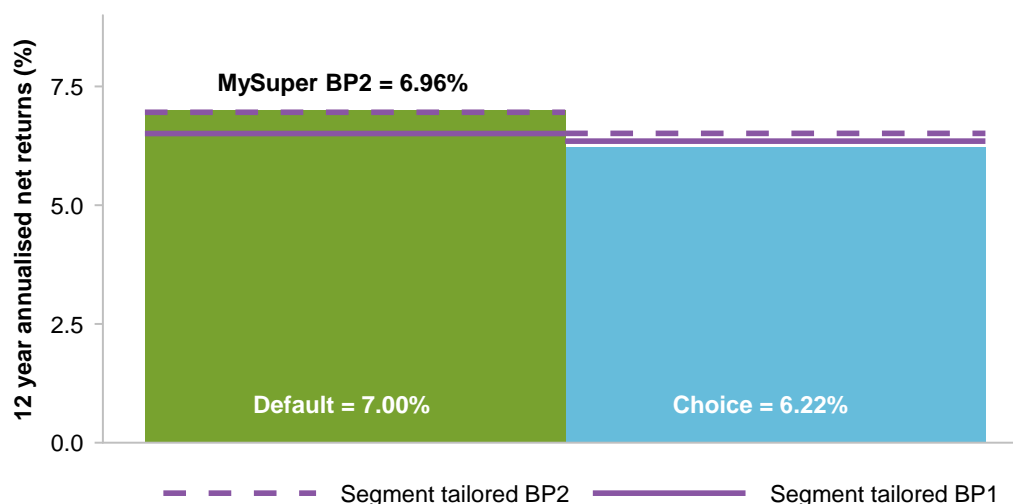
The default and choice segments

Many members rely on default arrangements to allocate them to good products. The default segment comprises one-quarter of assets in the system and, importantly, half of member accounts in APRA-regulated funds. Approximately two-thirds of members use the default selected by their employer on starting a new job (APRA 2017a; Colmar Brunton 2010; Delpachitra and Rafizadeh 2014; PC 2017a). The performance of the default segment therefore matters from the perspective of a large proportion of (largely disengaged) members, particularly those entering the workforce.

In many ways, the choice segment is inherently different to the default segment. On the demand side, members are more likely to have exercised some level of choice about the product or option they are invested in. On the supply side, the products on offer are more heterogeneous, and some provide flexibility to adjust the mix of assets in the portfolio, such as through the use of platforms. As such, trustees may have less direct control over the asset mix ultimately selected by choice members (Rice Warner, sub. 56).

Nevertheless, the performance of the choice segment is vital to an overall picture of system efficiency. Excluding SMSFs, the choice segment accounts for 58 per cent of total assets and 40 per cent of member accounts (chapter 1). And, ultimately, trustees remain responsible for designing and offering products that meet the best interests of their members (AIST, sub. 39, p. 29, chapters 4 and 9).

Figure 2.6 **Products by segment: default beats choice and just beats some benchmarks, *but* selection bias materially lifts results^a**
Benchmark adjusted for asset allocation, 2005–2016



Sources	PC analysis of SuperRatings data and financial market index data (various providers).	
Benchmark	Segment tailored BP1, BP2.	
Coverage^b	Accumulation options from APRA-regulated funds: In 2004-05, the figure represents up to 61% of total assets and 64% of member accounts of APRA-regulated funds In 2015-16, the figure represents up to 91% of total assets and < 92% of member accounts of APRA-regulated funds.	
Survivor Bias	No.	Selection Bias Yes.

^a Technical supplement 4 presents a similar figure with the broader definition of default (including default investment options). Overall results are similar when looking at the Rainmaker sample (tech. supp. 4). Current MySuper products were connected with pre-cursors with the support of SuperRatings where requested. ^b These coverage estimates are likely to be overestimates due to the estimation method (tech. supp. 4).

Over the 12 years to 2016, the default segment (which includes only MySuper products and their direct predecessors) — defined in this context as all MySuper products and their precursors — generated returns above segment tailored BP1 and consistent with BP2 (figure 2.6). This segment’s relatively good average performance was noted by several inquiry participants (for example ISA, sub. 5, p. 4; AustralianSuper, sub. 43, p. 19; AMP, sub. 80, p. 4).

The choice segment (excluding SMSFs) performed slightly less than both segment tailored BP1 and BP2. Participants did not typically express views on the performance of the *entire* choice segment (including all types of funds), and instead focused on underperformance within choice, the performance of retail funds, or member outcomes on switching into choice products offered by retail funds (Cbus, sub. 58, p. 3; ISA sub. 5, p. 5; ISA sub. 87).

The results for the MySuper segment differ from earlier results on the system of APRA-regulated funds, where performance was commensurate with BP1 and below BP2 (figure 2.3). This can likely be explained by several factors.

- First, results at the segment level need to be treated with more than a modicum of caution given the dataset used is based on a subset of default and choice investment options in the system, where the presence of positive selection bias skews the results upwards. For example, the estimated returns to APRA-regulated funds are 0.7 per cent higher in this dataset than in APRA data (box 2.1).
- Second, returns are measured at the fund-level and product-level using different methodologies, and are somewhat sensitive to the time period considered. For example, over a 5-year period (2012–2016) the default and choice segments perform below both their segment tailored BP1 and BP2.

Taking averages over particular segments masks a diverse range of products and fund types. For example, assets in the choice segment are evenly split between for-profit and not-for-profit funds (chapter 1). This suggests that other segmentations should be considered, such as by fund types.

For-profit and not-for-profit funds — a systematic performance divide

Many participants commented on the performance divide between not-for-profit and for-profit funds (or the more narrow comparison of industry and retail funds) as a group. Different reasons were provided as to the magnitude of any differences in performance, and the underlying reasons (box 2.3).

The Commission’s analysis indicates that, over the 12 years to 2016, not-for-profit funds generated materially higher net returns than for-profit funds when viewed at an overall fund level. To enable more like-for-like comparisons — and account for the relatively more conservative asset allocation of for-profit funds — benchmark portfolios tailored to each segment’s average asset allocation were constructed to take into account systematic differences in asset allocation between for-profit and not-for-profit funds.

Once these systematic differences in asset allocation are accounted for (to the extent possible), not-for-profit funds perform above their segment-tailored benchmarks and the performance of for-profit funds collectively (on average) falls below their segment-tailored benchmarks (figure 2.7). Performance of the segments relative to benchmarks appears worse over shorter time periods, including the 5 and 8 year periods up to 2016. The results are robust to the way asset allocation was estimated prior to 2014 and alternative tax assumptions (box 2.1).

Box 2.3 **Participants' views on the performance gap between not-for-profit and for-profit funds**

Several participants argued that a performance gap arises from fundamental differences in incentives and governance structures between retail and not-for-profit funds (ISA sub. 5, p. 1). Several others pointed to differences in asset allocation (and greater exposure by industry funds due to unlisted assets because of more certainty over inflows due to being default-listed funds in awards) as the driving explanatory factor (for example, BT sub. 32, p. 3).

ISA (sub. 59) submitted that over the 10-year period to May 2017, not-for-profit funds generated net returns of 5.3 per cent compared to retail funds 3.5 per cent (a gap of 1.8 percentage points). In an earlier comparison, Industry Super Australia (2016) indicated that the not-for-profit funds generated returns of 2.2 per cent above retail funds over the 10 year period to March 2016. ISA and several other participants argued that the performance divide can be explained by retail funds being for-profit entities (for example, Cbus sub. 58, p. 3; AustralianSuper sub. 43 p. 8; Vision Super sub. 30, p. 6).

However, Chant West (2016b) noted that this analysis failed to account for systematic differences in the way that industry and retail funds report their returns. In particular, many retail funds have legacy products (now closed to new members) that deduct adviser commissions (as well as investment fees, taxes, and administration fees) to calculate net returns. Once these differences are accounted for, Chant West's analysis identified a gap of 0.9 percentage points over 10 years.

In more recent research, ISA demonstrated the divide in performance using option-level data and some distributional analyses. It found that the 25th percentile of annualised 10-year returns to cash options in industry funds' retirement accounts was higher than the 75th percentile for the same types of options in retail funds (ISA 2018). Further, ISA commissioned research by Sy (2018) found that asset allocation was unlikely to explain the lower performance of retail funds, instead attributing the performance to differences in cost structures.

Chant West (2017) undertook analysis of 'growth' options (61–80 per cent growth assets) over the past 5, 10 and 15 years to 2017 (unlike other analyses, this was net of investment fees and taxes, but not administration fees). The analysis found that industry funds outperformed retail funds by 0.8 per cent over the previous 10 years, and 0.9 per cent over the previous 15 years. Chant West attributed this result to the fact that industry funds as a group have had higher long-term exposure to unlisted assets (on average 20 per cent of their growth options compared to 5 per cent in the case of retail funds), partly because they have more certainty of inflows due to being default listed funds in awards.

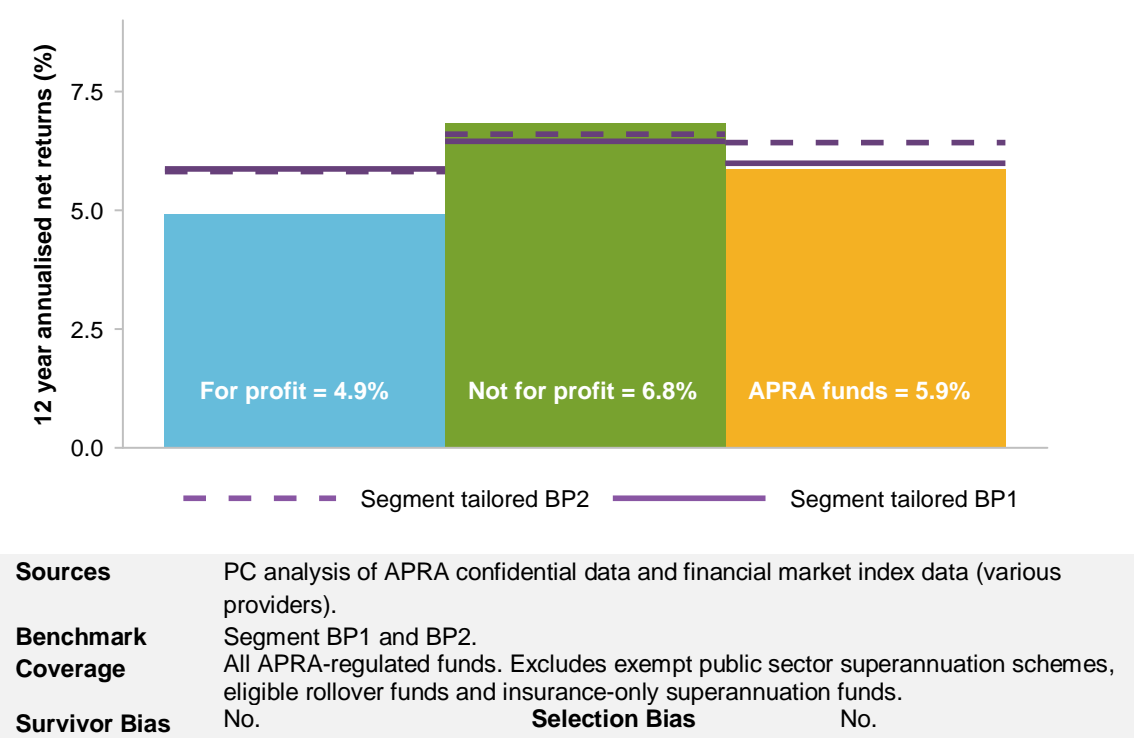
This is not to say that individual funds of both types have not beaten benchmarks — several of both types have — and this is explored further in section 2.5 in the assessment of the all-important distribution of performance across funds and products, which best captures the real experience of members.

The above results suggests that — despite accounting for differences in asset allocation as far as possible — there is still a clear performance divide, with not-for-profit funds clearly outperforming for-profit funds.³

³ As returns as asset-weighted, small funds in each segment have a limited impact on the Commission's results.

The Commission also examined whether the observed difference in performance between not-for-profit and for-profit funds is likely to be explained by differences in administration expenses. To examine this issue, the analysis was also undertaken on net of investment fees and taxes, but not reported administration expenses. This analysis suggests that reported administration expenses explain a small part of the observed differences, but the overall result does not change (tech. supp. 4).

Figure 2.7 Fund-type segments: not-for-profit funds outperform their benchmarks on average
Benchmark adjusted for asset allocation, 2005–2016



A performance divide between for-profit and not-for-profit funds is also apparent in the Commission’s analysis of SuperRatings and Rainmaker option-level data, segmented by both fund type and asset allocation for the various types of diversified options available to members (and only considering investment options that are ‘open’, to remove the impact of legacy options). However, the gap between estimated option-level returns and the asset band tailored benchmarks is generally smaller than that which is observed at the overall fund-level.

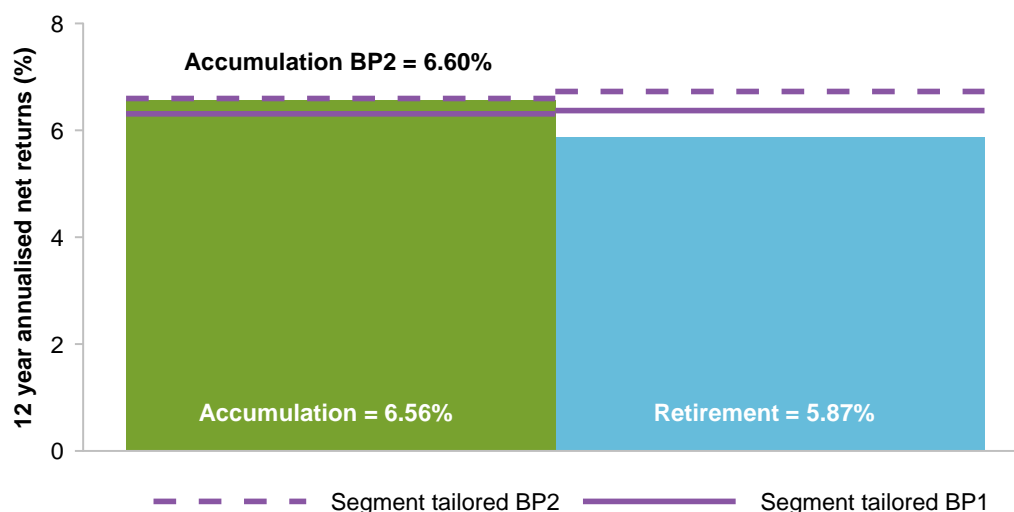
The accumulation and retirement segments

The main purpose of most accumulation products is to grow balances for members' retirement. Retirement products, on the other hand, typically adopt relatively more conservative investment strategies to reduce the risk of losses (SMSF association, sub. 67, p. 8; Rice Warner, sub. DR112, p. 27; chapter 4).

Over the 12 years to 2016, the accumulation segment performed above its segment tailored BP1 but just below BP2. By contrast, the retirement segment performed below both its segment tailored BP1 and BP2 (figure 2.8). However, these results vary significantly depending on the time period considered. For example, in the 8 years following the GFC (2009–2016), the retirement segment performed above accumulation and both segment-tailored benchmarks. Notably, the retirement segment has lower realised volatility of returns compared to the accumulation segment, which is consistent with a more conservative asset allocation.

Figure 2.8 Products by segment: the retirement segment performed below its benchmarks^a

Benchmark adjusted for asset allocation, 2005–2016



Sources	PC analysis of SuperRatings data and financial market index data (various providers).		
Benchmark	Segment tailored BP1, BP2.		
Coverage^b	Accumulation options from APRA-regulated funds: In 2004-05, the figure represents up to 61% of total assets and 64% of member accounts of APRA-regulated funds In 2015-16, the figure represents up to 91% of total assets and < 92% of member accounts of APRA-regulated funds		
Survivor Bias	No.	Selection Bias	Yes.

^a Overall results are similar when looking at the Rainmaker sample. ^b These coverage estimates are likely to be overestimates due to the estimation method (tech. supp. 4).

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APRA-regulated funds have delivered investment returns to members over the past two decades (net of all fees and taxes) of 5.7 per cent a year, on average. The majority of members and assets in the system are in products that have performed reasonably well. But there is significant variation in performance within and across segments of the system which is not fully explained by differences in asset allocation. Not-for-profit funds, as a group, have systematically outperformed for-profit funds. While retail funds dominate the ‘tail’ of underperformance, industry and corporate funds also reside in the tail.

2.5 What is the variation in performance within the system and segments?

Assessing the performance of system and segment averages provides an important check on the overall efficiency of the superannuation system. However, averages hide significant variation in performance within the system and particular segments — which is what matters most for the experience of members. It also provides a key insight into the competitive dynamics of the system.

As such, the Commission has analysed distributional outcomes within the system and segments to ascertain the level of persistent under- and overperformance by funds and products compared to the benchmarks. This section considers distributional outcomes over time and across all funds (using fund-level data) before focusing on the default and choice segments (using product-level data).

There is evidence of an underperforming tail of funds

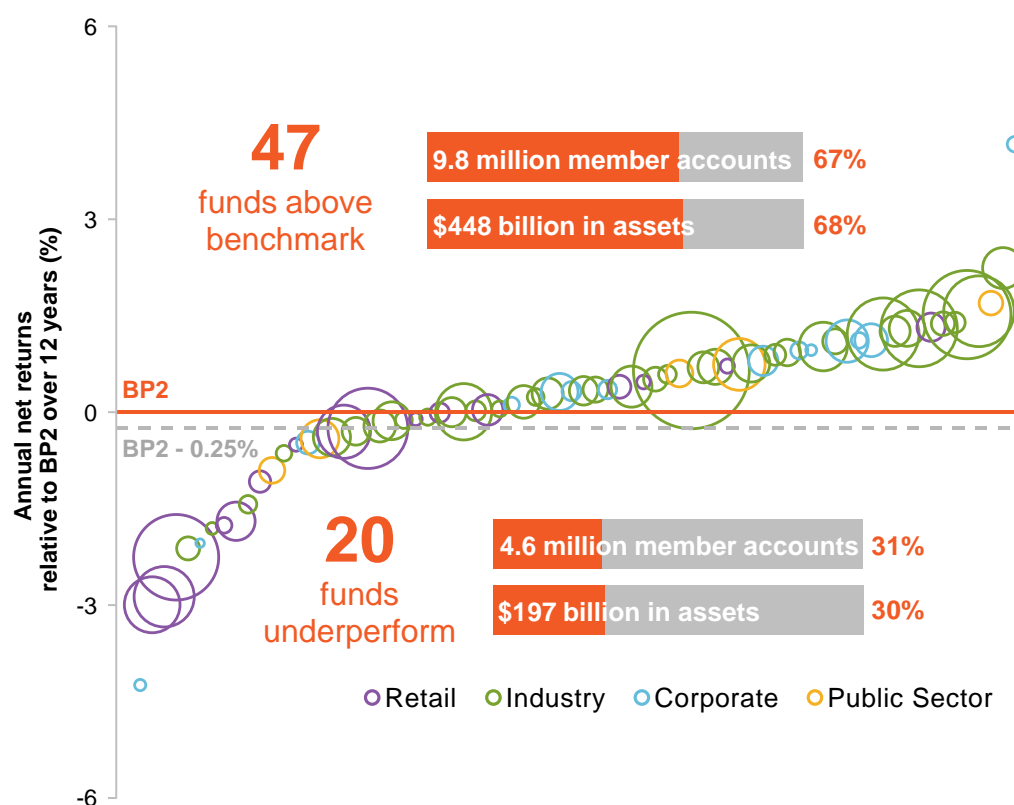
The Commission analysed the performance of all APRA-regulated funds over the 12-year period to 2016. Due to limited asset allocation data prior to 2014, assumptions had to be made based on MySuper data, meaning that this analysis only covers funds that provided a MySuper product at June 2016 (tech. supp. 4). The limited sample means the results need to be carefully interpreted. The funds represented are more likely to be industry funds and less likely to be retail funds.

Collectively, the funds in this analysis represent half of all member accounts (14.6 million accounts) and about a third of system assets (\$664 billion). When compared to a benchmark portfolio tailored to each fund’s asset allocation (BP2), approximately 27 per cent of funds (some 20 funds) underperformed their tailored benchmark portfolio — where underperformance is 0.25 percentage points or more under the benchmark (figure 2.9). These funds represented 30 per cent of assets and 31 per cent of member accounts in this sample.

Figure 2.9 **Individual funds (with MySuper products): nearly 5 million accounts are in underperforming funds**

Performance relative to individual funds' benchmark portfolios, 2005–2016

Size of circles indicates the size of each fund's assets under management



Sources	PC analysis of APRA confidential data and financial market index data (various providers).
Benchmark	Fund tailored BP2.
Coverage	All APRA-regulated funds with a MySuper product in the dataset over the full period (52% of assets and 61% of member accounts in all APRA-regulated funds with a MySuper product in 2016). Over the whole system, the figure represents 74 funds, 32% of assets and 50% of member accounts in 2016.
Survivor bias	Yes.
Selection bias	Yes.
Further results	Seven funds performed less than 0.25 percentage points below BP2 (262 000 member accounts and \$18.8 billion in assets).

By all measures, retail funds are overrepresented in the tail relative to other types of funds. Of the 20 underperforming funds, 9 are retail, 6 are industry, 3 are corporate and 2 are public sector. Put another way, 56 per cent of retail funds (in this sample) underperformed, compared with 15 per cent of industry funds, 21 per cent of corporate funds and 40 per cent of public sector funds.

On the other hand, two-thirds of accounts and assets (67 and 68 per cent, respectively) in this sample are in funds that perform above their tailored benchmark, many of these are large not-for-profit funds.

An alternative adjustment is to assume a static asset allocation over the period based on each fund's 2016 asset allocation. This analysis is presented in the technical supplement and captures a much larger proportion of the super system (over \$1 trillion in assets and 20 million member accounts). Though this assumption is less robust, the analysis reveals a much larger proportion of underperforming assets and accounts (51 and 53 per cent, respectively), suggesting that there may be many underperforming funds that do not offer a MySuper product (and thus are not captured in figure 2.9). Retail funds continue to be over-represented in the tail of underperforming funds in this analysis.

Larger funds appear to do somewhat better, but not always

In terms of size, the median underperforming fund in figure 2.9 has \$2.3 billion in total assets, suggesting that a large proportion of such funds are small. However, some large funds also underperformed. For example, while the median size of funds beating their benchmark was \$3.5 billion, 25 per cent of underperforming funds hold more than \$10 billion in assets, whereas 19 per cent of underperforming funds larger than \$10 billion beat their tailored benchmark. This suggests that there is not always a consistent relationship between performance and scale.

To examine this issue more closely, the Commission analysed the relationship between returns and fund size (left panel, figure 2.10). There are some indications of a positive relationship between fund size and long-term net returns at the fund-level, particularly for industry funds, but it is not a conclusive relationship. This finding is consistent with Cummings (2016), which found that fund size had a positive impact on the performance of not-for-profit funds (evident both in gross returns and expenses) but not for retail funds.

However, the Commission's regression analysis indicates that the relationship is not statistically significant for all fund types. And survivor bias is likely to be an issue — small funds which were underperforming over the period may have dropped out of the sample (discussed below).

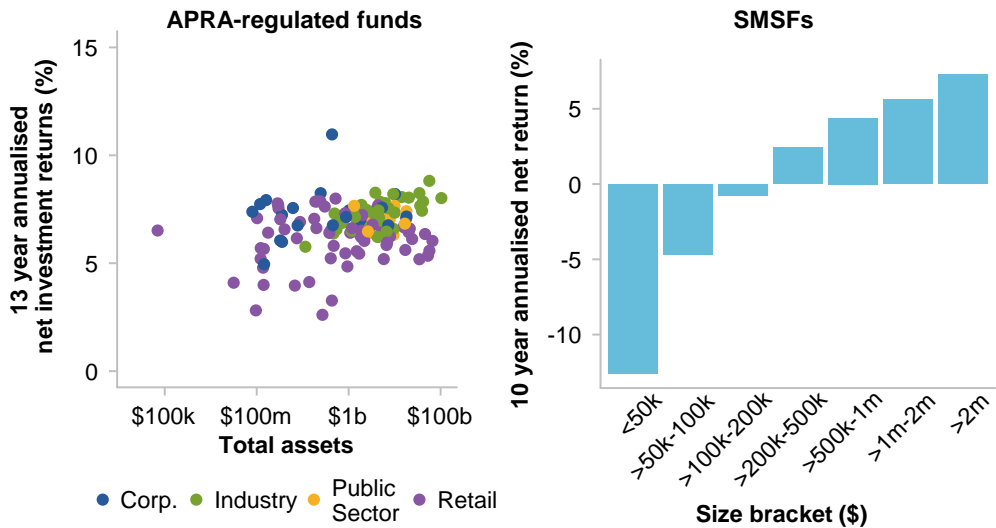
Hence, there is some uncertainty in interpreting the results. The Commission's preliminary analysis of economies of scale suggests that many funds which have grown in size have not been able to achieve scale benefits by reducing their average costs (chapter 7). Results in this chapter suggest that while *some* large funds (particularly industry funds) may have been able to achieve economies of scale benefits through higher-cost investment strategies delivering higher returns, this is unlikely to be the case for all funds, nor is it consistent with the fact that some small funds have been able to deliver strong performance.

If many funds have not been able to achieve scale benefits by reducing their average costs — and few have achieved this through delivering higher returns through higher-cost

investment strategies — this could be a sign of a lack of competitive pressure in the system. The Commission is looking to explore these issues further as it continues its economies of scale analysis with a technical supplement to be released following this draft report.

The lack of a size–returns relationship among APRA-regulated funds contrasts starkly to a clear size–returns relationship in the SMSF segment (right panel, figure 2.10), which is consistent with ATO findings (ATO 2016c). Larger SMSFs have consistently delivered higher net returns over the period 2006–2015, compared to smaller SMSFs.

Figure 2.10 Relationship between fund size and returns: clear for SMSFs but less clear for APRA-regulated funds
2004–2016 (APRA-regulated funds) and 2006–2015 (SMSFs)



Sources	PC analysis of APRA confidential data and ATO confidential data.		
Coverage	All APRA-regulated funds and all SMSFs. Excludes exempt public sector superannuation schemes, eligible rollover funds and insurance-only superannuation funds.		
Survivor Bias	Yes.	Selection Bias	Yes.

However, these results need to be interpreted with some caution. As noted above, ATO data reporting practices mean upfront SMSF establishment costs are embedded in the operating costs, which can detract from measured net returns, even though they reflect capital expenditure (SMSF Association, sub. 67). This will particularly affect newly established SMSF funds (typically with low balances). Moreover, lower returns to SMSFs are only likely to be problematic if they are experienced over a period of multiple years (which may not occur once upfront costs have already been incurred and balances grow over time).

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The SMSF segment has broadly tracked the long-term investment performance of the APRA-regulated segment on average, but many smaller SMSFs (those with balances under \$1 million) have delivered materially lower returns on average than larger SMSFs. The difference between returns from the smallest SMSFs (with less than \$50 000) and the largest (with over \$2 million) exceeds 10 percentage points a year.

Under and overperformance can persist

The net returns achieved by funds can be influenced by many factors, some of which are outside trustees' control, such as asset-price cycles. These may affect funds differently depending on their investment strategy.

Nevertheless, over a long time period, it is relevant to consider whether there is evidence of persistence in funds performing near the top of their peers, and near the bottom. Assessing funds' performance relative to their peers is a useful exercise for at least two reasons. First, cross-sectional dispersion and longitudinal persistence (or lack thereof) can both be indicative of the level of competitive pressure in the system (chapter 7). Second, assessing funds' relative performance also allows for an observation of whether assets and accounts are disproportionately distributed in relatively good or poor performing funds.

Assessing relative fund performance as average returns over rolling five-year periods illustrates that there is some performance persistence over time. As at June 2016, there were 11 active funds that were persistently in the top quartile on investment performance, and 15 in the bottom quartile (over the previous 13 years). The funds persistently in the top are across an even spread of fund types, while those in the bottom are all retail funds. There are also noticeable differences in size — funds persistently in the top quartile had an average of \$15 billion and 131 000 in assets and accounts, compared to \$445 million and 9500 for the bottom quartile.

This persistence in performance can have a material impact on members' balances. The Commission's cameo model suggests that a member receiving the median long-term return for a bottom quartile fund could have 53 per cent less (\$635 000) at retirement, compared to a member receiving the median long-term return for a top quartile fund (cameo 2.2).

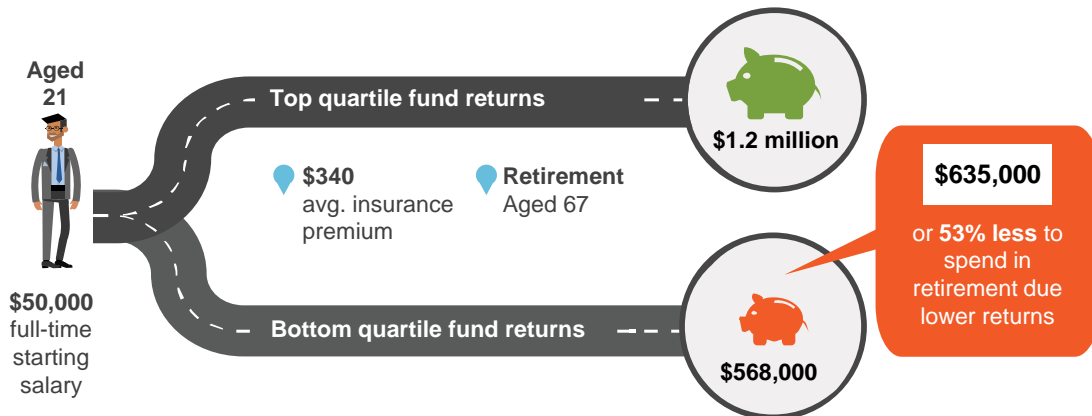
This relative performance difference may also be partially explained by differences in risk profile of funds. On average, funds that were persistently in the top quartile (and still in existence) had an additional 10 percentage point allocation to growth assets compared to those that were persistently in the bottom quartile.

However, a key caveat affecting these results is that a degree of merger activity has occurred since 2005, although it is not clear which way the resulting survivor bias would skew the results. While 25 funds that were persistently in the bottom quartile exited during the time

period under observation, 22 funds that were persistently in the top quartile also exited (mostly corporate funds) (chapter 7).

Cameo 2.2 Underperformance compounds to substantially lower retirement balances

Super problem: Underperforming fund = 13 years' lost pay



^a The assumptions underpinning this cameo are set out in chapter 1.

Performance varies in the default segment

The default segment is difficult to analyse for the key reason that the MySuper regime represents a significant 'break' in these data. For nearly half of the current MySuper products, there are no data available on a precursor product (if there was one) prior to the MySuper reforms commencing in 2013. Therefore, comprehensive product-level analysis is constrained to just three years of data. However, the Commission has conducted a longer-term analysis of a sub-sample of products using research firm data, which identified precursor products and thus provided a 10-year time horizon for performance in the default segment. Importantly, the sub-sample represents most MySuper assets and member accounts (over 73 per cent).

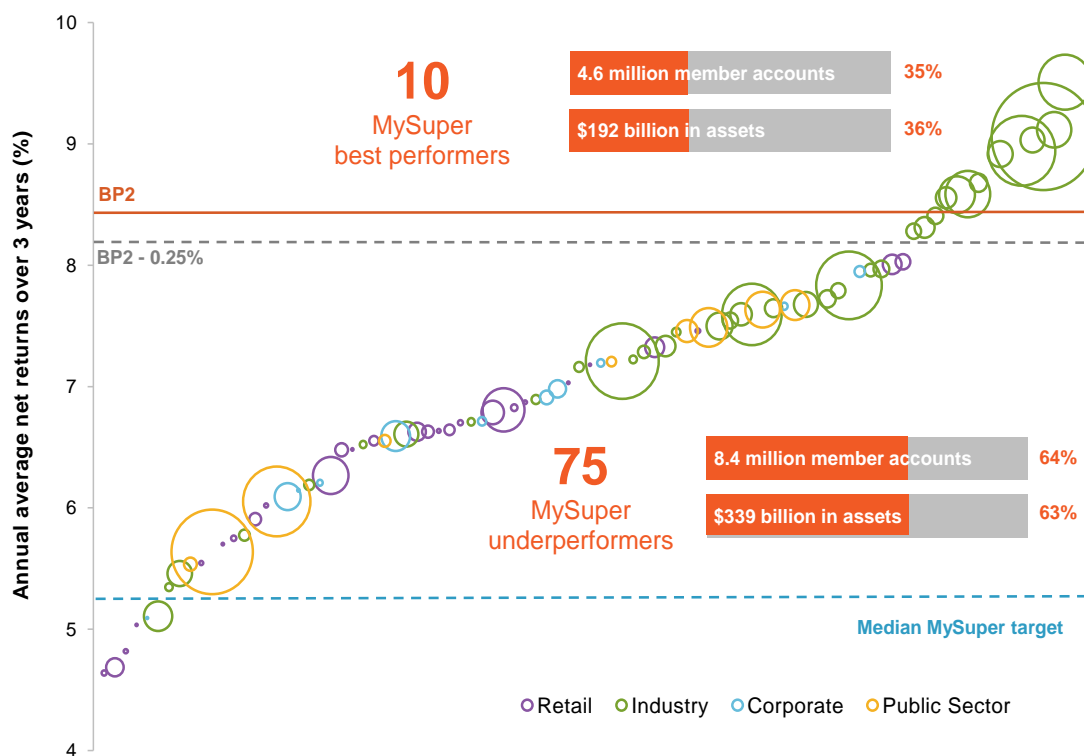
There is a significant spread of performance among MySuper products

The first analysis is only for returns across three years and therefore needs to be viewed with caution as it is investment performance over the longer term that matters most and is of robust interpretive value. Despite this, short-term outcomes can be still be informative, particularly on the question of dispersion, given the near-completeness of the MySuper data (figure 2.11).

Figure 2.11 MySuper short-term performance: many MySuper products have underperformed in the short term^{a,b}

Performance relative to a MySuper benchmark portfolio, 2014–2017.

Size of circles indicates the size of each product's assets under management



Sources	PC analysis of ABS data (<i>Consumer Price Index, Australia, June 2017</i> , Cat. no. 6401.0), APRA (2017a, 2017c) data, financial market index data (various providers) and SuperRatings data.
Benchmark Coverage	BP2 and median MySuper target. 90 of 111 MySuper products active as at June 2017 representing 85% of current MySuper assets (\$537b) and 87% of current MySuper accounts (13.2m). 87 of these products are currently active (three corporate products from June 2017 data do not appear in the latest (December 2017) data.
Survivor bias	Yes.
Selection bias	Yes.
Further results	Three MySuper products performed less than 0.25 percentage points below BP2. Six products underperformed the median MySuper target — mostly small retail products — representing \$9 billion in assets and 185 000 in accounts.

^a Life-cycle product returns are derived from the weighted average returns to individual stages. ^b Analysing this series gross of administration fees does not materially alter the results relative to the benchmark.

Over the short term, 75 of the 90 MySuper products in the sample underperformed — defined here as performance 0.25 percentage points or more below a BP2 benchmark tailored to the average asset allocation of all MySuper products (on the basis that default members do not tailor their asset allocation themselves). These underperforming MySuper products yielded a median net return of 6.8 per cent a year, and include all 17 of the life-cycle products in the sample.

At the other end, the top 10 products were all single-strategy industry fund products. They produced a median annual net return of 8.9 per cent. On average, these products were much larger than those that underperformed, with average assets and accounts of \$16 billion and 380 000 respectively, compared to \$4.5 billion and 112 000, respectively for the underperformers.

Differences in risk do not explain the dispersion in performance

Some variation in performance is to be expected in the default segment, reflecting the different risk profiles associated with more conservative or growth-oriented asset allocations. However, there is no obvious rationale for having a significant dispersion in risk profile among default members. A simple balanced portfolio is likely to maximise lifetime returns (chapter 4).

The relationship between risk (as measured by the percentage of assets categorised as ‘growth’) and net returns is weak for MySuper products over the three years to June 2017 (a correlation coefficient of 0.1) (figure 2.12). However, these results may be subject to random variation. As the MySuper regime matures, a longer time series may see the relationship between risk and return strengthen.

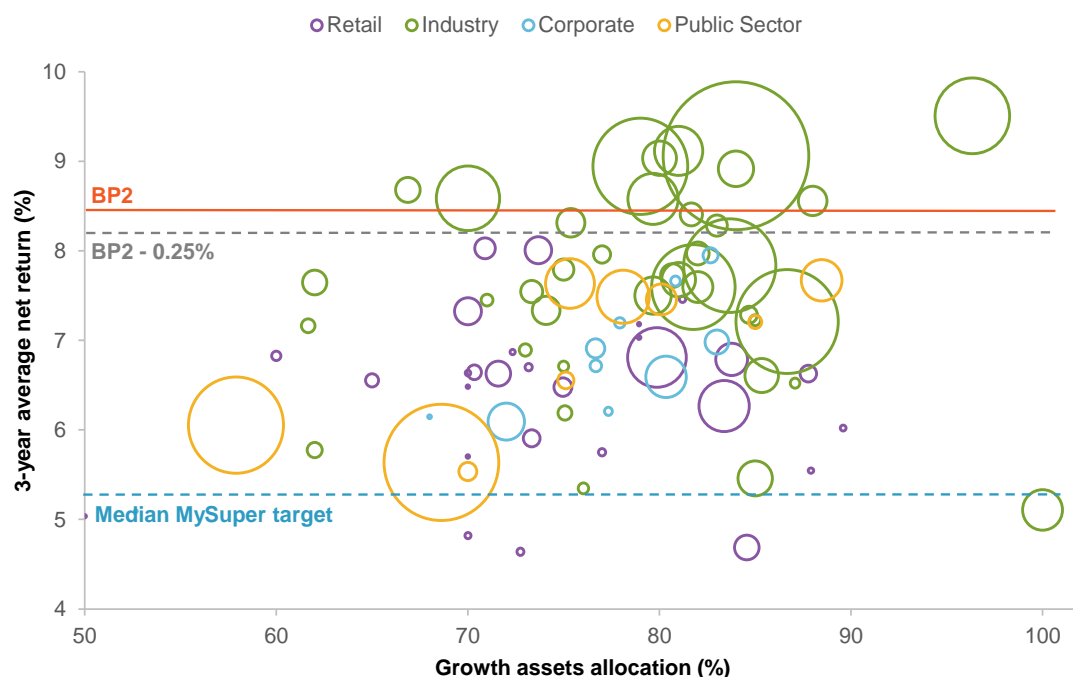
The dispersion of performance is also evident over the longer term

The short time series of MySuper data can be overcome by using research firm data covering a longer time period (in this case, SuperRatings). However, this comes with the key limitation of a smaller sample, given not all current MySuper products have direct precursor products from the pre-MySuper era. Further, these data also likely suffer from upward selection and survivor biases — better products are both more likely to have reported to SuperRatings and to have survived for at least 10 years.

Nonetheless, the SuperRatings 10-year sample of current MySuper products and connected precursors still represents over half of all current products, and nearly three-quarters of current assets and accounts. Therefore, the results of this analysis are likely to be broadly indicative of a typical default member’s long-term experience (figure 2.13).

Overall, 26 of the 66 products in the sample underperformed BP2 by at least 0.25 percentage points. These include eight (of the 15 in the sample) life-cycle products. Twelve of the 26 underperforming products were retail fund products (of 14 in the sample), with the remaining being 10 (of 36) industry fund products, three (of eight) corporate and one (of 11) public sector. These underperforming products produced a median return of 3.9 per cent a year.

Figure 2.12 Underperformers are typically not more conservative
Performance relative to a MySuper benchmark portfolio and growth assets allocation, 2014–2017^a
Size of circles indicates the size of each product's assets under management



Sources	PC analysis of ABS data (<i>Consumer Price Index, Australia, June 2017</i> , Cat. no. 6401.0), APRA (2017a, 2017c) data, financial market index data (various providers) and SuperRatings data.		
Benchmark Coverage	BP2 and median MySuper target. 90 of 111 MySuper products active as at June 2017 representing 85% of current MySuper assets (\$537 billion) and 87% of current MySuper accounts (13.2 million). 87 of these products are currently active (three corporate products from June 2017 data do not appear in the latest (December 2017) data.		
Survivor bias	Yes.	Selection bias	Yes.

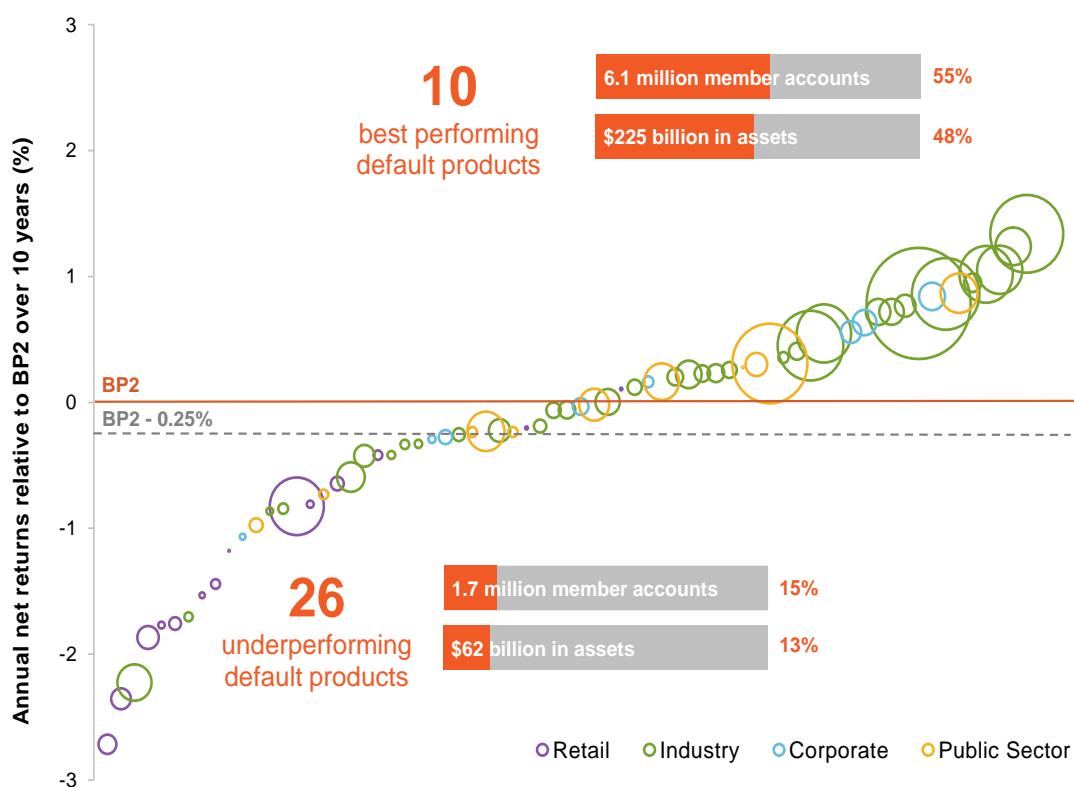
^a The growth assets allocation is the average over the three-year period.

At the other end, the top 10 products were all in not-for-profit funds (eight industry, one corporate and one public sector). They produced a median annual return of 5.7 per cent, well above the median of 4.7 per cent for all MySuper products in the sample. And as with the short-term analysis, the top 10 were much larger on average. They had average assets and accounts of \$23 billion and 618 000 respectively, compared to \$2.4 billion and 65 000 for the 26 underperformers.

Figure 2.13 Default products: default members get vastly different net returns, with 1.5 million accounts in underperforming products

Compared to MySuper average asset allocation, 2008–2017^a

Size of circles indicates the size of each fund's assets under management



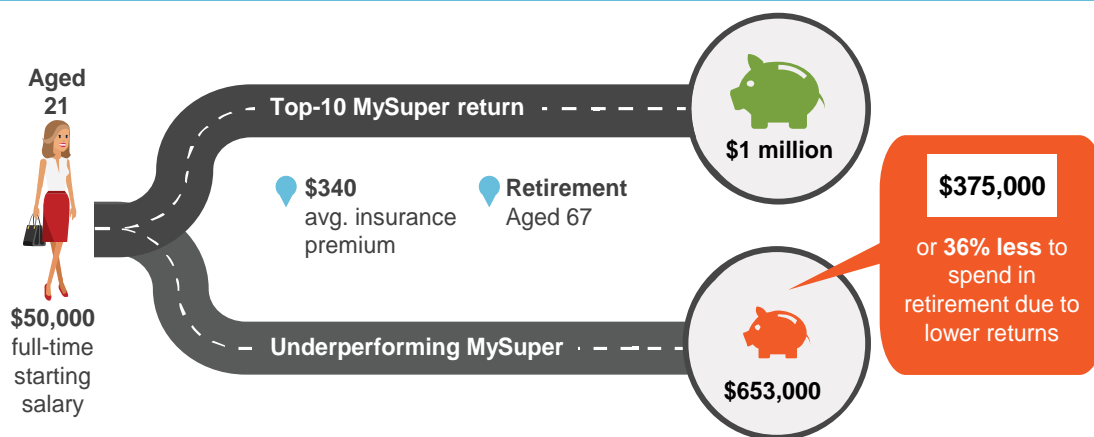
Sources	PC analysis of APRA (2018a, 2018e) data, financial market index data (various providers) and SuperRatings data.		
Benchmark Coverage	BP2. 66 of 108 MySuper products covering 75% of member accounts and 73% of assets in all MySuper products as at December 2017.		
Survivor bias	Yes.	Selection bias	Yes.
Further results	22 MySuper products performed above BP2 but not in the top 10 (3 million member accounts and \$150 billion in assets). Ten products performed less than 0.25 percentage points below BP2 (428 000 member accounts and \$29 billion in assets).		

^a Current MySuper products were connected with pre-cursors with the support of SuperRatings where requested. Fifteen life-cycle products are represented by their largest 'balanced' (according to SuperRatings definitions) option (with three having two representative options).

The Commission's cameo model suggests that a member receiving the median underperforming default product's return could end up with 36 per cent less (or \$375 000) at retirement compared to a member receiving the median top 10 product's return (cameo 2.3).

Cameo 2.3 MySuper returns can be a lottery for default members^a

Super problem: Underperforming MySuper = 7.5 years' lost pay



^a The assumptions underpinning this cameo are set out in chapter 1.

The 10-year returns for this sub-sample of default products is only weakly correlated (a correlation coefficient of 0.3) with the 3-year return for the products that appear in both samples. This reinforces the level of caution needed when deriving conclusions from short-term returns analysis.

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There is wide variation in performance in the default segment that is not fully explained by differences in asset allocation. About 1.7 million member accounts and \$62 billion in assets are in MySuper products that underperformed conservative benchmarks over the 10 years to 2017. This suggests that many members are currently being defaulted into underperforming products and could be doing better.

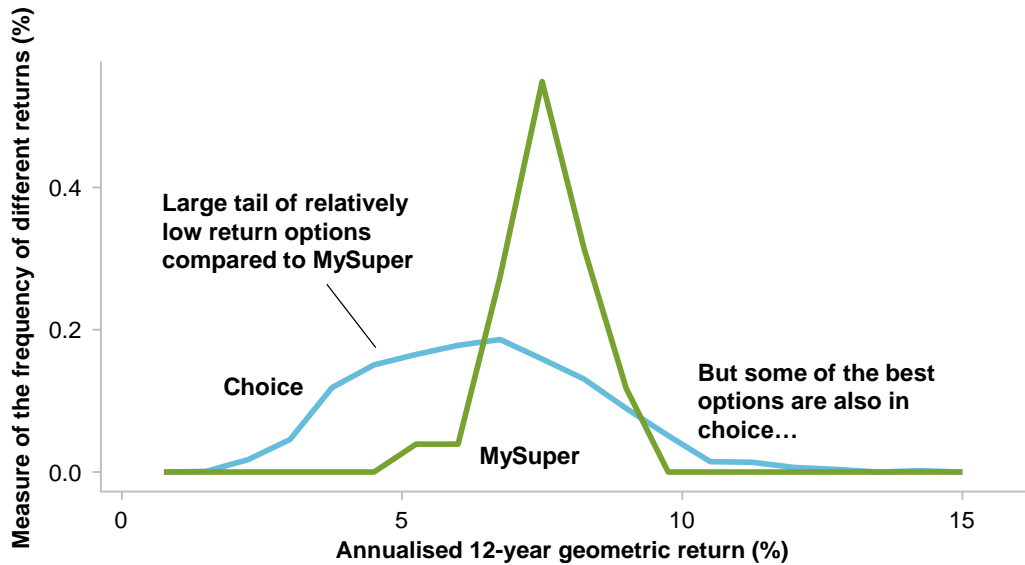
If all members in these underperforming products received the median return from a top-10 MySuper product, they would collectively be \$1.3 billion a year better off. Being in an underperforming product means that, on retirement, a typical worker (starting work today) is projected to have a balance 36 per cent lower (or \$375 000 less to retire with).

Performance also varies in the choice segment

The choice segment is highly heterogeneous, and this makes it inherently challenging to evaluate the choice segment at a disaggregated level. Some of the products and options offered by funds in this segment (particularly retail funds) provide members with a greater level of discretion and control over the asset mix of their portfolios (chapter 4). Products may also have different (non-investment) service features attached to them which result in

different fee structures. Not surprisingly, there is much dispersion in investment performance across products, especially compared to the default segment (figure 2.14).

Figure 2.14 **Choice investment options: wider variation in choice than default^a**
2005–2016



Source	PC analysis of SuperRatings data.		
Benchmark	Option tailored BP1, BP2.		
Coverage	362 accumulation options from APRA-regulated funds with at least \$133.3b assets in the choice segment.		
Survivor Bias	Yes	Selection Bias	Yes.

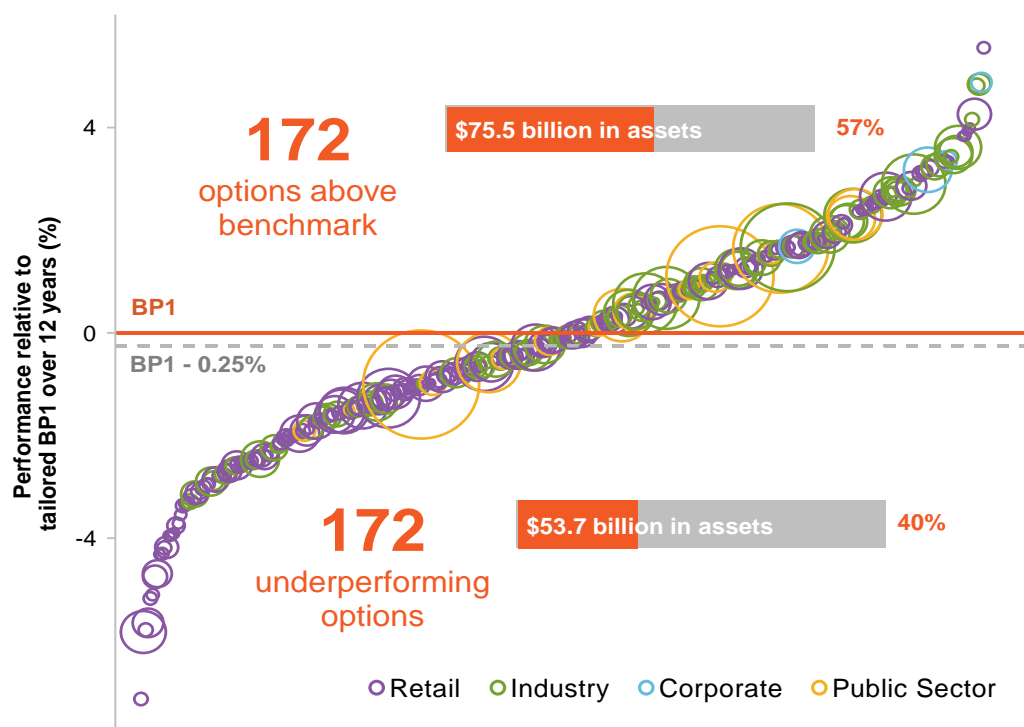
^a This figure is an empirical density, and the bucket size used is 0.75 (per cent). The analysis only includes 'open' options. Not all options have assets under management data so the absolute coverage metric is an underestimate.

To accommodate these differences, the Commission has benchmarked individual choice investment options to their own individual asset allocations, rather than applying a single choice segment average. The analysis is also confined to options on which sufficient data are available and which are still active today — which comprise 362 options with an estimated total of \$133 billion assets (about 13 per cent of assets in the entire choice segment). Data on the number of member accounts in these options were not available.

The analysis shows that almost a half of the choice investment options (accounting for 40 per cent of assets with data available, or \$53.7 billion) delivered returns more than 0.25 percentage points below their tailored benchmark (figure 2.15). Notably, 76 per cent of these underperforming options were from for-profit funds, which accounted for 57 per cent of all retail options in the sample. 20 per cent and 3 per cent of underperforming options were industry and public sector options respectively, which account for 32 and 30 per cent

of all industry and public sector options. There were no underperforming corporate options in this dataset.

Figure 2.15 Substantial tail of underperforming choice options^{a,b}
Compared to own asset allocation, 2005–2016
Size of circles indicates the size of each fund's assets under management



Sources	PC analysis of financial market index data (various providers) and SuperRatings data.		
Benchmark	Option tailored BP1.		
Coverage	362 accumulation options from APRA-regulated funds with an estimated \$133 billion in assets in the choice segment.		
Survivor Bias	Yes.	Selection Bias	Yes.

^a This analysis only includes options which are open today. Not all options had assets under management data so absolute coverage metrics are an underestimate. ^b For this analysis, BP1 (not BP2) is used to benchmark performance, as asset allocation data on unlisted assets are limited.

An important caveat is that these returns data utilised are net of investment fees *and* implicit asset-based administration fees. As such, some of the options which perform below the tailored benchmark may have high administration fees that reflect members' preferences for more costly 'non-investment services' — which ultimately detract from net returns. However, the results vary only slightly even when allowing for substantially higher

administration fees in the retail segment of well over one percentage point each year (tech. supp. 4).

Scaling up these results to the entire choice segment would suggest that at least \$53.7 billion in assets (or 40 per cent of choice assets) are in underperforming investment options. While data are not available for the rest of the choice segment, to the extent that the SuperRatings dataset is more likely to capture relatively good options, the percentage assets in underperforming options is likely to be an underestimate.

DRAFT FINDING 2.4

There is wide variation in performance in the choice segment that is not fully explained by differences in asset allocation. Over \$50 billion in assets are in investment options that underperformed conservative benchmarks over the 12 years to 2016. Many choice members could be doing a lot better.

INFORMATION REQUEST 2.2

Aside from administration fees, asset allocation and tax, what other factors might explain differences in investment performance against benchmark portfolios of the superannuation system, as well as segments such as for-profit and not-for-profit? What evidence is available to test the influence of such factors?

3 Fees and costs

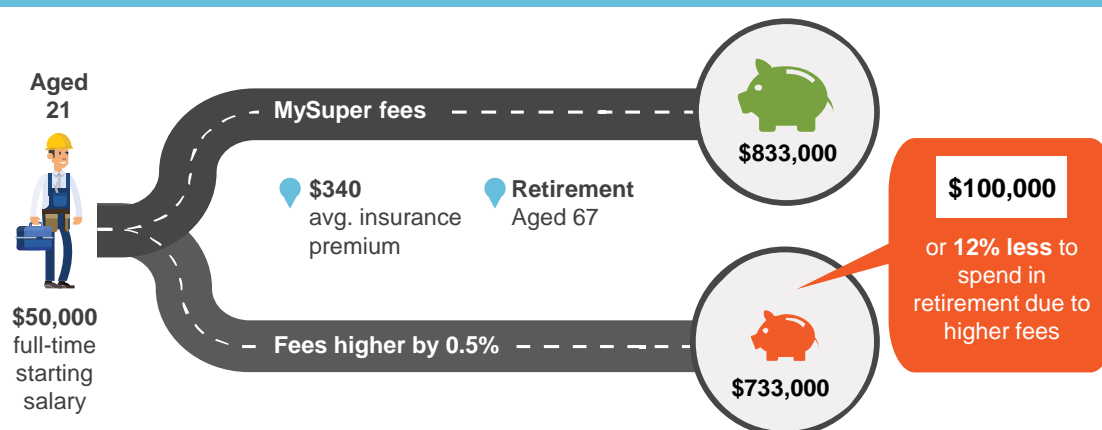
Key points

- Fees matter — they directly detract from members' returns and, ultimately, their retirement incomes. Higher fees of just 0.5 per cent a year could reduce the retirement balance of a typical worker starting work today by around \$100 000.
- In 2017, members of APRA-regulated funds collectively paid \$8.8 billion in fees (excluding insurance fees and premiums). In dollar terms, fees per member account rose over the preceding decade, largely due to account consolidation (reducing a regressive cross subsidy) and higher balances (corresponding to higher investment costs).
- The fees members pay are driven by market dynamics and (to some extent) regulation.
 - Since the global financial crisis, total fees (as a proportion of balances) have fallen by about 0.2 percentage points. This may reflect an increase in competitive pressure in the system, though it is more likely a consequence of small scale funds exiting than efficiencies within remaining funds being passed through to members.
 - Reported investment management costs have been falling. However, there is some evidence that costs for particular asset classes are high relative to international averages, at least for those industry funds that responded to the Commission's funds survey.
 - In aggregate, fees in Australia are higher than in many other OECD countries.
- These trends belie much variation across segments.
 - Fees have fallen markedly for retail funds (to 1.5 per cent on average) but, with the exception of MySuper products, remain higher than fees for industry funds (which have not substantially changed, at 0.9 per cent).
 - High fee dispersion persists across products. There is a not insignificant 'tail' of choice products with high fees (exceeding 1.5 per cent of balances), mostly offered by retail funds.
 - The MySuper reforms appear to have contributed to lower fees within the default segment (especially for retail funds), with some likely spillover to the choice segment. Fee dispersion is limited across MySuper products, mainly by regulatory design. Lower fees in the choice segment may also reflect competitive pressure stemming from the growth of SMSFs.
 - Costs for low-balance SMSFs are high relative to APRA-regulated funds, driving poorer net returns on average. However, the number of small SMSFs has decreased over time.
- On average, funds that charge higher fees do not deliver better net returns to their members over time. High-fee funds (around 10 per cent of system assets) tend to persistently have higher fees over time — suggesting there is significant potential to lift retirement balances by members moving, or being allocated, to lower-fee and better performing funds.
- Inconsistencies abound with how fees and costs are reported, despite regulator endeavour. Many funds significantly underreport their investment costs, with some even reporting zero. This complicates comparisons across funds and over time, and renders effective price-based competition elusive. This needs immediate redress by regulators.

Fees matter. Fees charged by funds detract from the net returns received by members and, ultimately, from retirement incomes. Fees are not only the biggest driver of long-term net returns across funds, but are also a much more predictable indicator of a funds' investment performance (*ex ante*) than gross returns. Even small differences in fees can significantly impact retirement incomes (cameo 3.1). Higher fees of just 0.5 per cent can cost a typical full time worker about 12 per cent of their balance (or \$100 000) by the time they retire.

Cameo 3.1 Higher fees materially erode balances at retirement^a

Super problem: Higher fees = 2 years' lost pay



^a The assumptions underpinning this cameo are set out in chapter 1.

In a competitive system, funds would have an incentive to minimise their costs for a given return and to align their fees with those costs. They would also have an incentive to pursue greater scale (including via mergers) where this brings efficiencies that would further reduce fees. And in an efficient system, fees would reflect the value of the service funds are providing. Fees that are too high can mean suppliers are benefiting at the expense of members' retirement incomes. This can be due to a lack of demand-side pressure, or practices such as funds paying inflated costs to related parties.

Movements in fees over time, along with the costs incurred by funds, thus provide an indicator of competition and efficiency in the superannuation system. What is happening to fees and costs can indicate whether larger average fund scale, growth in average balances and government regulations (such as MySuper, which imposed limits on the type and extent of fees a default member can be charged) have flowed through to benefit members (in the form of lower fees, and thus better net returns).

But fees and costs cannot be looked at alone. They need to be considered both in tandem with broader system characteristics like contestability, and with the quality of service being provided (such as investment returns and member services). This chapter examines whether funds are competing on price and minimising their costs — which come in a range of types (box 3.1). It discusses performance on fees and costs over time, including against

international comparators (section 3.1). It then assesses the impact of recent reforms, namely MySuper and SuperStream (section 3.2), as well as the performance of the self-managed superannuation fund (SMSF) segment (section 3.3). This chapter also assesses the relationship between fees and net returns (section 3.4).

The following criteria (from the Commission's stage 1 study) are addressed in this chapter.

- Are costs incurred by funds and fees charged to members being minimised, taking account of service features provided to members? (E2)
- Do funds compete on costs/price? (C6)

While much of the assessment is at the system level, there is also a focus on specific segments where the data allow: the default and choice segments, the Australian Prudential Regulation Authority (APRA) regulated and SMSF segments, and the accumulation and retirement segments.

Several data sources are used in this chapter, including data from regulators and private research firms (appendix B), and data collected directly from the Commission's funds survey (appendix C). In drawing on these sources, the Commission has become acutely aware of their limitations. Data gaps, underreporting and incomplete and inconsistent disclosure all contribute to poor data quality.

One critical issue here is the significant underreporting of *indirect* investment costs. Indirect investment costs are deducted by a fund's outsourced provider from an investment return before those returns are paid back to the fund (and in turn the member). But because they are not charged directly to the member (in the form of a deduction on their account statement), they are not captured in some datasets. Underreporting of these costs materially influences estimates of fees and costs, including measured trends over time.

The different data sources used in this chapter differ mainly in terms of how well they capture these indirect investment costs. Advertised fees (drawn from product disclosure statements) generally include an estimate of indirect investment costs, although may not capture their full extent for all funds and products. Fee and cost data reported to APRA generally do not capture most of the indirect costs in the system (discussed below), meaning that APRA data need to be interpreted cautiously.

As such, the data in this chapter cannot provide categorical evidence of whether a segment of the market is efficient or not, but they can provide evidence of where issues may lie in the system, where efficiency gains have been realised, and where there is scope for improvement.

Few submissions to this inquiry provided explicit commentary or data on fees. Very few documented trends in fees beyond discussions of the fee differences between for-profit and not-for-profit funds, and almost none adopted a discernible member focus in the presentation of evidence on fees (for example, by looking at the implications for retirement incomes).

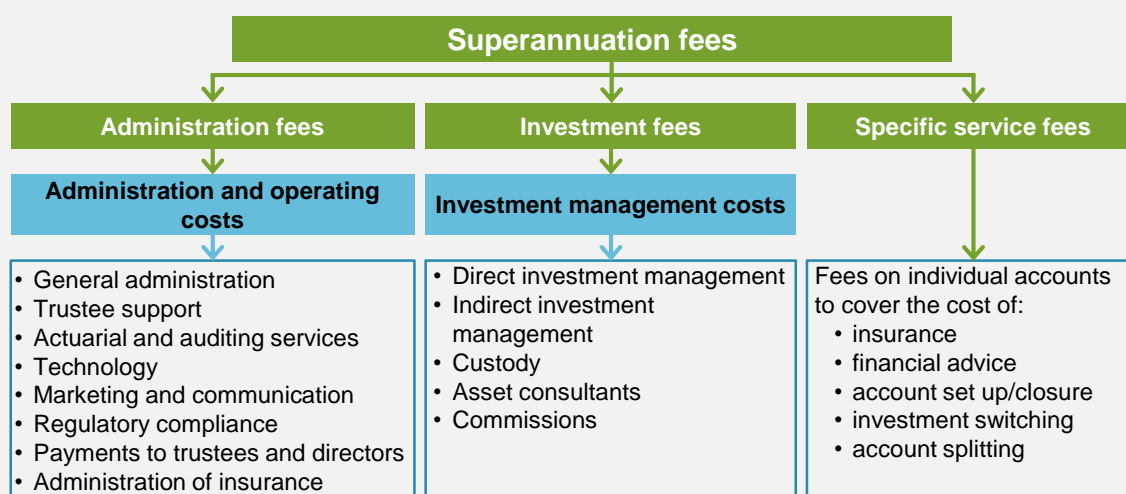
Box 3.1 Key definitions of fees and costs

This chapter distinguishes between **fees** (which are paid by members to funds) and **costs** (which are incurred by funds in managing members' accounts). Fees generally include:

- *administration fees* — which can be levied as a dollar charge over time (for example per month) or as a percentage of a member's assets
- *investment fees* — which are typically levied as a percentage of a member's assets
- *insurance fees* — the cost of administering any insurance policy that is on a member's account
- *specific service fees* — such as switching fees, withdrawal fees and fees for financial advice (which are levied based on a member's individual activities)

Insurance premiums are different from insurance fees (the latter only covering the cost of administering policies on members' accounts). Insurance premiums and fees are both generally excluded from the analysis in this chapter.

Members can sometimes pay lower than advertised fees because their fund provides discounts (for example, given their account balance, or due to employer discounts).



This chapter uses a mix of data on advertised fees (which are the fees advertised in product disclosure statements) and fee revenue (which is the actual amount in fees collected by funds). The choice of metric is influenced by what data are available. Making fee comparisons is difficult because how fees are charged differs across funds, and because of inconsistent disclosure by funds. Further, the actual fees incurred by a member can differ depending on the product and option their assets are in, as well as costs associated with particular types of services and features they may use. In some cases, a 'representative' member concept has been used to show the fees a member would pay for a given account balance (tech. supp. 5).

Costs, by contrast, are incurred by superannuation funds to administer and manage retirement savings on behalf of members. They include investment costs, payments to trustees and directors, professional services from auditors and actuaries, administration costs and other management costs.

For SMSFs, costs (often paid to advisors) are conceptually analogous to fees in that they detract from net returns and, ultimately, retirement incomes. Costs for SMSFs also include the opportunity cost of members' time, which is typically not measured.

Sources: Minifie, Cameron and Savage (2014, 2015); Rice Warner (2014b).

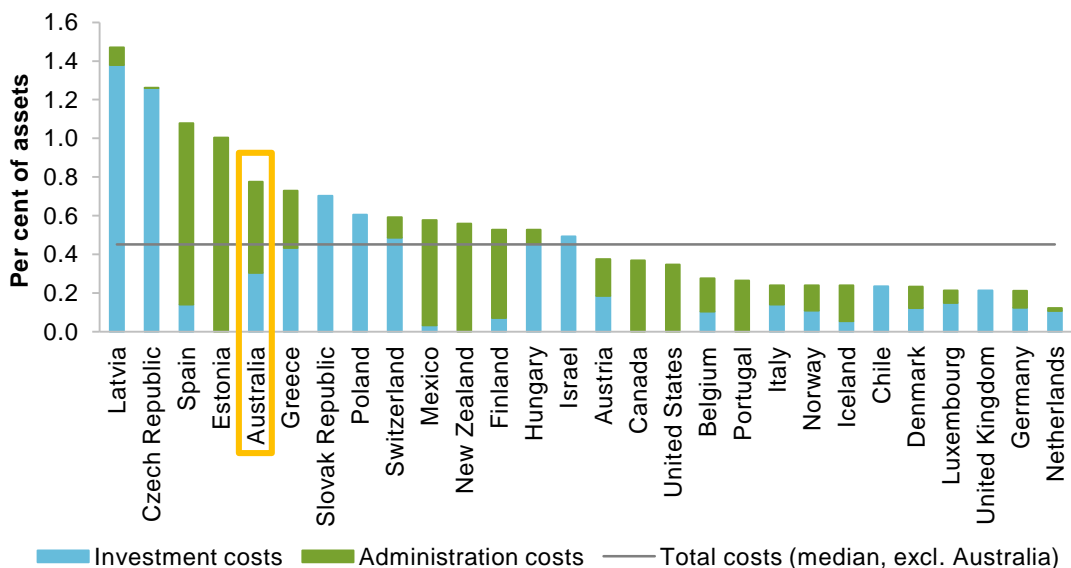
Further details on the quantitative analysis in this chapter, limitations of the data, and the methodological issues encountered in undertaking the analysis are in technical supplement 5.

3.1 Trends in fees and costs

Notwithstanding large differences in pension systems across countries, especially in asset allocation and administration, the costs incurred by Australian superannuation funds are some of the highest in the Organisation for Economic Cooperation and Development (OECD) (figure 3.1). This manifests in the levels of fees that members pay. In total, Australians pay over \$30 billion a year in fees (excluding insurance premiums).⁴ The OECD has argued that Australia's relatively high investment and administration fees reflect the high prevalence of SMSFs and defined contribution (as opposed to defined benefit) plans, as well as a relatively large number of smaller funds with higher average costs (OECD 2017a).

The margin between Australia and some other countries raises the question of whether the Australian system can 'do better' for members through lower fees, and ultimately higher net returns.

Figure 3.1 **Administration and investment costs are high^{a,b}**
Operating costs as a proportion of assets, 2016



^a Based on the OECD measure of 'operating expenses', which comprises costs arising from investment management and administration. The median for total costs is for those countries who have non-zero reported costs for *both* administration and investment costs. ^b Administration and investment cost data are not collected for all countries.

Source: OECD (2017a, figure 8.9).

⁴ This conservative figure includes all reported fees paid by members of APRA-regulated funds across administration, direct and indirect investment management, financial advice, activity-based fees and insurance fees, plus the aggregate annual costs reported by SMSFs.

Fees have trended down in aggregate

Across APRA-regulated funds in Australia, total fees as a percentage of assets were, on average, around 1.1 per cent in 2016-17. This implies that an accumulation member with a balance of \$50 000 would be paying about \$550 a year.

At least since the global financial crisis (GFC) in 2008-09, total fees have fallen (figure 3.2) — a finding backed up by a number of studies (Burke 2017; Minifie, Cameron and Savage 2014, 2015; Rice Warner 2017h). This trend reflects a number of factors including the influence of regulation, SMSF-driven competition, growth in average fund scale and changes in aggregate asset allocation.

It could also reflect the requirement for all default balances to be transferred to MySuper products (by 1 July 2017) showing up in the data, as well as the exit over time of relatively poorly performing funds that charge higher fees (and the movement of their members to lower fee funds). These themes are explored further in subsequent sections.

Advertised fees have decreased slightly

Over the past six years, advertised fees for a representative member in an APRA-regulated fund with a \$50 000 account balance have decreased. This reduction has been driven by falls in investment fees (from 0.80 to 0.68 per cent of assets) and, to a lesser extent, in administration fees (from 0.50 to 0.42 per cent of assets) (figure 3.2).

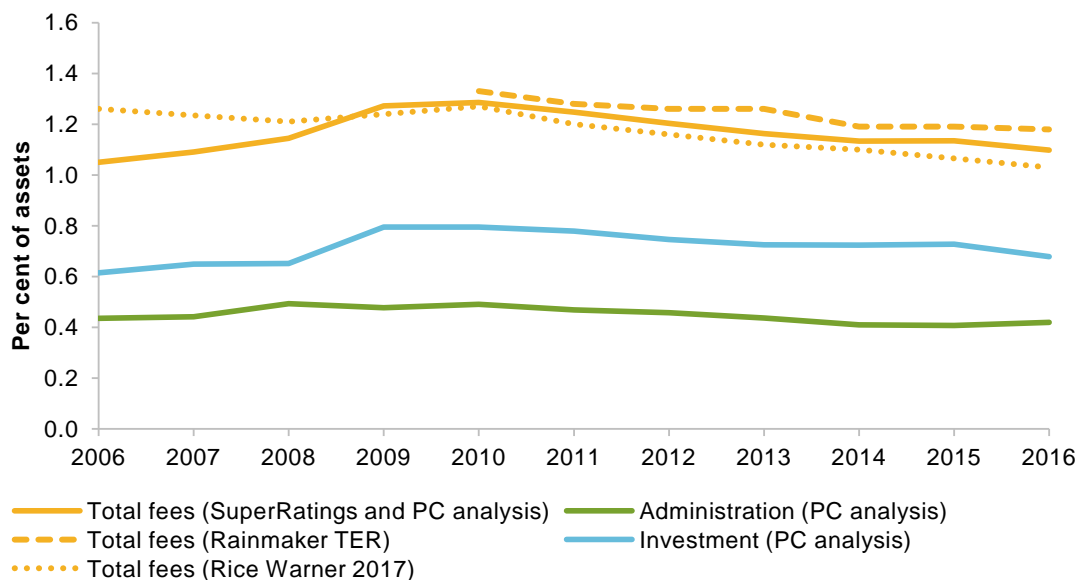
The rise in average fees around the time of the GFC may reflect an increase in direct investment management costs charged by external investment managers as they sought to build reserves and profit margins (Rice Warner 2014b). However, competitive pressures and increases in average fund scale may have more than offset this rise in subsequent years.

Total fee revenue as a proportion of assets has also fallen

Another way of analysing fees is by looking at APRA data on fee revenue collected by funds (available from 2014 onwards only). Fee revenue data are useful in that they are expressed in dollar terms, and indicate how much members, in aggregate, actually pay in fees (though, as noted, these data exclude indirect investment costs and thus do not indicate how much members effectively pay via lower net returns).

In total, \$9.4 billion in direct fees were paid to APRA-regulated funds in 2017, or \$8.8 billion excluding insurance fees. The large majority of this fee revenue was for administration and investment management, although retail funds also source a significant amount of fee revenue from financial advice services.

Figure 3.2 Total fees have fallen slightly^{a,b}
 Advertised fees for APRA-regulated funds, 2006–2016



**Sources
Coverage**

Rainmaker (2017), Rice Warner (2017), PC analysis of SuperRatings data. The SuperRatings sample is APRA-regulated funds only and in 2016, comprised 327 products containing 91% of total assets and 92% of member accounts, in the APRA-regulated system (some selection bias). Data exclude SMSFs.

^a Average product fees are calculated as the weighted average of the fees of individual products (weighted on the basis of assets in each product). ^b TER refers to funds' total expense ratio, which is an estimate of expenses applicable for members.

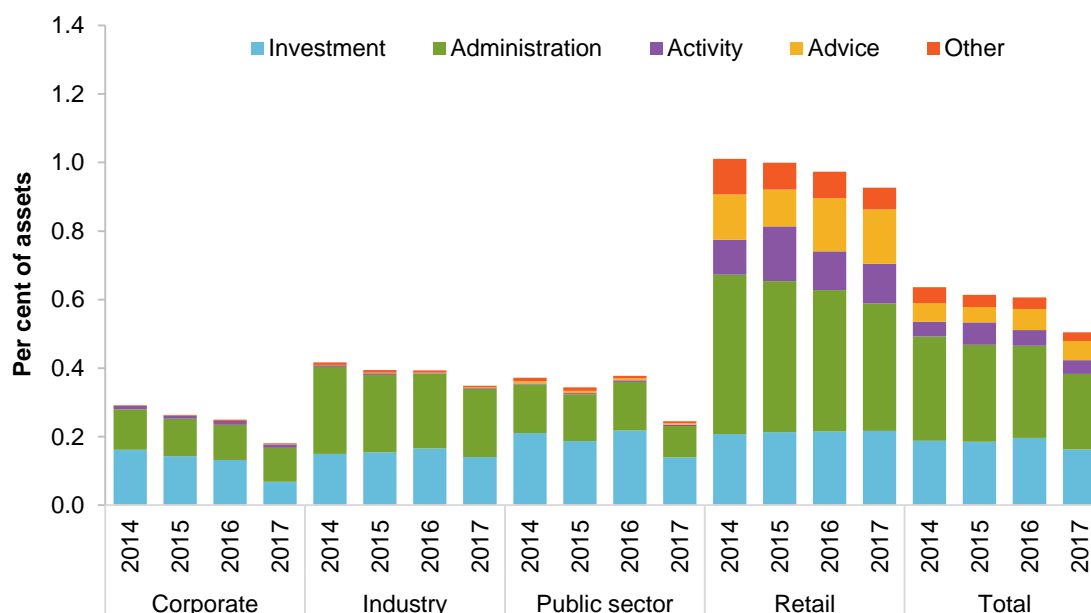
Annual aggregate fee revenue (again, excluding insurance fees) rose by \$1.1 billion between 2014 to 2017. However, as a proportion of assets, fee revenue fell from around 0.64 to 0.50 per cent of assets, driven almost entirely by falls in administration fees (figure 3.3). This indicates that the absolute dollar value of fee revenue has grown due to a combination of growth in the number of members in the system alongside strong growth in average account balances over the period.

That advertised fee levels remain above that of fee revenue (by about 0.5 per cent as a proportion of assets in 2016) largely reflects, among other reporting issues (such as incomplete disclosure), that fee revenue data do not include indirect investment costs flowing to upstream providers (which detract from returns but are not captured as a direct 'fee' in APRA data).

By contrast, these costs are captured to some extent in advertised fees. Further, that investment fee revenue has remained largely flat over 2014 to 2017, while advertised investment fees have fallen, suggests that the downwards movement in advertised fees is being driven by a reduction in indirect investment costs.

Figure 3.3 Fee revenue as a proportion of assets has fallen across fund types^{a,b}

APRA-regulated funds, 2004–2017



Source APRA (2018c, table 6a).
Coverage These data account for the full APRA-regulated system (no selection bias), and exclude SMSFs.

^a These data include the effect of some funds providing rebates on fees (for example, to certain employers). However, these rebates are small in overall magnitude (at 5.1 per cent of total fees paid). These issues are explored in technical supplement 5. ^b 'Other' fees are an amalgam of switching, exit and other fees.

Lower fee revenue (as a proportion of assets) is evident across fund types, particularly for administration. In the for-profit segment, this has been offset by a small increase in fees for financial advice services (figure 3.3). Large falls in fees were particularly apparent in 2017, although it is worth noting that these data are highly variable and subject to revision, and APRA generally advises that short-term movements should be interpreted with caution.

On a *per member account* basis, average fee revenue per account has increased over time.⁵ This reflects that most fees are levied as a percentage of assets (which have grown), though it also reflects increases in fixed administration fees and significant account consolidation over the observable period (accounting for around a quarter of the increase).

In part, this suggests the gradual reduction of a cross-subsidy from low- to high-balance members, and suggests the gradual realisation of an efficiency in the system. There remains significant scope for further account consolidation (chapter 6), meaning this process may continue over the coming years.

⁵ Across fund types, fee revenue per member account is highly dependent on average balances. For example, corporate and public sector funds have significantly higher average balances per account.

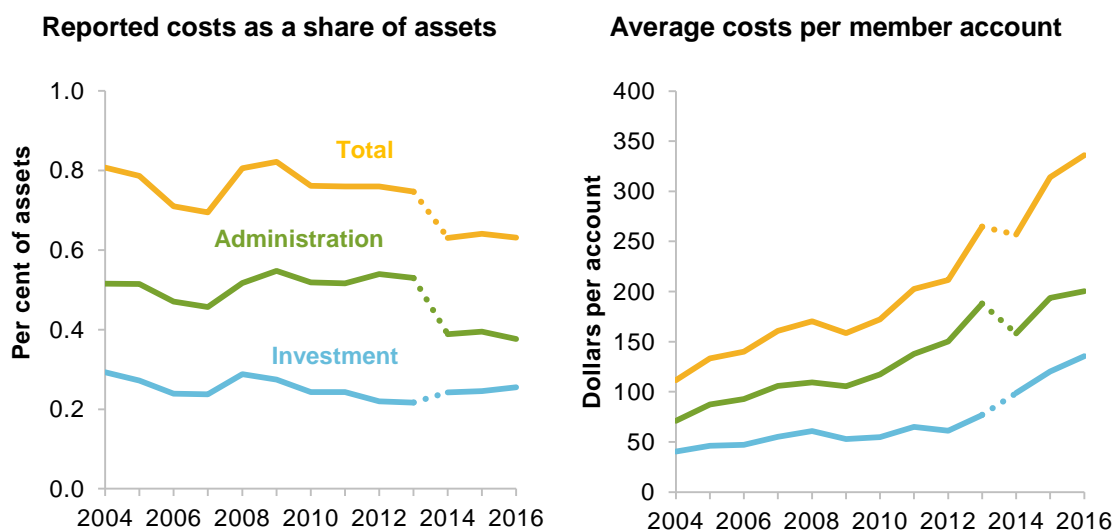
Reported costs have fallen slightly in aggregate

There is also some alignment in aggregate fee trends with those of costs over time. Reported costs for the APRA-regulated funds have, in aggregate terms, fallen over the past decade (figure 3.4).

Reported investment management costs (as a share of assets) have been largely unchanged over time. This is *not* indicated in advertised investment fees (which have trended down over the period), and likely reflects problems with APRA's investment cost data, as noted above.

Administration costs (as a share of assets) have come down over time. The series break in figure 3.4 in 2014 is an artefact of APRA revising its reporting framework from June 2013 onwards (in conjunction with the MySuper reforms). The new framework requires funds to report administration costs in greater detail.

Figure 3.4 Costs have fallen (as a share of assets) but increased per account^{a,b}
APRA-regulated funds, 2004–2016



Source	APRA confidential data.
Coverage	These data account for the full APRA-regulated system, but exclude 68 (generally smaller) funds reporting zero investment expenses.

^a Indirect investment costs are not captured in these data. Funds that report zero investment costs are not included in averages. The effect of this is to shift up investment costs by around 0.06 percentage points on average over the period. ^b APRA revised its reporting methodology in 2014, resulting in a discontinuity in the series (indicated by dashed lines).

Exit and switching fees are generally low

This section analyses two primary sources of data on exit fees — private research firm data on funds' disclosed exit fees, and APRA data on the reported exit fee revenue of funds (that is, the dollar value of exit fees incurred by members through actual account switches). While these data are useful to assess the prevalence and magnitude of direct exit fees for members of APRA-regulated funds, they do not provide any indication of the extent of any indirect fees or other pecuniary factors that members may face upon exiting, or the extent that (direct or indirect) fees are *mitigating* switching activity (chapter 5).

While many funds do not charge members fees for exiting or switching, around 52 per cent of assets and 61 per cent of members were in products that included an exit fee in 2016 (on the basis of SuperRatings data). Generally, exit fees are levied as fixed dollar amounts, ranging from small nominal amounts up to around \$180 in 2016. For the average MySuper member, exit fees are 0.1 per cent of assets, or \$50 for a representative member with a \$50 000 balance. For choice members, average exit fees are around double this, at 0.2 per cent of assets, or \$100 for a representative member.

Yet reported exit fee revenue in aggregate is negligible (at least relative to other sources of fee revenue collected by APRA-regulated funds), at \$59 million in 2016, or 0.004 per cent of assets. This may reflect low levels of switching activity among members (chapter 5).

By law, exit fees on default MySuper products are limited to a notional cost recovery level. This, of course, does not preclude that there may be instances — namely in the choice segment — where exit fees are levied at above cost-recovery levels. Taking the highest MySuper exit fee as a proxy for cost recovery, SuperRatings data imply that around 1 per cent of choice assets may face exit fees that exceed cost recovery levels.

The Commission is aware that in some instances, exit fees can be levied as a proportion of assets, meaning that the dollar fees incurred could be large if balances are large (for example, in retirement or legacy products). While this practice does not appear to be widespread, the Commission considers that there is no justifiable basis for variable exit fees levied as a proportion of a members' assets, and that any such fees should be dollar amounts that reflect the administrative cost of processing an account switch or outwards rollover.

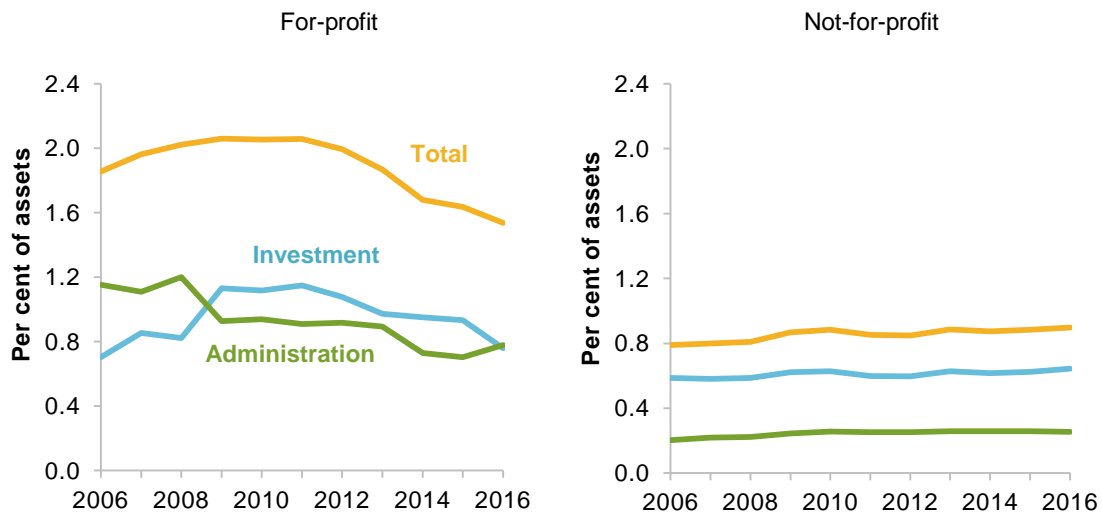
The potential for high exit fees to preclude switching from legacy products (which may mitigate moving to a more appropriate product) legitimises more concerted oversight from the regulator. Chapter 5 discusses exit fees (whether direct or indirect) from the perspective of their impact on member engagement (during the accumulation or retirement phases), while issues with legacy product transfers are discussed below and in more detail in chapter 4.

There is wide fee variation across segments

Falls in advertised fees for APRA-regulated funds in aggregate mask wide variation between fund types, both in terms of trends and magnitudes of fee levels. Aggregate reductions in advertised fees are due mainly to reductions among for-profit (retail) funds, while fees among not-for-profit funds have remained comparatively steady (figure 3.5) (SMSFs are addressed separately in section 3.3).

That fees among not-for-profit funds — industry, corporate and public sector funds — have not changed substantially over the period may reflect that, collectively, their fee levels have historically been (and remain) below that of the retail funds. However, it could also potentially suggest a lack of competitive pressure *within* the not-for-profit segment.

Figure 3.5 Total fees have fallen markedly for retail funds, but from a higher base^a
APRA-regulated funds, 2006–2016



**Source
Coverage**

PC analysis of SuperRatings data.
The SuperRatings sample is APRA-regulated funds only and in 2016, comprised 327 products containing 91% of total assets and 92% of member accounts, in the APRA-regulated system (some selection bias). Data excludes SMSFs.

^a Fees are calculated for a representative member with a \$50 000 balance.

Advertised fees for both administration and investment management have fallen in for-profit funds, at least since the GFC (figure 3.5). The fall in administration fees has been attributed, among other things, to the introduction of choice of fund legislation in 2005, which gave more employees the ability to exercise choice over which fund their contributions were paid into (Australian Government 2005). Survey evidence indicates a higher proportion of retail members were likely to have changed funds, and many of these members' assets are likely

to have shifted into an SMSF (Clare 2006). The extent to which the introduction of MySuper may also have contributed to this trend, particularly since 2013, is not directly quantifiable.

Another explanation is that for-profit funds may have become more responsive to member needs, both within the MySuper segment (partly driven by regulation) and in choice. While the MySuper reforms are part of this story, there is also likely to be competitive influence stemming from the SMSF segment for engaged members (which has grown substantially over recent years), as well as competition by institutional funds for those members (section 3.3) — likely at the expense of the retail choice market. This can be seen in, for example, the emergence of more sophisticated advice models and the introduction of member-directed investment strategies (Rice Warner 2014a).

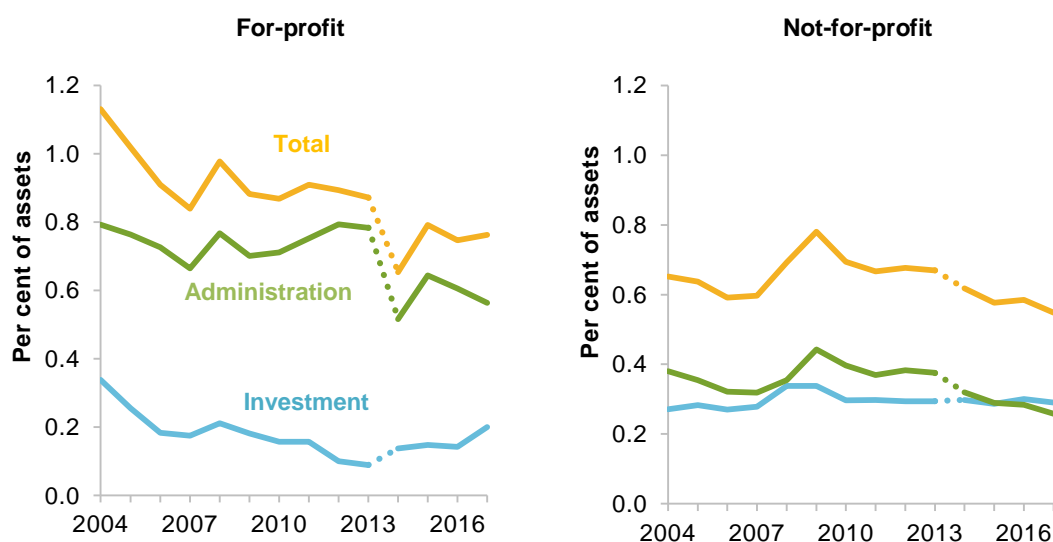
By contrast, investment management fees have been reasonably steady among the not-for-profit funds, despite observable falls in fees at the asset-class level. There are two possible explanations for this. First, there is evidence of a compositional shift to higher-cost investments among some industry funds. To the extent that these are driving higher net returns, this should not be seen as problematic. Second, there is evidence that industry funds have greater relative exposure to external investment management services, which are likely to push costs up and be reflected in fees (chapter 7).

Reported costs relative to assets exhibit broadly similar trends with fees in both the for-profit and not-for-profit funds (figure 3.6). Administration costs remain relatively high within the for-profit segment. Reported administration costs fell more within the for-profit segment after APRA revised its reporting obligations in 2013. In figure 3.6, the series for investment costs excludes the impact of funds who report zero investment costs. The effect of including them is to shift the line down, notably for-profit funds, while there is no substantial change for not-for-profit funds. This serves as an indicator of the extent of non-reporting of investment costs, and suggests it is greater among for-profit funds, which limits direct comparability across sectors (chapter 10).

Reported costs can also reflect compliance requirements stemming from regulation, including those associated with reporting obligations. The Association of Superannuation Funds of Australia argued that complying with various regulatory obligations and requirements imposes ongoing compliance and trustee support costs on funds (ASFA, sub. 47, pp. 21–6). It presented Rice Warner data showing significant increases in estimated compliance costs of almost 70 per cent per member account between 2011 and 2015, from around \$21 to \$36 annually (representing 6.5 per cent of system average fees on a \$50 000 balance).

Figure 3.6 **Significant divergence in costs to assets ratios by fund type^{a,b}**

APRA-regulated funds, 2004–2017



**Source
Coverage**

APRA (2018g).
These data account for the full APRA-regulated system (no selection bias), but exclude 50 (mostly smaller) funds reporting zero investment expenses.

^a These data are adjusted to exclude the impact of funds reporting zero investment costs. ^b APRA revised its reporting methodology in 2014, resulting in a discontinuity in the series (indicated by dashed lines).

Retirement fees have come down faster than accumulation fees

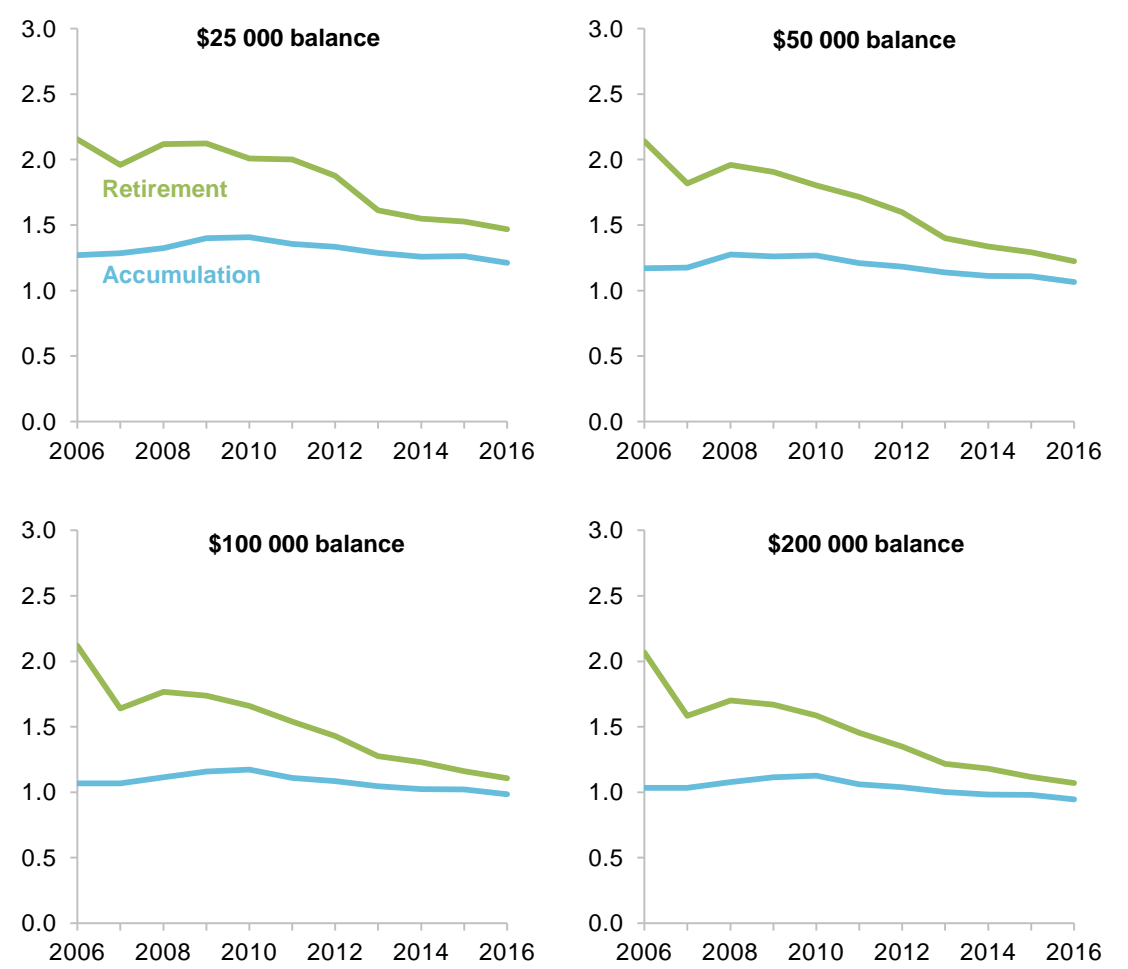
Fees also differ, on average, across accumulation and retirement members. Members in retirement often pay higher total fees because they have larger balances (and most fees are charged as a per cent of assets). But across the system, members with lower balances tend, on average, to pay more as a percentage of their balances.

Fees in the retirement phase can reflect, among other things, greater levels of member engagement, tailored products and advice as members begin to draw down their balances. As such, retirement products generally incur higher administration costs than accumulation products. As the superannuation system matures, average retirement balances have grown, meaning proportionately more member accounts and assets are in products where administration fees are lower as a proportion of assets.

Historically, fees in the retirement phase have been higher (as a per cent of assets) than for accumulation phase products, but have been falling over time (figure 3.7). The relative fall in retirement fees has been driven by reductions in investment management fees, from around 1.15 per cent of assets in 2010 to 0.71 per cent in 2016. This is likely to reflect a

competitive response from funds to the emergence of SMSFs, which have grown to represent 53 per cent of retirement assets.

Figure 3.7 Fees in retirement have been trending down^a
 Total fees as a percentage of assets, 2006–2016



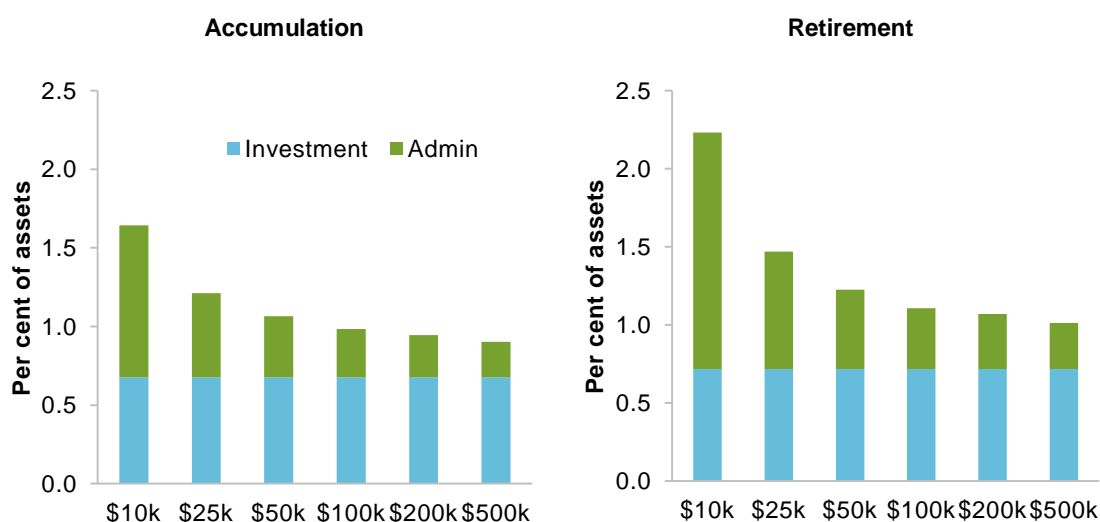
Source	PC analysis of SuperRatings data.
Coverage	The SuperRatings sample is APRA-regulated funds only and in 2016, comprised 327 products containing 91% of total assets and 92% of member accounts, in the APRA-regulated system (some selection bias). Data excludes SMSFs.

^a Fees analysed here are those applicable to a representative underlying balanced option.

These differences in fees (as a proportion of assets at a given point in time) between the accumulation and retirement segments appear to be mainly driven by administration fees which, as noted, tend to be higher in retirement — especially for members with smaller balances (figure 3.8).

Figure 3.8 Low balance accounts are more expensive (as a proportion of assets), particularly in retirement^a

Fees as a percentage of assets, 2016



**Source
Coverage**

PC analysis of SuperRatings data.
The SuperRatings sample is APRA-regulated funds only and in 2016, comprised 327 products containing 91% of total assets and 92% of member accounts, in the APRA-regulated system (some selection bias). Data excludes SMSFs.

^a Fees analysed here are those applicable to a representative underlying balanced option.

The relationship between administration fees and services is unclear

Administration fees also depend on product features and services on offer to members. It could be that administration fees for a particular account are higher because the member has taken advantage of services which are costly to administer. For most members, however, the core services funds provide are straightforward — investment management and basic administrative services. If members are paying for additional costly features that they do not use (or are even aware of), this will ultimately detract from retirement incomes.

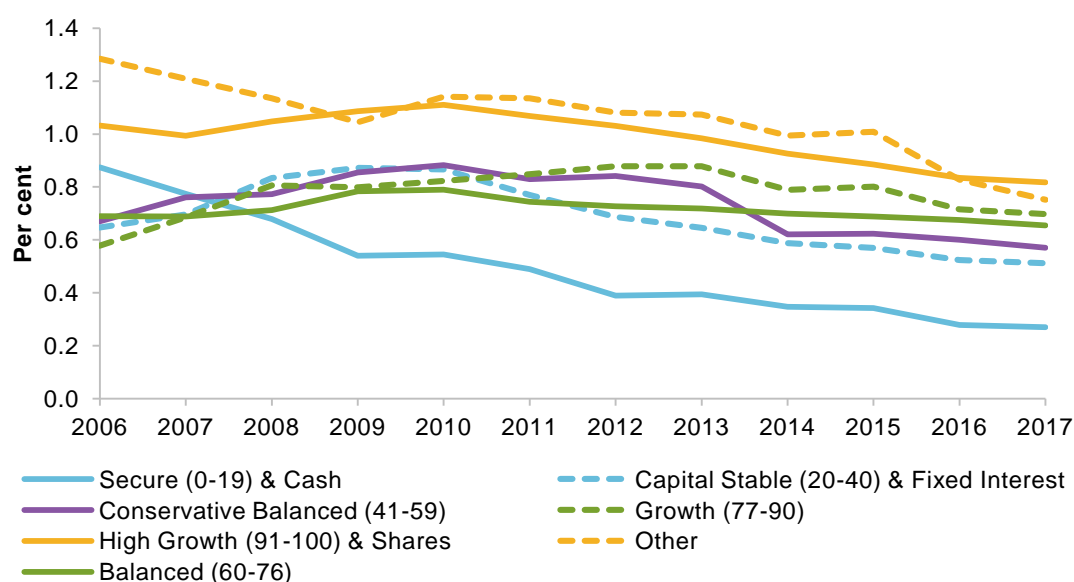
Yet this is difficult to quantify with available data because the extent to which members use features and services, and the costs associated with this use, cannot be directly observed. Moreover, the impact of these services on administration fees could be positive or negative. For example, funds offering online account access may have higher costs and fees, which is passed on to members through fees. Conversely, providing online transactions can reduce the cost of providing call centres and mailing paper statements, which could reduce fees.

Investment management costs have trended down

There is variation in how costly it is for funds to invest in particular asset classes — assets such as cash are less costly than asset classes that require more bespoke arrangements, such as unlisted infrastructure. In an efficient market, the fees associated with different asset classes would largely reflect corresponding costs — that is, cheaper asset classes would be expected to have lower investment management fees. Some funds may also cross subsidise across their member base, for example, by charging the same investment fee to members with different holdings of growth assets. Public data on asset class fees are limited, but trends in overall investment management costs can be inferred indirectly from trends in fees for particular investment option types (which will each have different weights given to underlying asset classes).

Across all types of investment options, investment management fees (in aggregate) have trended down over the past decade as a share of assets (figure 3.9). The increase in average fund scale could partially explain this. Scale economies could arise on the cost side if larger funds can exercise greater power in investments and bargain for lower fees. To the extent that larger scale enables funds to move investment management in-house, this could also help them to avoid higher costs associated with outsourced providers (chapters 2 and 7).

Figure 3.9 Investment fees have fallen across most asset classes^{a,b}
Per cent of funds under management, 2006–2017



Source PC analysis of SuperRatings data.
Coverage The SuperRatings sample is APRA-regulated funds only and in the 2017 data point, comprised 74% of total assets (some selection bias). Data exclude SMSFs.

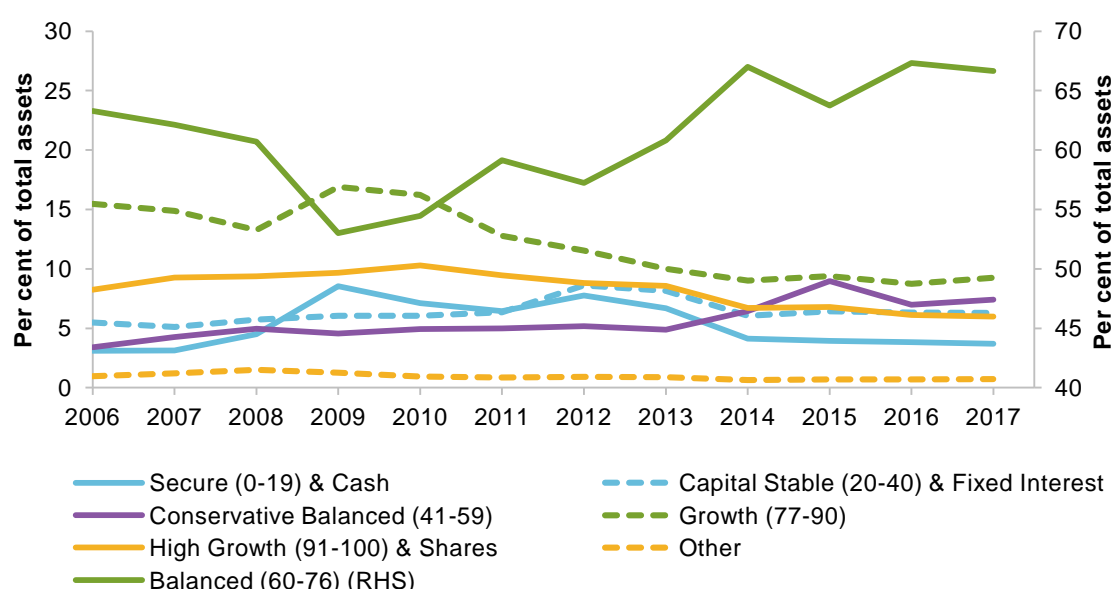
^a In this figure advertised fees for investment options are used as proxies for asset class fees. ^b Numbers in parenthesis in the legend refer to the proportion of growth assets in each option type.

It is notable that the fall in investment management fees has been broadly observed across all types of investment options. Since the GFC there has been a compositional shift away from high-growth products and towards balanced options (defined as having 60 to 76 per cent of funds in growth assets) (figure 3.10). Since the average fee for a balanced option is less than that of higher-risk growth options, this shift has contributed to around 60 per cent of the observed decline in the average total investment management fees.

The decline in investment management fees as a percentage of assets is part of a global trend (bfinance 2017; Graseck et al. 2017). Global experience suggests there may be scope for investment management fees to continue to fall in Australia, particularly as average scale in the industry continues to grow.

Figure 3.10 A compositional shift towards balanced options^{a,b}

Assets by option type as a share of total assets, 2005–2017



**Source
Coverage**

PC analysis of SuperRatings data.
The SuperRatings sample is APRA-regulated funds only and in the 2017 data point, comprised 74% of total assets (some selection bias). Data exclude SMSFs.

^a In this figure advertised fees for investment options are used as proxies for asset class fees. ^b Numbers in parenthesis in the legend refer to the proportion of growth assets in each option type.

Comparing investment costs internationally

To gauge the extent of any differences in investment costs between Australia and other countries, the Commission incorporated a question on investment management costs across different asset classes into its funds survey, with a view to comparing the results to cost data for different pension systems globally.

The response rate to the survey on this particular question was, at best, underwhelming. Remarkably, only 17 per cent of responding funds (19 funds in total) provided any information about investment management costs paid for Australian listed equities — an asset class that virtually all funds have exposure to. Response rates also differed substantially for different types of funds. Only six of the 60 retail funds that participated provided any information on investment management costs. Around half of industry funds (16 out of 34) provided some investment cost information.

Responses to other questions in the survey suggest this is not because funds were unaware of their investment costs at the asset-class level. Indeed, 40 retail funds indicated they conduct performance attribution analysis⁶, of which 65 per cent said they did so at an asset class level, and an additional 30 per cent doing so within each asset class. Such analyses cannot be meaningfully undertaken in the absence of underlying investment management cost data (chapter 10).

Notwithstanding poor response rates, results from the funds survey afford the inference that costs for the asset classes in which most domestic assets reside (that is, domestic and international fixed income and listed equity products) are likely to be higher than those observed internationally (at least for those 26 funds which responded). The Commission is conscious that the results are consistent with aggregate results produced by the OECD (figure 3.1) and also likely embody a (positive performance) selection bias in the data attributable to funds that elected to respond to this part of the survey.

Indeed, international benchmarks suggest that costs in Australia are significantly higher than in comparable pension systems around the world (tech. supp. 5). When applied to the aggregate asset allocation in Australia, these benchmark costs (which include both direct *and indirect* investment management costs), suggest that aggregate average investment management costs should be around 0.4 per cent of assets. However, advertised investment fees in Australia (which include some but not all indirect investment costs) are around 70 per cent higher, at about 0.68 per cent on average.

Though international comparisons are complex (given differences in data collection and tax treatment across countries), these results suggest that there is likely to be some scope for Australian superannuation funds to achieve savings on their overall investment costs relative to other countries.

However, to the extent that these costs reflect factors specific to Australia, such as lower average scale across many smaller funds, this would only be realised gradually. Moreover, this potential to achieve cost reductions does in no way suggest or imply that strategic asset allocations in Australian funds ought to change to drive down average costs, if doing so would come at the expense of lower long-term net returns for members.

⁶ Performance attribution aims to unbundle the sources of return to an investment portfolio to explain how and why excess returns (over a relevant market benchmark) were achieved, and to disentangle those elements outside the investment manager's control.

Investment strategies among Australian superannuation funds have been subject to change in recent years, including growth in unlisted exposure, passive investment, and in-house investment management. These trends also have implications for underlying investment costs, as well as for net returns (chapter 7).

Fee dispersion

While fees have fallen in recent years in some parts of the system, there remains significant variation between funds, across products, and between funds of different sizes. At the fund level, there is large dispersion in fees. The distribution of administration fees is especially skewed, with a relatively large number of funds with average administration fees above 0.5 per cent of assets. Most of these are for-profit funds.

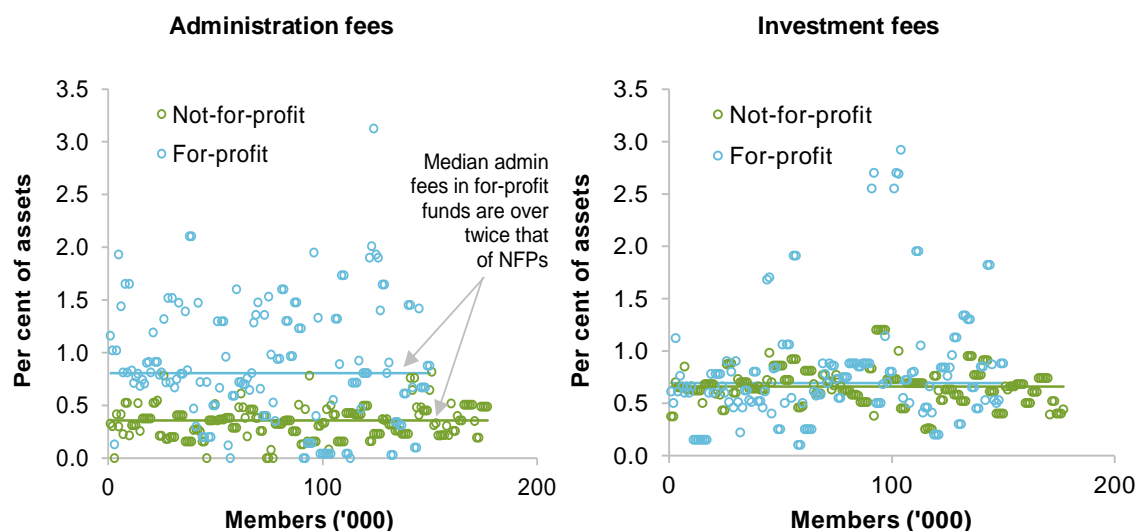
Investment fees tend to be more concentrated around 0.7 per cent of assets, likely reflecting the more generic nature of investment management across funds. That is, superannuation funds have some pricing power in relation to administration fees (which reflect costs particular to their business and the demands of the member). By contrast, the costs of investment management are set in much broader financial markets.

Fee dispersion at the fund level masks variation across the products offered within funds. Understanding where fee dispersion is most pronounced in the system is pertinent to evaluating the outcomes for members with low engagement, which could be at risk of ending up in high-fee products (chapter 5).

There is a wide dispersion of fees across products, which is greatest within the for-profit segment (for both administration and investment fees) (figure 3.11). In 2016, the median administration fee in the for-profit segment was 0.81 per cent, compared with 0.36 per cent for the not-for-profit segment. There is less dispersion among investment fees, with the median fee of 0.70 per cent in the for-profit segment compared with 0.66 per cent for the not-for-profit segment. There does not appear to be any clear relationship between the number of members in a given product and the fees charged.

Over the past decade, the dispersion of total fees has narrowed — proportionately more member accounts are observed at lower levels, and there are proportionately fewer member accounts in the ‘tail’ of higher fee levels (figure 3.12). In 2011, 25 per cent of member accounts were in products with fees above 1.5 per cent of assets. By 2016, this had fallen to 14 per cent.

Figure 3.11 There is high dispersion of fees across products^{a,b}
 Advertised fees, 2016



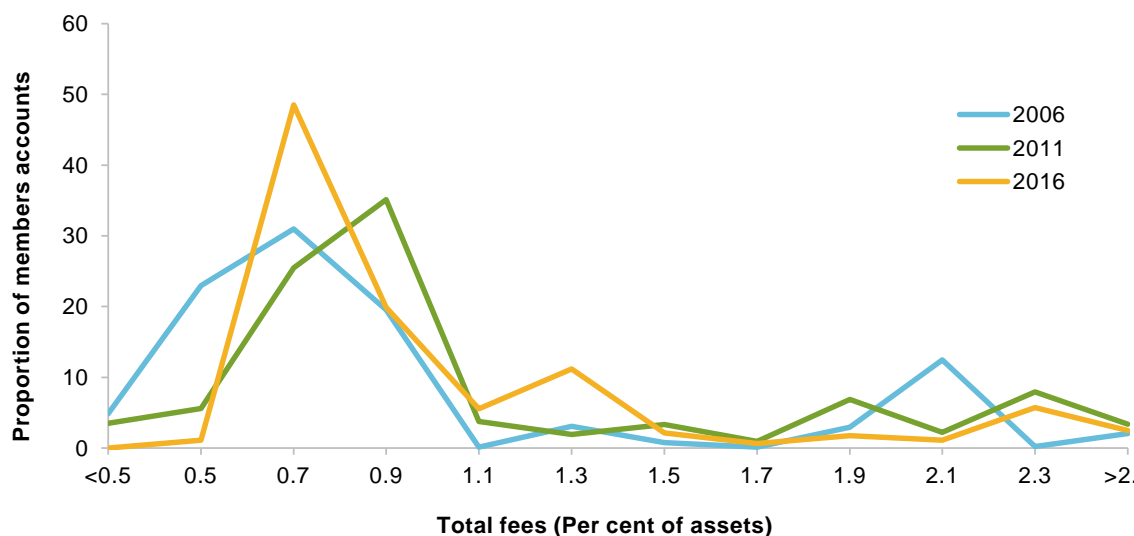
Source PC analysis of SuperRatings data.
Coverage The SuperRatings sample is APRA-regulated funds only and in 2016, comprised 327 products containing 91% of total assets and 92% of member accounts, in the APRA-regulated system (some selection bias). Data excludes SMSFs.

^a Fees are product level averages. The lines are medians of product level fees. ^b Products with zero or negative administration fees have been removed from the sample.

Choice products offered by for-profit funds account for almost all the ‘tail’ of higher-fee products — those with fees above 1.5 per cent of assets (figure 3.13). Dispersion of fees, in itself, is not necessarily indicative of inefficiency in the system — indeed, price dispersion is a common feature of almost all markets. A tail of high-fee products could be efficient if those products generate greater net returns for their members, or reflect particular (and more expensive) member services or investments that meet members’ needs. Conversely, persistent dispersion can also reflect inefficiencies, such as an absence of competition and member disengagement, or higher fees in legacy products (such as trailing commissions).

That 14 per cent of member accounts and 15 per cent of assets in the SuperRatings dataset were in products with fees above 1.5 per cent of assets in 2016, implies that about 3.9 million accounts or \$212 billion in assets were in the tail (if scaled up to the whole APRA-regulated system).

Figure 3.12 **Dispersion of total fees has narrowed over time^a**
2006–2016



**Source
Coverage**

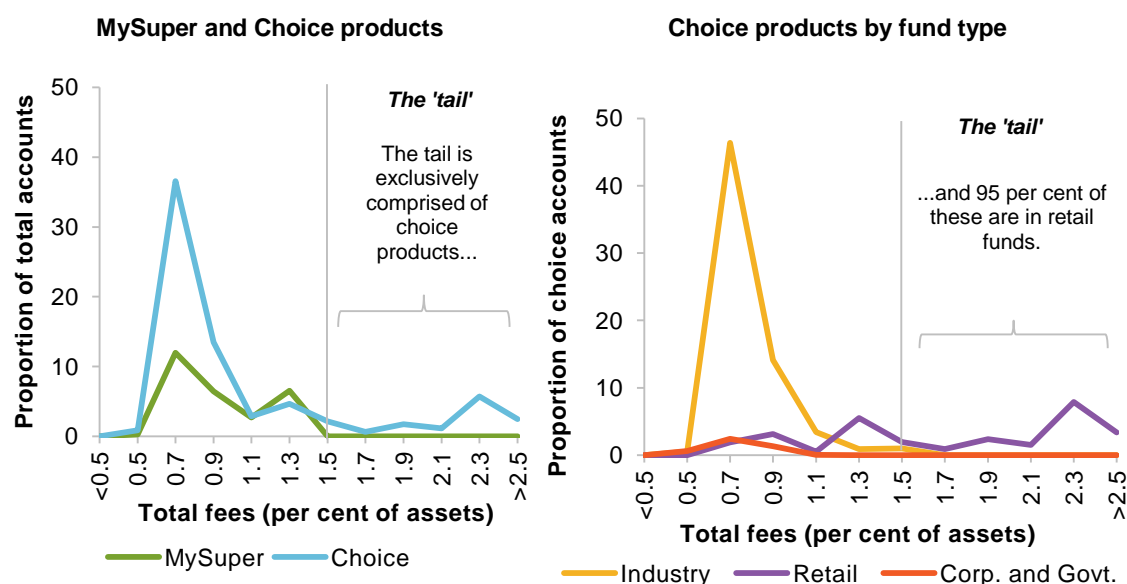
PC analysis of SuperRatings data.
The SuperRatings sample is APRA-regulated funds only and in 2016, comprised 327 products containing 91% of total assets and 92% of member accounts, in the APRA-regulated system (some selection bias). Data excludes SMSFs.

^a Fee level bins on the x-axis are minimums for that category, meaning that, for example, the '1.5' bin should be interpreted as above 1.5 and up to 1.7 per cent.

On the basis of SuperRatings data in 2016, just over half of assets in the tail (51 per cent), and around three quarters of products (76 per cent) were in legacy products (those closed to new members or new employers). Retail funds account for all legacy products in the tail. These products account for around 7.6 per cent of total assets in the SuperRatings data, which if scaled up to the APRA-regulated system, represents around \$98 billion.

The prevalence of legacy products in the tail is likely to fall over time, and APRA's reformed guidance on successor fund transfers should help to ensure members being transferred to another fund are being moved into equivalent products, although ongoing regulator monitoring of costs and associated fees associated with these products is warranted to ensure equivalence is generating the best outcomes for members. Similarly, the net costs associated with members being transferred to other products within funds, though unlikely to represent a significant issue, should be subject to appraisal by APRA (chapter 4). Initiatives to improve the performance of products over time (for example, a proposed outcomes test), and to eliminate poorly performing products, are discussed in chapter 10.

Figure 3.13 Choice products account for the ‘tail’ of high fee products^{a,b}
2016



Source PC analysis of SuperRatings data.
Coverage The SuperRatings sample is APRA-regulated funds only and in 2016, comprised 327 products containing 91% of total assets and 92% of member accounts, in the APRA-regulated system (some selection bias). Data exclude SMSFs.

^a The tail is defined as those products with fees above 1.5 per cent of assets. Fee level bands on the x-axis are minimums for that category, meaning that, for example, the ‘1.5’ band should be interpreted as above 1.5 and up to 1.7 per cent. ^b Calculated fees are for a representative member with \$50 000 balance.

What impact does fund size have on fees?

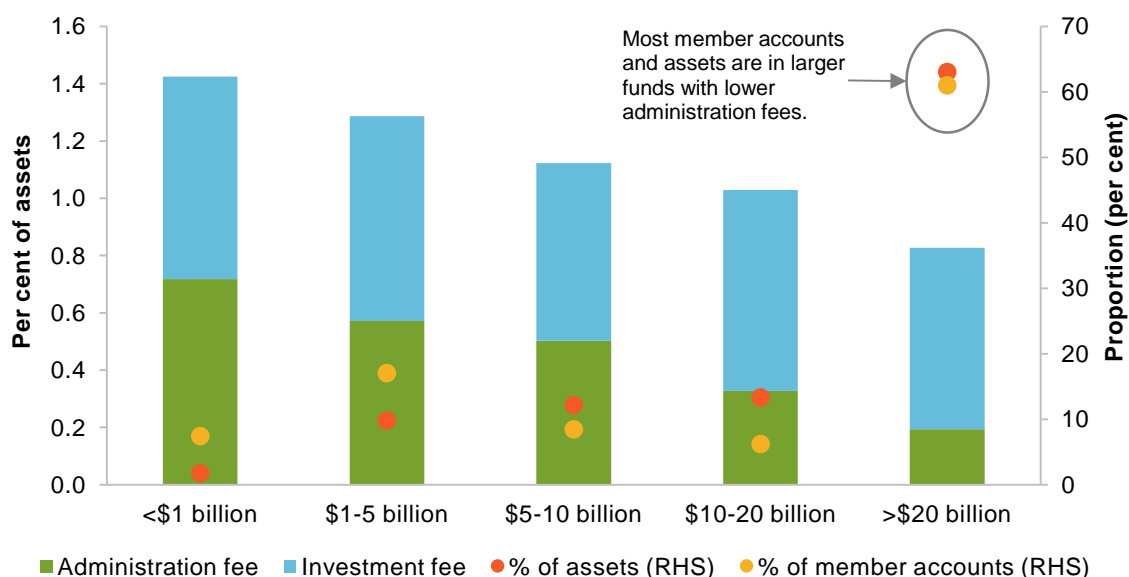
Notwithstanding issues in the reporting of costs to APRA, there is an observable relationship between fund size (measured by assets) and costs, with larger funds having lower average costs (chapter 7).

There is also a clear association between fund size and administration fee levels. Smaller funds on average charge higher fees than larger funds (figure 3.14). The tail of small funds in Australia is relatively large — those with under \$5 billion in assets represent around 12 per cent of total assets among APRA-regulated funds and 24 per cent of member accounts.

By contrast, around 63 per cent of assets and 61 per cent of member accounts were in large funds (those with over \$20 billion in assets) in 2016. Because larger funds can spread fixed administration costs across more members, members of larger funds are likely to be better off, all else equal (although size is not the only determinant of fee levels). This is especially pertinent for default members who do not choose a fund themselves.

Figure 3.14 **Larger funds have lower administration fees**

Fees applicable for a \$50 000 balance, 2016



Source Coverage

APRA (2017i); PC analysis of SuperRatings data. The SuperRatings sample is APRA-regulated funds only and in 2016, comprised 327 products containing 91% of total assets and 92% of member accounts, in the APRA-regulated system (some selection bias). Data exclude SMSFs.

Fund margins

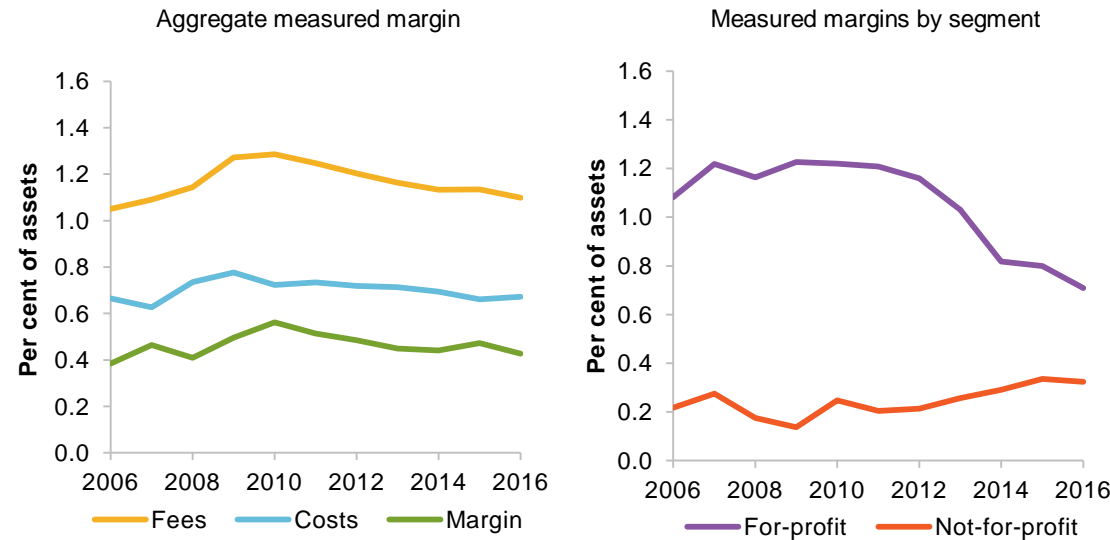
Conceptually, superannuation funds are not like other firms in the economy. They are required, by trust law, to act in the best interests of their members. For-profit funds must, in effect, reconcile this fiduciary duty with the requirement to deliver a profit to their shareholders. Within the for-profit segment, profits can be embedded in, for example, payments to related providers (that is, indirect investment management costs) or trustee-director fees (chapter 7). However, they should, assuming full disclosure, be included in a fund's reported costs. This means that the extent to which profits are being taken out of funds should be reflected in their costs, rather than measures of the margin between a fund's costs and fees.

Nevertheless, there is merit in analysing the difference between total advertised fees charged to members (which include some, albeit imperfect, information on indirect investment costs) and total costs as reported to APRA (which exclude most indirect investment costs). These 'measured margins' have been used in previous analyses (Rice Warner 2014b).

At the system level, aggregate measured margins have been falling, yet this conceals wide variation, with measured margins falling significantly for retail funds, but not materially changing for not-for-profit funds (figure 3.15). This supports the earlier analysis by Rice Warner (2014b), which attributed falling margins in the retail segment to increased competition for members stemming from the introduction of choice of fund legislation in 2005. Over the pre-MySuper era from 2006 to 2013, fees in the retail segment fell around 0.4 per cent in aggregate. This indicates some degree of competitive pressure in the system.

Figure 3.15 Competitive pressure has eroded margins in the for-profit segment^{a,b}

Measured margins are total advertised fees less APRA costs, 2006–2016



Source	APRA (2018c), PC analysis of SuperRatings data.
Coverage	The SuperRatings sample (for fees) is APRA-regulated funds only in 2016, comprised 327 products containing 91% of total assets and 92% of member accounts in the APRA-regulated system (some selection bias). Data excludes SMSFs. APRA data for costs represent the entire APRA-regulated system.

^a Total fee data are weighted by assets and are based on those applicable to a representative member with a \$50 000 balance. ^b Margins for the fund types comprising not-for-profit funds (corporate, government and industry funds) are broadly similar both in terms of magnitudes and trends.

The decline in measured margins in the for-profit segment suggests that fees have fallen by more than reported costs — an indication that most of the decline has been in indirect costs that are not reported to APRA. Figure 3.15 also shows that in the post-MySuper era, the retail funds have seen significant further falls in measured margins. The difference in measured margins between the retail and not-for-profit funds is also large.

That there is a significant difference is likely to indicate the extent of non-reporting of indirect investment costs. That is, where funds are not reporting the types of costs which provide them a source of profit, one would expect to see artificially higher measured

margins. That these margins have fallen over time is also suggestive that indirect investment management costs have fallen over time, which supports inferences from the section on fee revenue above.

Comparability across segments could improve with better disclosure

Analysis of trends in fees across segments of the superannuation system and over time is heavily compromised by poor data quality. Foremost among many issues is the incomplete and inconsistent disclosure of fees by superannuation funds, especially for investment management. As noted earlier, indirect investment management costs (that come out of a member's investment return) appear to be effectively absent from APRA data, making it nearly impossible to get a true sense of the full costs that funds are incurring. This has broader implications for the governance of the superannuation system (chapter 10).

This apparent non-reporting and underreporting of investment management costs erodes funds' accountability to their members, which ought to require that they fully disclose costs which detract from returns. On this basis, it is inexplicable that some funds report zero investment management costs. However, given the regulator appears to have enabled this non-reporting, the behaviour is to some extent a function of the regulatory guidance provided (chapter 10).

Measurement problems also make it difficult to discern underlying levels of 'profitability', and thus the extent of competitive pressure bearing on funds. As noted by APRA, there is a degree of RSE licensee (trustee) discretion in categorising expenditures, a lack of consistent information reported on indirect costs paid to related parties,⁷ and incomplete collection of information at the trustee level (sub. 89, pp. 1–2). This latter issue impacts the true representativeness of both expense and revenue flows between the trustee and the fund. Indeed, APRA submitted that this limits both their own and external stakeholders' ability to understand and compare how fund assets are being used in the management of fund operations (APRA, sub. 89, p. 2).

To address known deficiencies in fee disclosure, the Australian Securities and Investments Commission (ASIC) recently amended regulations for the disclosure of superannuation fees in its Regulatory Guide 97 (RG97) (box 3.2). The efficacy of RG97 has been long debated within the industry and introduction of the revised guide has been repeatedly delayed. Recently, ASIC commissioned a further independent review of RG97 (ASIC 2018d).

It is too early to evaluate whether the new disclosure requirements will improve the comparability of superannuation products. However, as long as poor reporting practices exist, this harms members by rendering fee comparability very difficult (at best). This thorny issue should preferably be drawn to a firm conclusion by ASIC as soon as possible. Given the difficulties inherent in these processes, achieving perfection should not be a barrier to

⁷ This is partly due to uncertainty about the definition of 'associate', and because the collection of expenses is only in respect of arrangements between the RSE licensee and the service provider (APRA, sub. 89, p. 2).

realising sound regulatory outcomes. The potential for inconsistency in how funds comply warrants ongoing monitoring and decisive action by the regulator where contravened (chapter 13).

Box 3.2 Disclosure of superannuation fees — RG97

The Australian Securities and Investments Commission (ASIC) has been revising Regulatory Guide 97 (RG97). RG97 establishes the rules for how funds are required to disclose superannuation fees in product disclosure statements and periodic statements to members. The revision has been motivated by concerns that inaccurate, incomplete and inconsistent reporting of fees and costs harms members and makes comparisons across funds and products difficult (if not impossible).

The first draft of RG97 was released back in December 2014, but finalisation has been repeatedly delayed and points of contention with industry are still not fully resolved. The delay hampers comparability of fees across funds, both for those members who rely on disclosure to make informed choices about their financial interests, and for assessments of the system overall.

A key issue for the revised guide is the extent to which it requires funds to include in their PDSs (and periodic statements to members) information on *all* fees and costs that detract from the value of the investments on a *look-through basis* (ASIC 2017c). Such a change is likely to result in an increase in disclosed fees.

A range of parties have expressed concerns about the new reporting standard, including that:

- it could distort asset allocation decisions since particular investment structures and asset classes are potentially subject to different disclosure obligations (Frontier Advisors 2016; HWL Ebsworth Lawyers 2015; IFAA, QIEC Super and Club Super, sub. 53, p. 8).
- the disclosure of ‘upstream’ investment fees could distort asset allocation as funds shift away from asset classes that face greater disclosure requirements, such as unlisted infrastructure, at the expense of investment returns (Rice Warner 2017g; MLC NAB Wealth, sub. 63 attach. 1)
- the scope for interpretation could lead to greater inconsistency than under the current disclosure regime (IFAA, QIEC Super and Club Super, sub. 53, p. 8).

Clearly, ensuring even handed transparency around disclosure and removing the distortions that currently pervade the system would be a positive step. Nevertheless, early indications are that the reported Indirect Cost Ratio of funds (indirect costs as a proportion of assets) may increase by up to 15-25 basis points as a result of RG97. This pertains to the disclosure of existing fees, not a change to the underlying fees — that is, an increase in disclosed fees is not an indication of worsening efficiency in the superannuation system (indeed, more accurate disclosure could improve efficiency over time).

3.2 The impact of MySuper and SuperStream

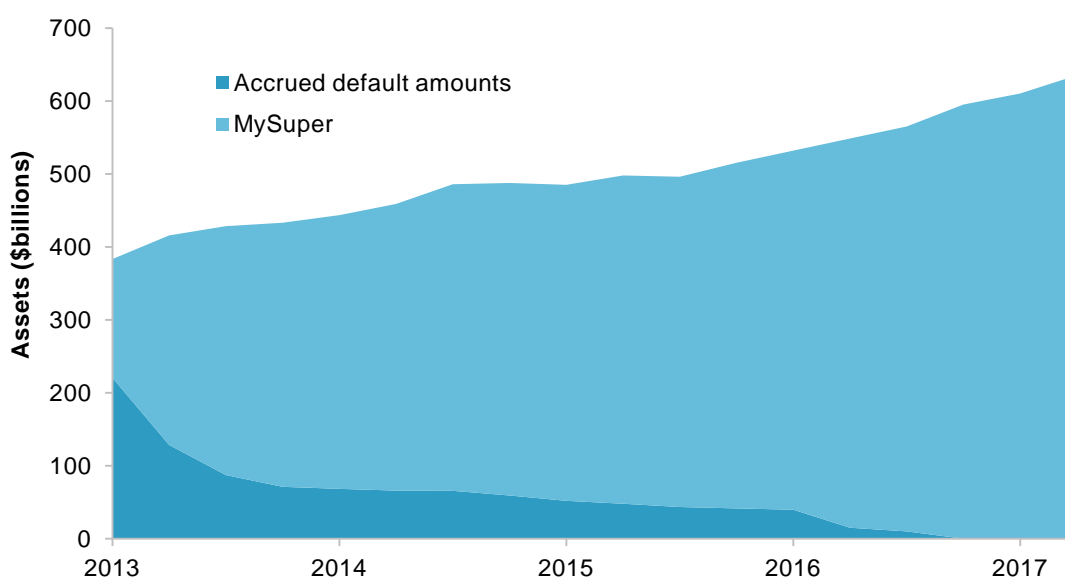
The Australian Government’s phased implementation of the MySuper and SuperStream reforms since 2011 (collectively known as Stronger Super) is now largely complete. Given the transition of default balances to MySuper products was required by 1 July 2017, it is timely to assess how the reforms have affected fees, costs and member outcomes.

MySuper

MySuper products are designed to have a simple set of product features. This is intended to ensure that members do not pay fees for services they do not need or use, as well as to facilitate greater comparability to better inform member choice. The fees a member can be charged in a MySuper product are limited to an administration fee, an investment fee, buy and sell spreads, an exit fee, and a switching fee (the last three of which are limited to cost-recovery levels). In addition, trustees may charge fees for certain member-specific costs initiated by the member (Australian Government 2011).

MySuper assets totalled just over \$635 billion at the end of 2017 (figure 3.16), which represents 24 per cent of system assets. The majority of default amounts were moved into MySuper products within the first year, with the final rollover of remaining default products into MySuper products required by 1 July 2017 under legislation.

Figure 3.16 **The transition from accrued default amounts to MySuper is complete**
APRA-regulated funds, 2013–2017



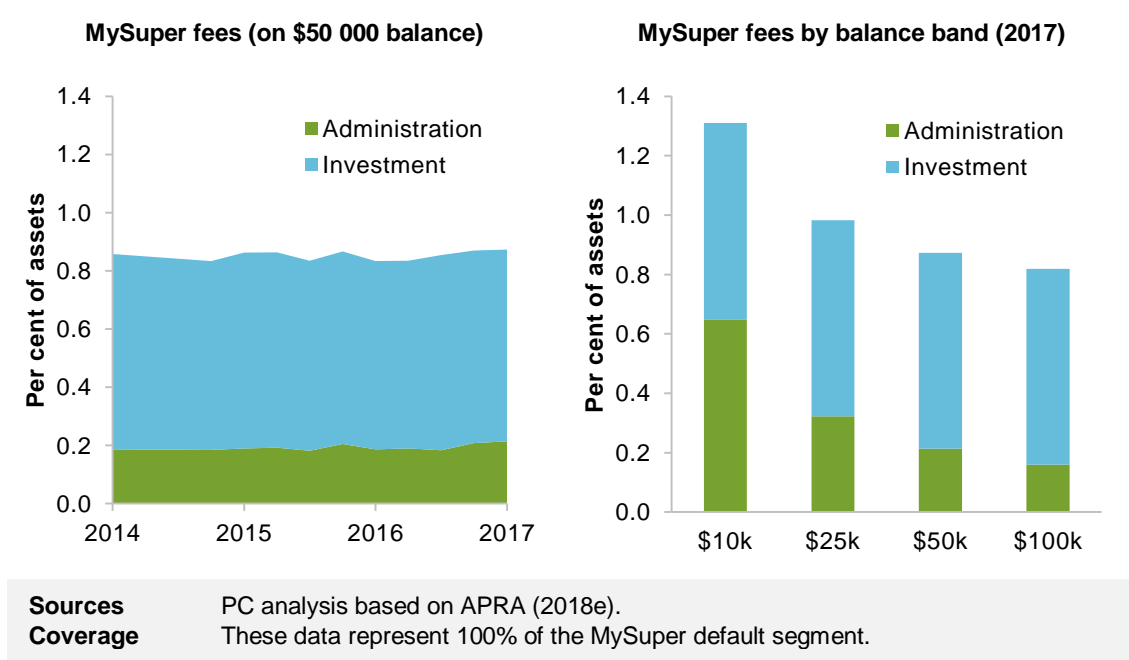
Source
Coverage

PC analysis based on APRA data (compiled using several sources).
These data represent 100% of the MySuper default segment.

Fees on MySuper products are lower, at around 0.9 per cent of assets in aggregate, than average fees for choice products in APRA-regulated funds (at 1.2 per cent in 2016). Total MySuper fees (both administration and investment fees) have increased marginally since MySuper was introduced (figure 3.17, left panel). In mid-2017, a representative member with a \$50 000 balance would have paid 0.87 per cent in fees, or around \$437 annually.

As with superannuation more generally, members in MySuper products with lower balances tend to pay higher administration fees as a proportion of assets (figure 3.17, right panel). This indicates that as the system matures and MySuper balances grow, fees in MySuper may, in percentage terms and on average, fall somewhat. The extent of such a fall will be influenced by the extent of further account consolidation into MySuper products (which increases fees per remaining account) (chapter 6), and the mechanism used to allocate default members to products (chapter 12).

Figure 3.17 MySuper fees have increased slightly, but remain lower than in choice^a
2014–2017



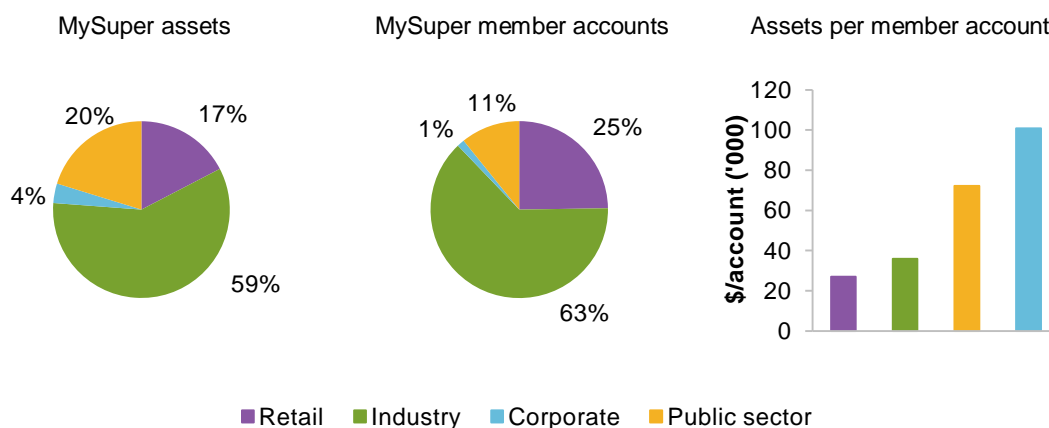
^aThe slight upward trend in MySuper fees is observed across all balance sizes.

The impact of MySuper fees on aggregate outcomes in the superannuation system also depends on the extent of default MySuper coverage within each type of fund, and how fees for those different fund types have changed over time. Overall, most of the MySuper segment resides in the not-for-profit funds, with industry funds the predominant provider in the market (figure 3.18).

The impact of MySuper on fees depends on what products default members were invested in prior to the reforms. There is only partial evidence on this. One piece of evidence is the fees that funds charge for their ‘default’ investment option (regardless of whether a member joined as a default member). Such data indicate that fees paid by these members fell markedly for retail funds, while they remained largely unchanged for industry funds

(figure 3.19).⁸ Whether a member is better off in one type of fund is difficult to gauge precisely, as it will reflect, among other things, differences in default investment strategies (for example, investment in unlisted assets).

Figure 3.18 MySuper coverage differs significantly by fund type^{a,b}
APRA-regulated funds only, 2017



^a Measured as the proportion of total MySuper assets and members accounts. Any errors in summation are due to rounding. ^b Assets per member account will partly reflect the extent of any duplicate accounts.

Source: APRA Annual Superannuation Bulletin (APRA 2018c tables 16a, 17a and 18a).

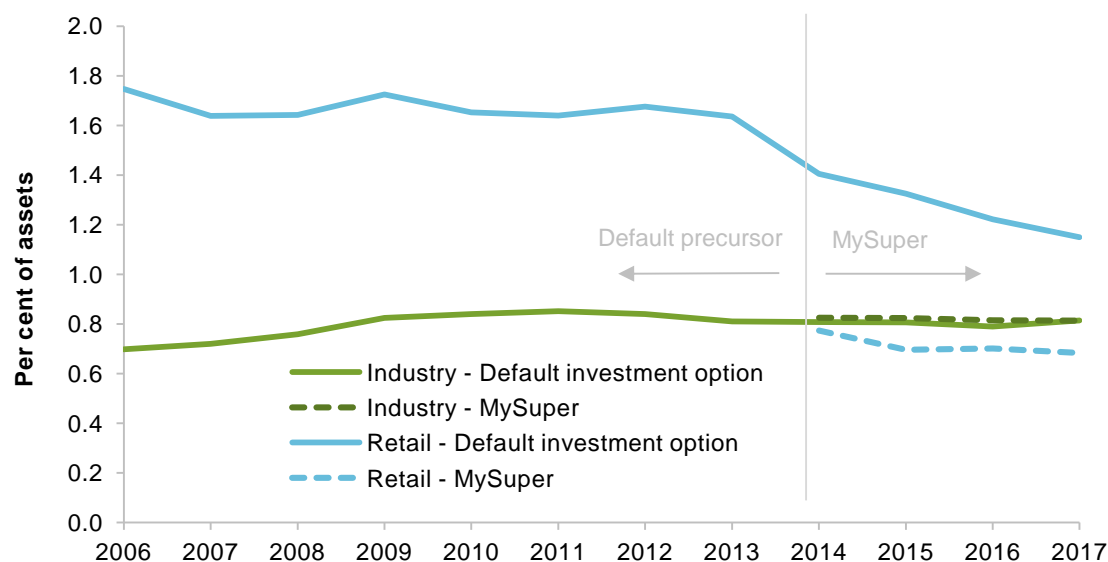
That reported fees for retail MySuper products appear around or below that of industry counterparts suggests that the requirement to move accrued default balances into MySuper accounts may have introduced a degree of competition for these products. Retail funds are likely to have more scope to reduce MySuper fee levels given they had significantly higher fees than other funds prior to 2014. Moreover, funds were also subject to competitive pressure by competing for choice members to join their MySuper products. The reduction in MySuper fees among retail funds could also reflect the removal of advice-based fees from MySuper products (Rice Warner 2014a).

Broadly, however, given that only 17 per cent of MySuper assets reside within retail funds (figure 3.18), the *aggregate* impact of fee movements within retail funds on fees in the period 2014 to 2017 is likely to have been relatively limited.⁹

⁸ The analysis uses Rainmaker data, which were sourced from funds' annual reports, product disclosure statements, and other public information. The Commission has transformed the data and undertaken its own linking of investment options over time.

⁹ Indeed this conclusion is supported by analysis of MySuper fee revenue data from APRA, which shows a steep decline in retail funds' fees, yet a relatively steady fee level for the MySuper segment as a whole.

Figure 3.19 Gaps in fees are narrowing across MySuper products^{a,b}
Default investment option fees, 2006–2017



Source PC analysis of Rainmaker data.
Coverage The Rainmaker sample is 60.1 per cent of the institutional fund total (by assets in the latest observation). This includes some smaller APRA-exempt public sector funds (some selection bias). Data exclude SMSFs.

^a Compared with other fee data in this chapter, option-level data are not weighted by assets or accounts, reflecting the absence of such data in the Rainmaker dataset. The estimated MySuper fees align with other published estimates. ^b As funds update Product Disclosure Statements in line with the regulatory changes of 1 July 2017 (and these are incorporated into research firm databases), fees on default options should converge toward fees for MySuper products.

According to some industry practitioners (Rice Warner 2014a), many industry funds made minimal changes to their existing default investment option (and simply rolled it over into a MySuper product), while many retail funds designed completely new products for MySuper. AMP noted that fees have come down since the introduction of MySuper in 2013 and its replacement of the previous default products (sub. 80, p. 3). The MySuper regulatory requirements also brought about higher costs associated with complying with the new regulations, such as the cost of designing new products and upgrading internal systems. In the retail segment, the administrative cost of MySuper compliance is likely to have been absorbed through lower margins.

There is a separate question about whether the introduction of MySuper brought about lower fees in the *choice* segment. There appears to be a small decline in fees charged for choice products since 2014, from 1.22 per cent to 1.17 per cent (for a representative member on the basis of SuperRatings data), although fees charged for choice products vary widely. Both investment and administration fees in choice remain above that of MySuper fees. To the extent that MySuper affected broader asset allocations within funds, and subjected the retail

funds to heightened competition, it is plausible that there was some positive ‘spillover’ of MySuper to the choice segment.

The Stronger Super reforms did not limit the types (or magnitudes) of fees that trustees can charge in choice products. Therefore, it is possible that fees for choice products could have been used to cross-subsidise across members (cross-subsidising from choice to MySuper appears to be permissible, whereas cross-subsidising across members within MySuper is disallowed under regulation). Such behaviour would be reflected in higher fees on choice products, but this does not appear to have happened. As such, the data suggest there is at least some competitive pressure in the choice sector.

That MySuper has brought about improvements in product offerings and greater competition within the default sector does not imply there is no scope for further efficiency gains. Indeed, there remains significant scope for improvements to processes for allocating default members to MySuper products, including by introducing greater competition for such members, which could drive further reductions in fees across the system (chapter 12).

SuperStream

SuperStream is a package of reforms introduced in 2011 to enhance administrative processes for superannuation, especially the way that contributions are transferred from employers to funds. These reforms were expected to improve the efficiency of payments processing while giving regulators the ability to better track transactions in the system (PC 2016a). Since 2016, all employers and superannuation funds (including SMSFs, with some exemptions) are required to use SuperStream to process contributions. Full implementation of all reporting components is expected to be complete by mid-2019 (ATO 2017).

Changes in regulation and regulatory compliance flow through to administration costs. In the short term, SuperStream is likely to have imposed some additional operational costs on funds (investing in system improvements), but these should be offset by cost savings over time.

Total implementation costs of SuperStream have been estimated at \$1.5 billion (over the period 2012 to 2018), with APRA-regulated funds bearing \$900 million and employers bearing \$600 million (ATO 2017). Most funds and employers made upfront capital investments in new equipment and processes to comply with SuperStream. In addition, APRA-regulated funds are required to pay a mandatory cost-recovery levy (to cover the implementation costs to government), from which over \$400 million has been raised thus far. The annual levy started at \$122 million in 2013 and has been gradually phased down each year. It is currently at \$32 million for 2018. Many of these costs would have been passed on to members in the form of higher administration fees.

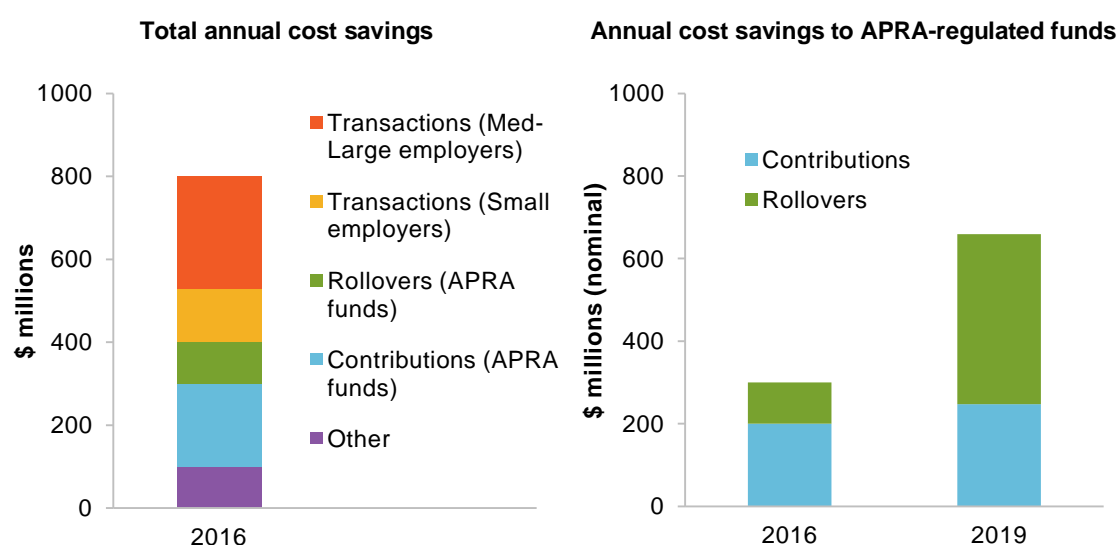
The administrative costs associated with SuperStream will be offset as cost savings accrue to APRA-regulated funds, SMSFs and employers. The Australian Taxation Office (ATO) has estimated that SuperStream has generated administrative cost savings of approximately

\$800 million per year (relative to a 2010 baseline of how contributions were processed prior to SuperStream), split evenly between superannuation funds and employers (figure 3.20, left panel). For employers, these savings reflect an estimated 70 per cent reduction in the amount of time spent processing contributions (ATO 2017g).

For APRA-regulated funds, improvements in contributions and rollovers processing were estimated to have led to avoided costs of \$200 million and \$100 million respectively in 2016, and the annual benefits are expected to increase to \$660 million by 2019 (figure 3.20, right panel). These estimated cost savings reflect a 75 per cent reduction in mail-room processing, 90 per cent reduction in cash handling and 60 per cent reduction in error-checking work (ATO 2017g, p. 20).

The ATO also estimated annual aggregate benefits to *members* of \$2.4 billion per year, mainly due to the recovery of lost accounts, closure of duplicate accounts, and the elimination of additional fees on those accounts (ATO 2017g, p. 12). Of this total, 9 per cent (\$206 million a year) was directly attributed to lower per-account fees resulting from SuperStream's impact on fund-level costs going forward. However, the impact of SuperStream on member fees may grow over time as the capital costs of implementation are fully amortised by funds and the remaining components of SuperStream are put in place.

Figure 3.20 **Estimated cost savings from SuperStream for employers and funds^a**



^a The 'Other' category in total annual cost savings consists of non-specific savings to APRA-regulated superannuation funds and their members.

Source: ATO (2017g, pp. 5, 39, 41).

DRAFT FINDING 3.2

Superannuation fees in Australia are higher than those observed in many other OECD countries. In aggregate, total fees — for administration and investment management services, and in both accumulation and retirement — have been trending down as a proportion of assets, from 1.3 per cent in 2010 to 1.1 per cent in 2016. Fees have fallen markedly for retail funds, albeit they remain higher (at least for choice products) than the (largely unchanged) fees for industry funds.

Among APRA-regulated funds, the MySuper and SuperStream reforms have likely acted to reduce fees (including some likely competitive spillover to choice products), albeit this is difficult to attribute directly given growth in average fund scale and the impact of other fee drivers.

While dispersion of product-level fees has decreased over the past decade, there remains a persistent ‘tail’ of relatively high-fee (mainly for-profit) choice products with total fees exceeding 1.5 per cent of assets each year. This tail comprises about 14 per cent of member accounts and 15 per cent of system assets.

3.3 Costs in the SMSF sector

The SMSF sector — comprising self-managed funds with four or fewer members — has experienced rapid growth in Australia over the past decade, with assets growing at a compound annual rate of 8.4 per cent in the decade to 2017, compared with 7.9 per cent for the APRA-regulated funds (APRA 2018c).

For the average SMSF member, total costs rose from around \$5100 in 2013 to around \$7300 in 2016. This reflects growth in both investment and administration costs for SMSFs (ATO 2017c).

Differences in how data are collected by the ATO (for SMSFs) and APRA (for institutional funds) mean that direct comparisons are not possible (tech. supp. 5). For example, cost data for SMSFs do not capture the opportunity costs of members’ time for those that do genuinely manage their own assets. This is likely to be a large impost relative to a member of an institutional fund.

In addition, the ATO revised its collection methodology in 2013 with new labels added to the SMSF annual return on non-deductible costs (that is, those costs that cannot be deducted from income for taxation purposes) (ATO 2015b). This had a significant impact, with reported total costs rising by 72 per cent in 2013, of which 95 per cent reflected the inclusion of non-deductible costs.¹⁰ In the period since then, non-deductible costs have contributed around 43 per cent of growth in total costs, however this reflects significant growth in the

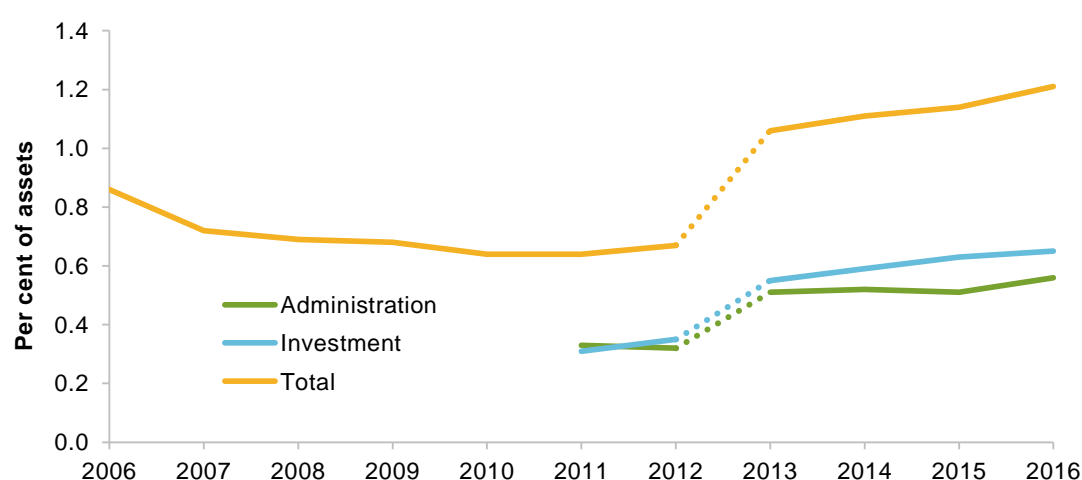
¹⁰ Costs incurred by SMSFs that are of a capital or private nature are generally non-deductible. This is because these costs are not outgoings strictly incurred generating income assessable for income tax purposes.

number of SMSFs reporting these costs — in average terms, deductible costs have grown by significantly more over the period. That reported costs are now apparently growing faster than assets (at least in total) suggests that the historical trend of declining costs (to assets) may not have been an accurate representation of trends in total costs (figure 3.21).

Data issues notwithstanding, it appears that low balance SMSFs report significantly higher costs (relative to assets) per member than APRA-regulated funds (figure 3.22). While costs decline as SMSFs get larger, the differential persists for SMSFs with balances less than \$1 million (on average). This would imply that the majority of SMSF members are likely incurring costs higher than those incurred (in fees) for members of an average APRA-regulated fund — though their net returns appear to be broadly similar (chapter 2).

It is unclear to what extent the presence of small SMSFs in the system is necessarily a problem. It may be that many of these SMSFs will move into higher balance categories over time (or as the upfront capital costs are paid off), although this is difficult to discern given the lack of publicly available panel data. There may also be other motivations for establishing an SMSF, such as having greater control over investments (chapter 5).

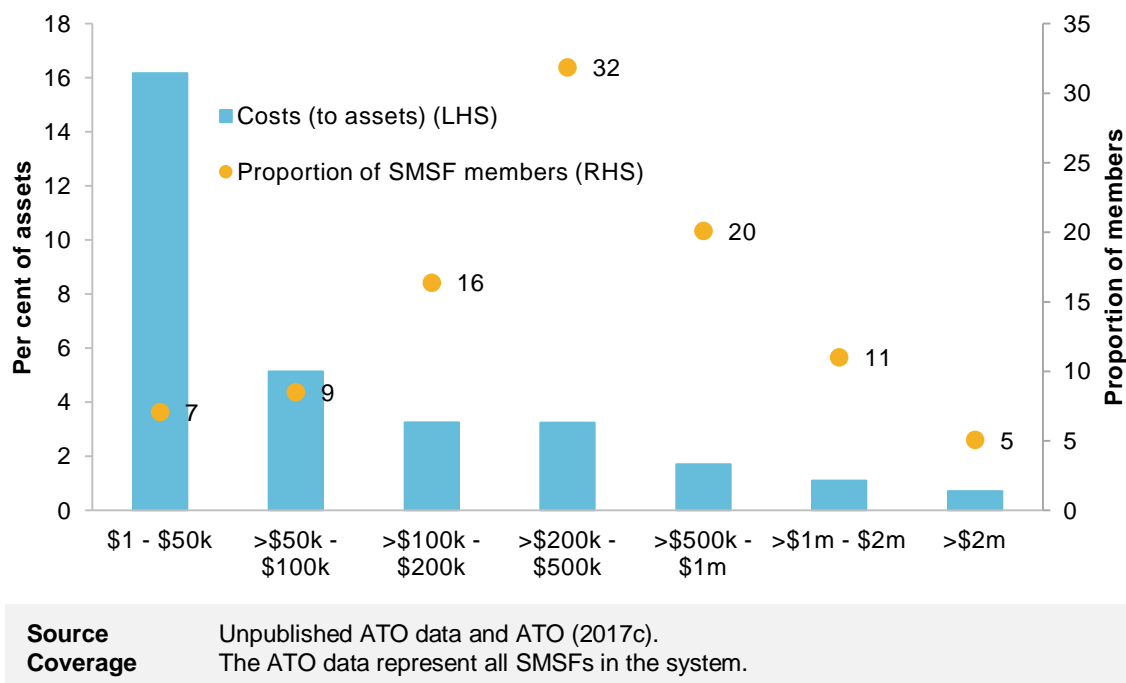
Figure 3.21 SMSF reported costs relative to assets^a
2006–2016



Source ATO (2017c) and various back editions.
Coverage The ATO data represent all SMSFs in the system.

^a The dotted lines represent a break in the series reflecting that the ATO revised its collection methodology in 2013 to collect better information on non-deductible expenses.

Figure 3.22 Smaller SMSFs face much higher costs than APRA funds^{a,b}
By balance band, average per member, 2016



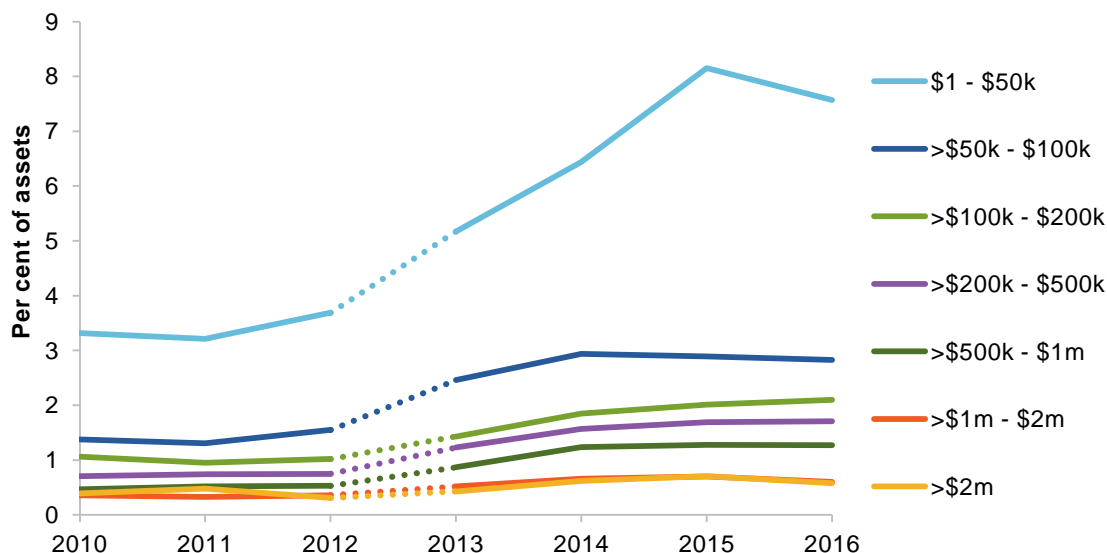
^a ATO data reporting practices mean upfront establishment costs are embedded in operating costs, which raise costs relative to assets more for low balance SMSFs. ^b Costs are estimated on a per member basis, recognising that SMSFs can have up to four members.

However, as noted in chapter 2, there is a strong positive relationship between size and net returns for SMSFs, and the returns of large SMSFs are broadly comparable to institutional funds. This means that returns alone cannot explain the willingness of SMSF trustees to incur higher average costs.

Nevertheless, the number of SMSFs in low balance categories has been falling, partly because average balances have grown. The proportion of SMSFs beneath \$500 000 has fallen by 18 percentage points over the decade to 2016. Further, data on the number of *new* SMSFs indicate that very small SMSFs (those with a starting balance of less than \$100 000) have decreased in both absolute and proportional terms. Such funds represented 35 per cent of new establishments in 2010, but only 23 per cent in 2016.

That fewer small SMSFs are being established could reflect not only the higher average costs of operating low-balance SMSFs, but also that these costs have risen significantly for *new* SMSF members over time (figure 3.23). This may have countered the benefits of operating an SMSF, such as control over investment decisions. However, it could also be driven by an improved awareness of underlying costs, and/or the quality of financial advice (chapter 5).

Figure 3.23 Costs have risen, particularly for low balance SMSFs^{a,b}
Administration and operating costs, new establishments only, 2010–2016



Source Unpublished ATO data and PC estimates.
Coverage The ATO data represent all SMSFs in the system.

^a Administration and operating costs are significantly higher than investment costs in general, and have also increased by more over time (across balance bands). ^b The dotted lines represent a break in the series reflecting that the ATO revised its collection methodology in 2013 to collect better information on non-deductible expenses.

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Reported costs for SMSFs have increased over recent years and, for those with over \$1 million in assets, are broadly comparable with APRA regulated funds as a percentage of member account balances. By contrast, costs for low balance SMSFs are particularly high, and significantly more so than APRA regulated funds. These high costs are the primary cause of the poor net returns experienced by small SMSFs on average. However, the number of new SMSFs with very low balances (under \$100 000) has fallen from 35 per cent of new establishments in 2010 to 23 per cent in 2016.

3.4 The relationship between fees and net returns

Fees matter because they detract from net returns. The primary issue for members is whether relatively higher fees generate a higher net return or provide other services they value. The relationship between fees and net returns is critical for what ultimately drives retirement balances, and there is evidence that variation in fees explains a significant amount of variation in net returns across the super system (box 3.3).

Box 3.3 **The relationship between returns and fees**

There is an extensive literature that investigates the relationship between fees and net returns. It is a contentious issue that relates to debates in academia and the financial sector about the effectiveness of 'active' versus 'passive' management, how the merits of different investment strategies differ across asset classes, and the long term benefits of investing in higher cost illiquid asset classes.

Overall, there is evidence that fees are a significant predictor of net returns, because on average it is not possible to outperform the market in the long term (Johnson et al. 2015; Jones and Wermers 2011). This does not preclude some fund managers from outperforming the market average by pursuing active management strategies (associated with higher fees), including by investing in alternative asset classes (PC 2016, pp. 126–128). National Australia Bank MLC Wealth (sub. 63) argued that 'in their experience' higher cost investments translate into higher net returns over the long term, and that a focus on minimising fees poses a risk of influencing investment decisions in ways that might compromise members' net returns.

However, the Grattan Institute found evidence that, on average, Australian funds that charge higher total (investment and administration) fees deliver lower net returns once fees are accounted for (Minifie, Cameron and Savage 2014). In 2015, the Grattan Institute extended this work and found a negative relationship between higher investment fees and lower returns within a range of asset classes.

The Grattan Institute's findings are consistent with other studies. Basu and Andrew (2014) found a (statistically) significant and negative relationship between gross returns from Australian superannuation funds and expense ratios (incorporating investment and administration costs). They found that a 1 per cent decrease in fees is associated with a 0.1 per cent increase in gross returns (and by extension a larger increase in net returns). Drew, Stanford and Veeraraghavan (2002) found that higher investment fees were associated with lower net investment returns across Australian superannuation funds between 1991 and 1999.

Chant West (2014) responded to the Grattan report by arguing that the higher investment fees charged by the ten largest MySuper products are justified by higher investment returns. This conclusion is based on evidence that these ten products, with allocations in unlisted assets between 10 and 36 per cent, had higher average annual investment returns over a 15-year period to 2014 compared with a passive benchmark portfolio. However, the Chant West measure of returns is not adjusted for administration fees, which ultimately reduce returns received by members.

Other studies have found that while higher fees lead to higher net returns, these higher returns may simply be compensating investors for higher risk. Ainsworth et al. (2016) found that Australian superannuation funds with higher investment fees usually have higher allocations to riskier asset classes, which are more expensive to manage. The study found evidence that funds that charged higher investment fees produced higher net returns than the cheapest funds; however, the most expensive funds did not realise significantly higher net returns once risk was taken into account. A different study, by Cummings and Ellis (2015), found that some Australian superannuation funds realised returns from illiquid investments (net of investment costs) that compensated for the non-diversifiable risk (such as liquidity risk) that the investments contributed to the portfolio.

Using historically linked investment option-level fee and return data, the Commission has examined the relationship between net returns expressed relative to the market average (net

of taxes and administration and investment fees), and average total fees at the fund level. This analysis has been conducted for funds in the Rainmaker database that had full data across the decade 2007 to 2016 — a sample of 88, on average larger, funds representing around \$1.2 trillion in assets (the effect of constraining the date range has been mainly to exclude some small retail funds for which data are less consistently observed). This is the same sample as analysed in chapter 2, with the linking process explained in technical supplement 4.

This analysis reveals a strong negative relationship between net returns and total fees (figure 3.24, top panel), consistent with previous analyses — that is, funds with higher total fees on average deliver lower returns (net of *all* fees) for their members. A substantial share of assets (as represented by bubble sizes in figure 3.24) are in funds that are performing relatively well compared with the market and are at lower fee levels. However, there are also several funds performing poorly relative to the market and doing so at higher fee levels. This indicates scope for substantial system-wide improvement in member outcomes from mechanisms which ensure members are either actively choosing, or are being defaulted into, lower-fee and better performing funds.

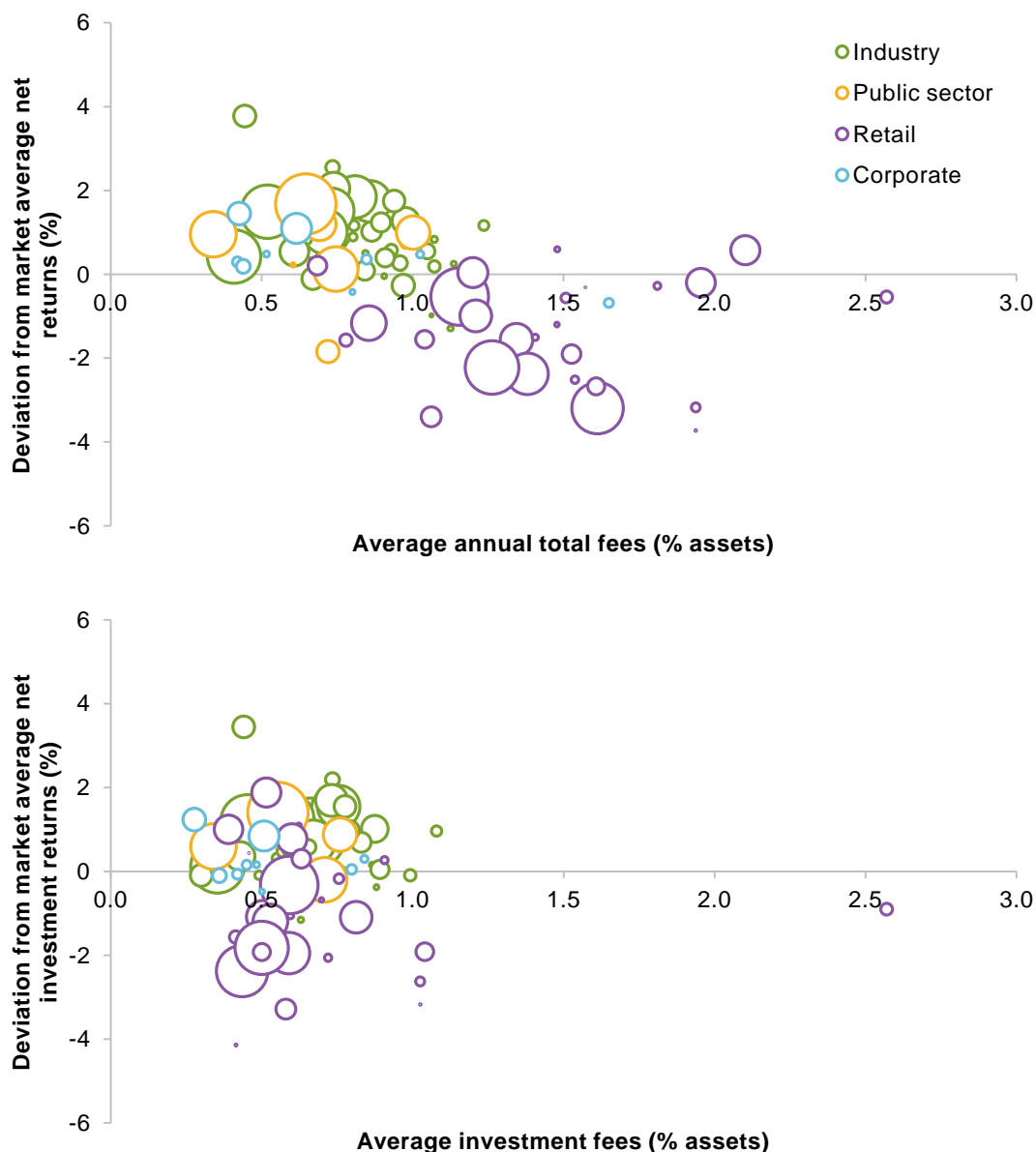
Because the analysis in figure 3.24 (top panel) is net of all fees (that is, examining returns net of both investment and administration fees), it provides a measure of the impacts of total fee levels on members' ultimate retirement balances. This is important given that many members do not necessarily value or utilise the additional administrative services offered by some funds and which members are nonetheless charged for. This analysis gives the clearest picture of the net benefits members receive in relation to the fees charged.

Other industry practitioners have analysed the relationship without adjusting for administration fees, namely by looking at the relationship between net investment returns (net of investment fees only) and investment fees in isolation (for example, Chant West (2017)). This analysis focuses more directly on the investment performance of the funds relative to the investment fees they charge.

The bottom panel of figure 3.24 replicates this alternative approach. It shows that retail funds, on average, appear to underperform the market even on this basis. This could reflect investment costs for retail funds being netted off returns, yet not being disclosed in investment fees; or alternatively a systematic investment in underperforming (related party) asset managers. Insofar as investment costs are driving the result, this is likely to reflect that retail funds derive significant fee revenue from specific services, financial advice and other discretionary fees charged to members, and that indirect cost ratio disclosure in product disclosure statements is understating the true indirect costs which ultimately detract from net returns (though this may improve with RG97).

It is also notable that the dispersion in retail funds' performance is large relative to other fund types. Some small retail funds deliver above-average net returns. That said, most have below-average net returns, which is *prima facie* evidence of fees driving persistent underperformance in those funds.

Figure 3.24 Members paying higher fees likely get lower net returns^{a,b,c}
Average annual figures with bubble size represents total assets, 2007–2016.



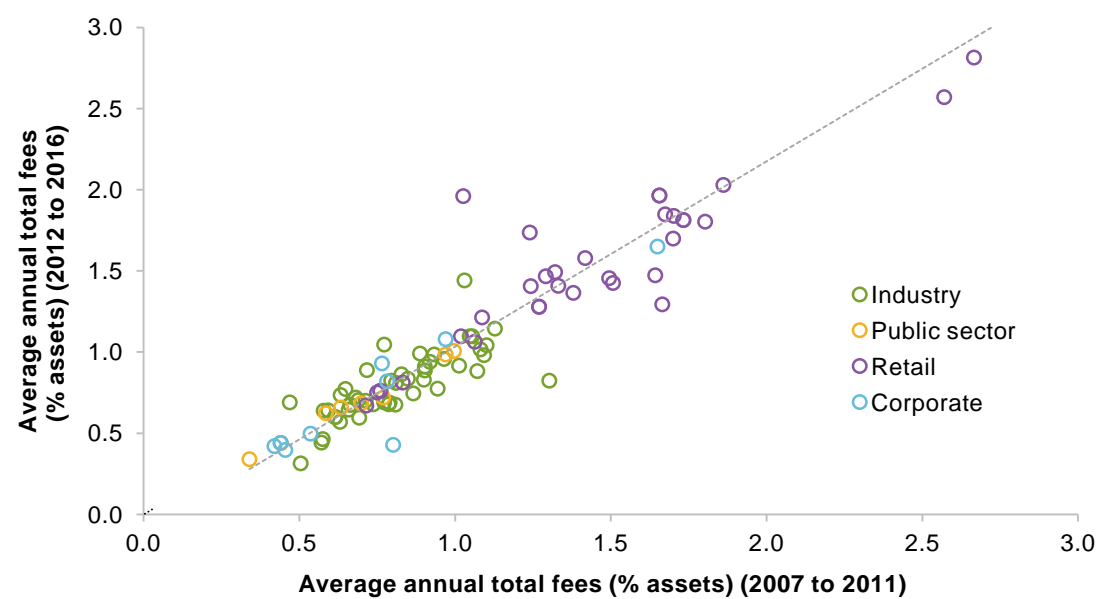
**Source
Coverage**

PC analysis of Rainmaker data.
The Rainmaker sample is 60.1 per cent of the institutional fund total (by assets in the latest observation) (some selection bias). For retail funds, the sample is 58.0 per cent of the institutional fund total, while for not for profit funds it is 61.8 per cent. This includes some smaller APRA-exempt public sector funds.

^a Data points are weighted by fund assets using APRA fund-level data for 2016. Where a fund is not captured in the APRA statistics, total assets have been sourced from Rainmaker or from annual reports. ^b The sample of funds in this figure is the sample in the Rainmaker database that had observable data for the entire 2007 to 2016 period and should not be interpreted as being *fully* representative of all institutional funds. ^c Market average net returns are a simple average across funds in the sample.

Moreover, fees persist through time. Figure 3.25 shows that funds’ average annual total fees in the five years to 2016 are highly correlated with those observed in the five years to 2011. It also shows that persistence in fees is seen at both high and low fee levels. This means that a member in a high-fee fund could pay those high fees over a long period to the detriment of their retirement balance.

Figure 3.25 Fee levels persist through time^a
Average annual total (administration plus investment) fees, 2007–2016



Source	PC analysis of Rainmaker data.
Coverage	The Rainmaker sample is 60.1 per cent of the institutional fund total (by assets in the latest observation). For retail funds, the sample is 58.0 per cent of the institutional fund total, while for not for profit funds it is 61.8 per cent. This includes some smaller APRA-exempt public sector funds.

^a The coefficient on the simple linear regression in the figure is above one (approx. 1.14) which is consistent with the result from preceding sections that overall, fees have come down slightly over time — that is, average fees for a fund between 2007 and 2011 were generally higher than observed in 2012 to 2016.

The subset of funds in the Rainmaker dataset with average fees in the ‘tail’ — that is, above 1.5 per cent of assets — constitute 9.3 per cent of assets, which if scaled to the system, would represent around \$180 billion in assets. These estimates are broadly representative of the system, albeit likely to be an underestimate for the tail given the selection bias embedded in research firm data (that is, that they are more likely to capture better performing funds — tech. supp. 4).

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Higher fees are clearly associated with lower net returns over the long term. The material amount of member assets in high-fee funds (about 10 per cent of total system assets), coupled with persistence in fee levels through time, suggests there is significant potential to lift retirement balances overall by members moving, or being allocated, to a lower-fee and better-performing fund.

Fees have a significant impact on retirement balances. For example, an increase of just 0.5 per cent a year in fees would reduce the retirement balance of a typical worker (starting work today) by a projected 12 per cent (or \$100 000).

4 Are members' needs being met?

Key points

- Much of the superannuation system is failing to deliver the right products and services to its members. Given a maturing system, the financial stakes and the need to give more weight to the drawdown (decumulation) phase, this failure is likely to be accentuated over time.
- The irony of the system is that if anything, products are most complex during accumulation and most simple in retirement — when the converse constellation is needed for most.
- For much of the accumulation phase, the greatest need for members is fundamentally simple — high average net returns on their contributions, low fees and simple products with balanced and growth balanced asset allocations.
- The proliferation of little-used and complex investment options (some 40 000 in 2016) in the choice segment of the market collectively appear to increase fees and to lower members' net returns (potentially reducing the retirement balance of a member in a high-option fund by much more than \$100 000). And it is a sign of unhealthy competition.
- Cognitive vulnerabilities may be at play in understanding the attractiveness of complex products to people, and why a fund is able to extract higher fees by offering them, even if on average, the gross return is not high enough to fund that premium.
- Excess variety (as distinct from 'virtuous' variety) also obscures people's capacity to find the funds that deliver good returns in the choice segment.
- The last few years of the accumulation phase are critical. Balances are high at this time. Reducing sequencing risk by switching to a conservative investment strategy at older ages could potentially reduce the retirement balance of a member by about \$130 000, a significant sacrifice for a relatively small improvement in certainty. Life-cycle products will not suit many people, especially, as people can continue to accumulate savings after retirement, bringing into question the inclusion of 'one-size-fits-all' life-cycle products into MySuper. 'Smarter' MySuper life-cycle options can be designed, but first need trialling in the choice segment.
- The decumulation phase is more complex than the accumulation phase. Retirees often have multiple and conflicting objectives that change as they age, and depend on the characteristics and needs of any spouse/partner. Interactions with the Age Pension, health and aged care, and assets held outside of superannuation add a further layer of complexity. Given that many retirement product decisions are largely irreversible, the need for good quality advice and member protection is essential
- There has been low take up of annuity-based retirement income products in the decumulation phase. Untangling why this holds is challenging, and may reflect:
 - that account-based pensions (used by the bulk of retirees) will suit many due to their flexibility and people's capacity to access the Age Pension to insure against longevity risk
 - behavioural biases, lack of understanding about their benefits, and the legacy of (now largely dismantled) regulatory impediments
 - relatively expensive product offerings alongside just a few vendors, which is now changing.
- The role of annuity products will likely grow over time, but are unlikely to be dominant.
- While 'data is the new black', the industry's use of data to design better products and services has progressed slowly, while broader innovation has been stifled through regulation and policy uncertainty.

Good markets meet consumers' needs.

A well-functioning and efficient superannuation system should ensure that it has a product range sufficient to meet people's sometimes varying needs ('virtuous variety') and that across this range, it matches products to people's needs as they age ('efficient matching'). It should do so at a price that is efficient.

Failures in these dimensions can adversely affect member outcomes through lower net returns or unwanted risks. A good system should provide a suite of products that are relevant to people's different needs over the life cycle and as the nature of work evolves. The goals would be to:

- allow members to maximise long-term net returns for most of the accumulation phase — a relatively simple task to achieve for most members. High-income members for whom tax and related matters are relevant might choose different accumulation strategies, but such members are in the minority
- provide asset allocation options that can meet *some* people's preferences for 'locking in', or at least reducing the variance of their balances, close to the point when they want to use these funds. The desirability of any product that seeks to do this *automatically* (life-cycle products) is not clear as it will depend on a member's risk appetite, preferences for a lump sum, expected withdrawal from the labour market (and capacity to re-enter), holdings of non-superannuation assets (and liabilities) and household characteristics
- cater for people's varying circumstances (including access to social welfare benefits), preferences and risks during retirement — a phase where the system should often provide solutions tailored to the individual. A key issue is the extent to which there are affordable options for risk pooling for those who want to insure against variance in market returns, inflation, idiosyncratic and systematic longevity risk, and other risky events that can lead to uncertain or unstable retirement incomes
- take account of the potential changes to working patterns associated with the gig economy, reduced demands for automatable skills, interruptions to job continuity, and the risk of continuing wage growth inequality (an issue covered in chapter 1)
- avoid products and system characteristics that lead to balance erosion. Unequivocally, deficiencies in insurance offerings, the potential for people to still hold multiple accounts, and high fees without commensurate returns do not meet members' needs. As critical as these concerns are, the Commission addresses them in other chapters in this report (chapters 3, 6 and 8).

A 'good' suite of superannuation products does not by itself meet members' needs, but requires a complementary product — disinterested advice — to achieve the goal of efficient matching. An analogy is the health care market where product variety is huge and usually desirable, but good consumer decision making requires trusted intermediaries (clinicians). There have been some reforms to 'advice products' in superannuation — such as for financial advice — but an open question is whether these critical complementary products are meeting members' needs. This is one of the concerns of the next chapter.

The irony of the superannuation system is that if anything, defined contribution products are most complex during accumulation, when they should be most simple for all but the wealthy.

In the transition and retirement phases, products may often still be elaborate, but are insufficiently-tailored to individuals' often distinct needs (sections 4.3 and 4.4). In part, this reflects the legacy of constraints posed by the tax and transfer system on the development of new types of products, such as deferred lifetime annuities and group self-annuitisation. Few superannuation funds are active in producing such products, notwithstanding relaxation of some of the key policy constraints.

Unlike many other goods and services, whose capacity to meet people's needs are quickly assessable either before or soon after purchase (a haircut, a meal and most physical products), the extent to which a super product meets a person's needs is only discoverable at certain junctures in a person's life, sometimes many decades into the future. There is evidence that people often cannot distinguish good superannuation advice from poor (ASIC 2006; chapter 5). Therefore, a person needs a product whose design appears likely to deliver the preferred outcomes in retirement, but also some reassurance that in the long period before maturation, the member is satisfied with the credibility of a super fund's claims about the characteristics of the product, its ongoing performance and its suitability for the person's circumstances. The intangible concepts of 'satisfaction' and trust are therefore an easily overlooked dimension of members' needs (section 4.1). Consumers' needs are not being met if they are not satisfied with, or do not trust, the business that manages a fair share of their mandatorily appropriated lifetime savings.

The extent to which businesses meet peoples' needs is often dependent on engaged, informed and footloose consumers. Unfortunately, members are mostly not engaged, and while they may be bombarded *with* information (and marketing), it can hardly be said that they are generally able to make informed decisions (chapter 5). Even some 'sophisticated' people making tailor-made choices among thousands of investment options can overplay their real ability to beat the market. Behavioural biases are rampant.

Information is a two way street. The 'data age' has demonstrated the value to businesses of mining customer data to add value, yet the degree to which funds use this strategy appears nascent (section 4.5). More generally, this raises the question of the inhibitors of innovation and the degree to which the sector applies innovation in areas that best meet members' needs.

The gap between needs and products is a symptom of the interplay between fund conduct, product complexity, and cognitive biases (and knowledge) of members. Regulation, market structure and limited competition play a decisive role behind this interplay. Many of the policy improvements proposed elsewhere in this report will play a role in narrowing the gap. For example, policies to improve engagement and information provision (chapters 5 and 13), the re-design of default allocation to encourage high performance (chapter 12), and an effective regulatory regime (chapter 13) will all increase the alignment of need and product offerings. However, some policies can directly target the tension between members' needs and the products delivered by the funds.

Overall, the key questions of this chapter are captured by the following three criteria identified in the stage 1 study.

- Do funds compete on member relevant non-price dimensions? (C8)
- Is there innovation and quality improvement in the system? (C9)
- Is the system providing products to help members manage risks over the life cycle and optimally consumer their retirement incomes? (E7)

4.1 Do members *believe* they are being well served?

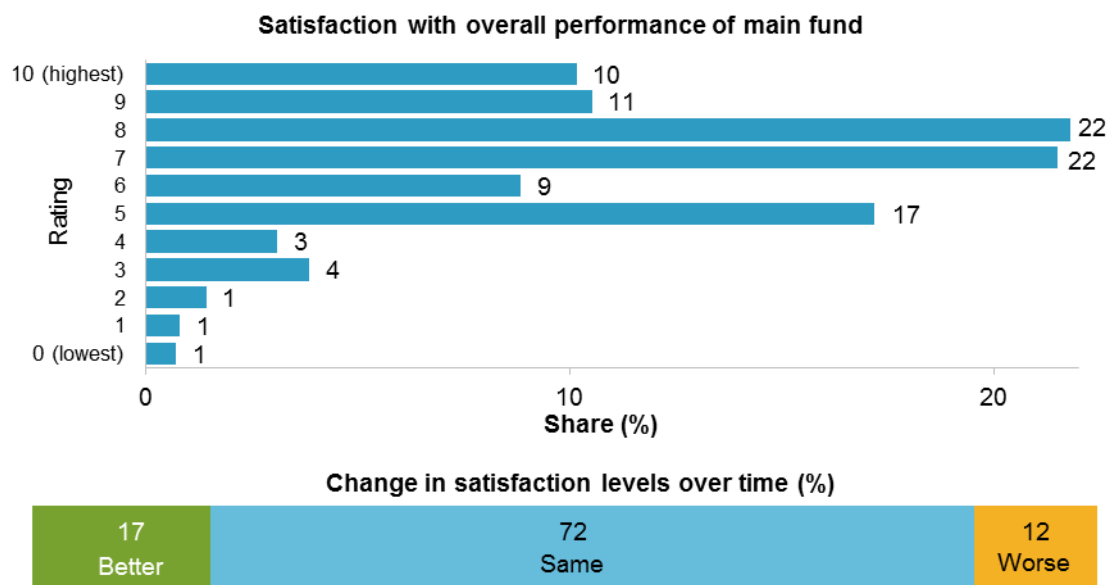
While not necessarily well-based, members' subjective assessments about the degree to which the system is working for them is an important indicator. Many aspects of a member's experience — such as trust or satisfaction with the various dimensions of products — can only be gauged this way.

Members had relatively high levels of satisfaction with the overall performance of their funds, with a small minority (around 10 per cent) expressing some degree of dissatisfaction (figure 4.1). While most considered their fund's performance had not changed much over the few previous years, where they did, it was normally for the better. There is evidence of greater diversity in members' satisfaction with specific dimensions of their fund's performance, though the overwhelming share of members were still positive (figure 4.2). The conspicuous source of dissatisfaction were fees charged (an issue placed under the microscope in this report in chapter 3).

Analysis at the member level found that there was close to a one to one relationship between a member's trust that their superannuation funds would act in their best interests and their overall rating of the performance of the fund. The strong relationship explains why the distribution of the two facets of perceived performance were almost identical. It also suggests that trust is a fickle aspect of people's subjective judgments because mere chance events affecting the returns on assets can result in poor (bad) performance without that implying that trustees are failing in their obligations.

In the retirement phase, there is a tendency for poorer ratings for annuities compared with account-based pensions and SMSFs, but this may reflect low sample numbers for members using annuities, which reduces confidence in the result (figure 4.3). The most revealing aspects of people's perspective on retirement products was that when they were deciding the product to choose, a significant minority of members expressed equivocal or negative views about the degree to which funds met their specific product needs. This judgment resonates with the Commission's findings about the current limited range of products in the retirement phase (section 4.4).

Figure 4.1 Overall satisfaction with superannuation funds^{a,b}
Including SMSFs



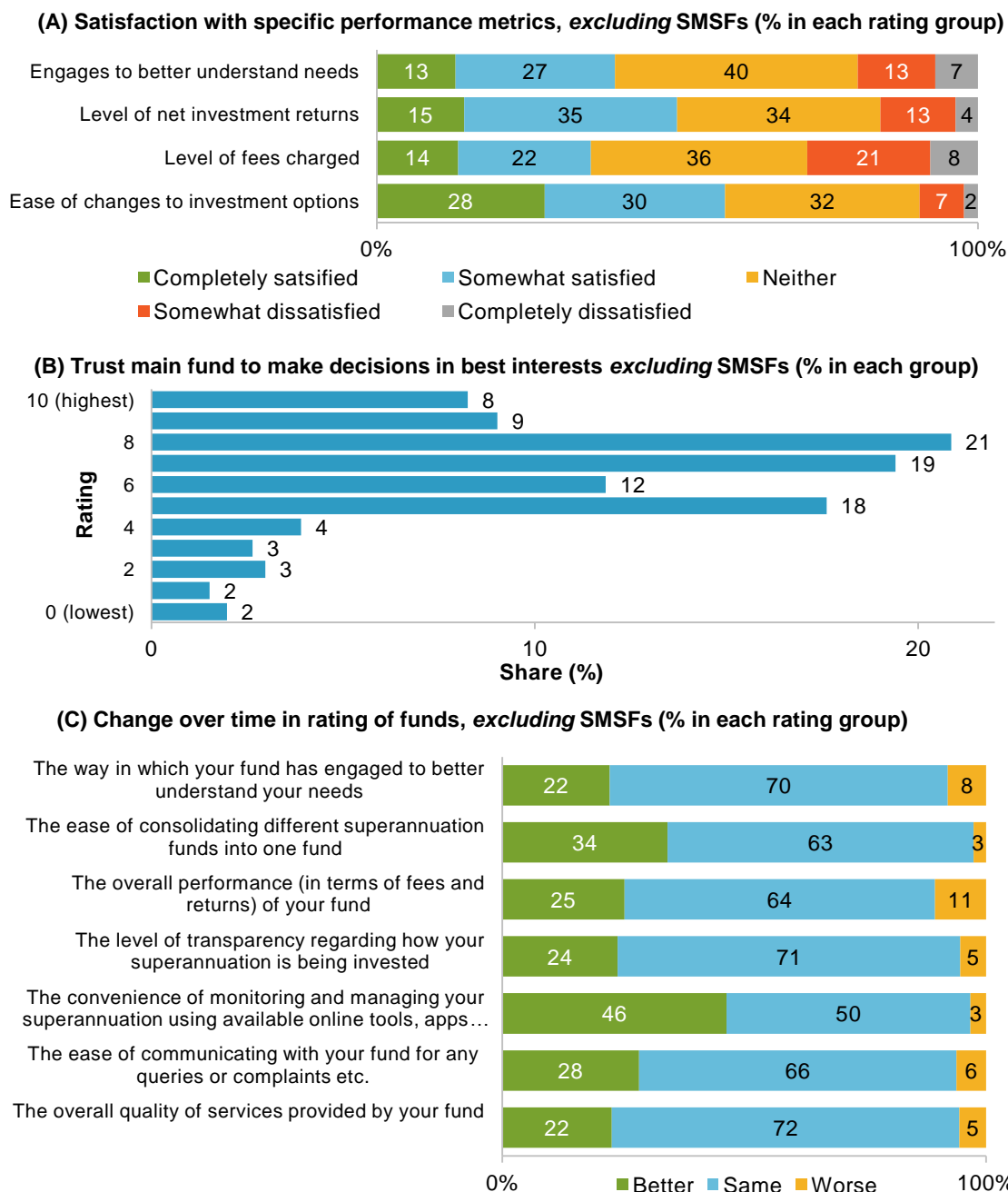
^a Responses are weighted using Commission weights. ^b The top panel (question Q6b) is based on 2069 observations and the bottom panel (question Q6c) is based on 1738 observations.

Source: Members survey.

The broadly positive views of members about superannuation has been repeated in other survey evidence. For example, results from a recent Choice survey of around 2500 people also suggested around 70 per cent considered that the system was ‘working for them’ (figure 4.4). The greater share of people with negative views than the more structured Commission members survey is likely to reflect differences in design and implementation.

Subjective assessments have some deficiencies regardless of how they are collected. There is evidence that poor understanding of, or interest in, superannuation translates to lower levels of satisfaction and trust (tech. supp. 6). Notwithstanding the aphorism, familiarity does not breed contempt. To that extent, subjective measures of performance may partly reflect the difficulties people face in making assessments when they do not understand the performance of a fund objectively. In that case, less weight should be given to such assessments.

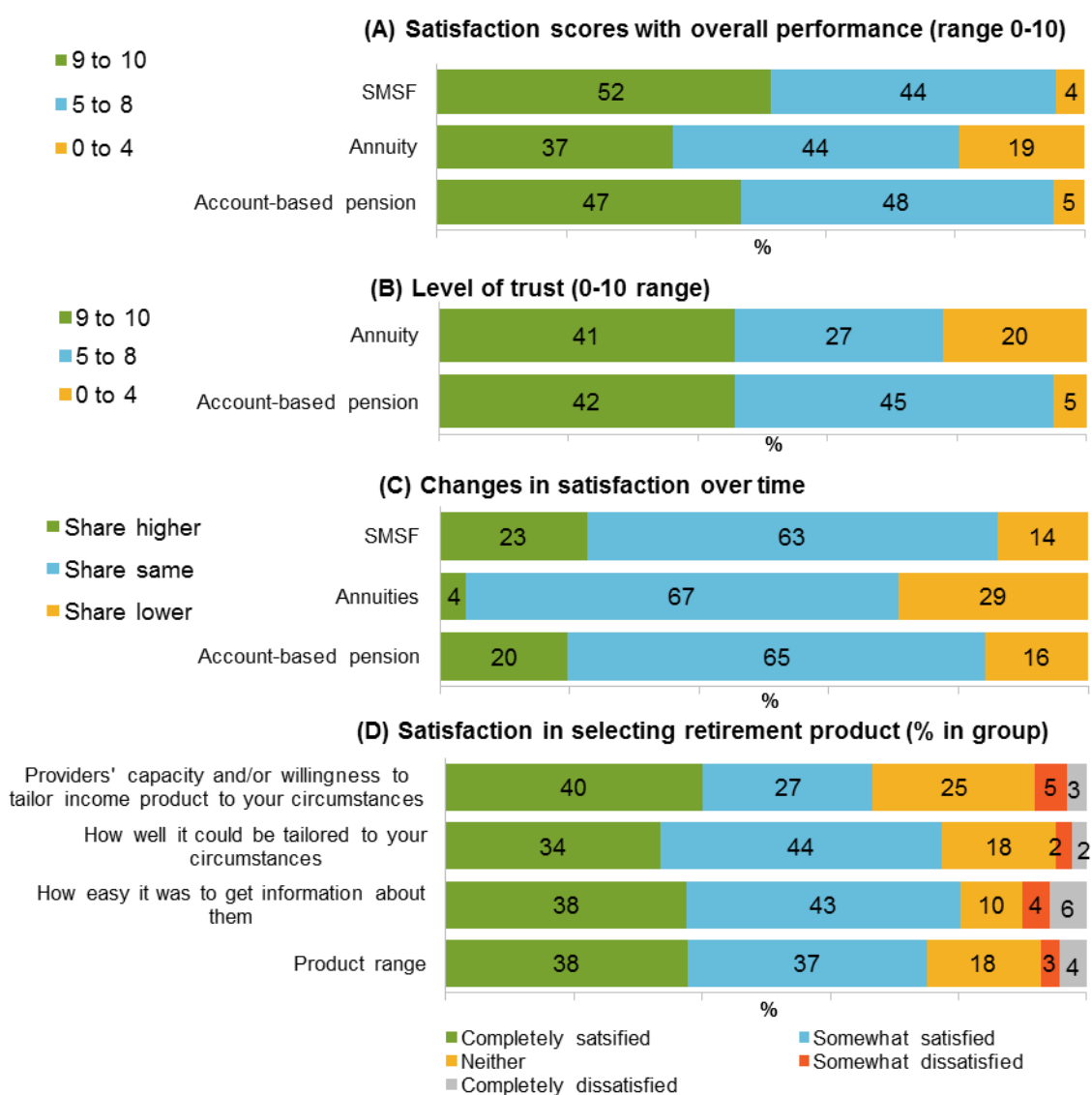
Figure 4.2 Satisfaction with, and trust of, funds^{a,b}
Excluding SMSFs



^a Responses are weighted using Commission weights. ^b Panel (A) (question Q8) is based on respondent numbers that vary from 1676 to 1945. Panel (B) (question Q7a) is based on 1908 respondents and panel (C) (question Q7b) is based on respondent numbers that vary from 1088 to 1304. 'Don't knows' and missing values are excluded.

Source: Members survey.

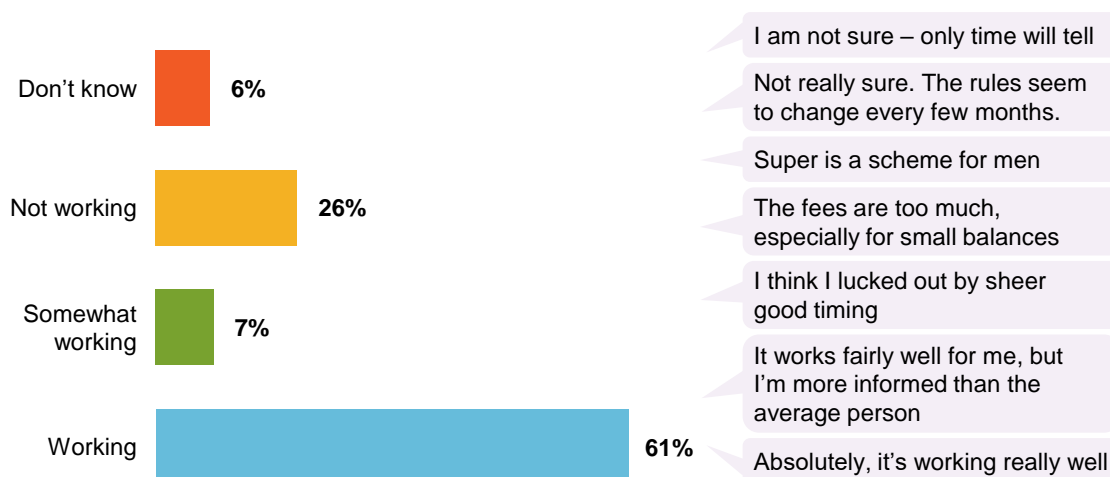
Figure 4.3 Subjective assessments about retirement products^{a,b}



^a Responses are weighted using Commission weights. ^b Panel (A) (questions R6a to R6c) is based on respondent numbers of 72 for account-based pensions, 18 for annuities and 23 for SMSFs. Sample sizes are sufficiently small that results need to avoid over-interpretation. Panel (B) (questions R7a and R7b) relates to trust that the fund will act in the member's best interest. It is based on respondent numbers of 69 for account-based pensions and 18 for annuities. Panel (C) (questions R6d, R6c and R6d) have respondent numbers of 51 for account-based pensions, 15 for annuities and 20 for SMSFs. Panel (D) (question R5) is based on 90 respondents and relates to the time when people were selecting their product.

Source: Members survey.

Figure 4.4 An overarching view of whether the system is working for members^a



^a Survey of 2498 CHOICE members, of which there were 2376 valid responses for the question of: 'Overall, do you think the superannuation system is working well for you?'.

Source: Survey data provided to the Commission by CHOICE.

DRAFT FINDING 4.1

Qualitative judgments by members of superannuation funds suggest that a small share are dissatisfied with the overall performance of their fund. Members who have a poor understanding of the system and less capacity for accurately gauging the performance of their funds tend to report being much less satisfied. However, many more members indicate that the performance of funds, including their service quality, has improved over time than those who feel that performance had flagged.

A sizable minority of members selecting a retirement product express equivocal or negative views about the degree to which funds meet their specific product needs.

4.2 Is there product proliferation and does it matter?

In many markets, product proliferation is desirable as it meets the diverging preferences and needs of consumers, fosters further innovation and creates downward price pressures on existing differentiated products protected by patents. The dynamism and variety of the smartphone sector is an exemplar. While less dynamic, the supermarket industry demonstrates even greater product variety, with the average full service supermarket stocking between 20 000 and 25 000 different products (Mitchell 2016) — a variety that most consumers would see as beneficial.

There appears to be a similarly large number of options in superannuation with concerns that unlike ‘normal’ markets, the variety adds little value for consumers, while increasing costs, fees and confusion, an issue relevant to the financial sector more broadly (PC 2018). The concern applies to all stages of people’s involvement with superannuation. However, it is most critical during the accumulation phase because this comprises peoples’ most protracted involvement in the superannuation system. Accordingly, it is where the potential adverse effects of poor product choice or high fees will have the greatest effect.

The blunt assessment of Industry Super Australia (sub. 59) was that product variety is an indicator of how for-profit funds extract value from the system as part of their business, including through distribution channels such as sales and marketing, product bundling and advisers. The Deputy Chair of the Australian Prudential Authority (APRA), Helen Rowell (2017b, p. 9) was not much less critical:

I have previously expressed the view that there are too many investment options within super ... Under APRA’s proposed member outcomes assessment, and as part of sound strategic and business planning, we would expect trustees to seriously consider the optimal number of investment options they should be providing to efficiently deliver quality outcomes for members.

A starting point for testing the validity of this grim diagnosis is the nature of product variety in the superannuation industry.

How many products are there?

About half of member accounts are in default products. Product variety is moot for such members. However, an open question is whether product proliferation in the choice segment might contribute to the dominance of the default market as product complexity may lead to member inertia (an issue we explore later).

For industry fund members, there are a relatively small number of options (a median of 16 among the funds in 2016).¹¹ Most members chose one of four pre-mixed options — high growth, growth, balanced or conservative (Rice Warner 2017d).

The story for retail funds is quite different. The ‘tail’ of funds with a large number of options is long (tech. supp. 6), and the median number of options are nearly double that of industry funds. In 2016, 18 APRA-approved funds offered more than one thousand investment options and a further 24 offered between 100 and 1000 options. All were retail funds. Such options give individual members the scope to develop highly customisable portfolios (for example, specific listed companies, and multiple managed funds with varying asset mixes). The consequence of the large number of options offered by some funds is that there are around 40 000 apparent options across all APRA-regulated funds (covering the pre- and post-retirement phases). The numbers exaggerate the real extent of proliferation because the

¹¹ Based on confidential APRA data. Medians provide a more meaningful indicator of central tendency than averages when the data are heavily skewed, as they are for option numbers.

concept of an option is woolly (box 4.1) and because 30 of all the investment options accounted for three quarters of all investments in the retail segment (Rice Warner 2017d).

Box 4.1 Quibbles about funds, products, categories and options

Measuring ‘product’ proliferation is not straightforward given the esoteric framework for categorising the outputs of superannuation entities. Super products somewhat resemble the financial equivalent to Matryoshka dolls in that they are packages of packages of packages of investment options. Registered superannuation entities (RSEs) are umbrellas for one or more funds, which offer one or more ‘products’ (typically for different client groups — retirees, individuals in the accumulation phase, and employers, though there are sometimes a few more variants.) Each fund offers one or more investment options — and it is in the latter that the choices seem extravagant. In 2016, there were over 40 000 such options among the 220 APRA-regulated funds. On face value, the number of options has trended up over the longer run, with APRA data revealing a startling increase of around 100 per cent between 2013 and 2014. However, before a rushed judgment about the significance of these numbers, several important caveats bear emphasis.

First, APRA changed its reporting standards in 2014, which seems likely to have affected the reported numbers, and thereby the meaningfulness of the trend data. In advice to the Commission, APRA does not regard the reported option numbers as a precise measure of product range.

Second, the reporting framework is complex, as even a peremptory examination of the relevant instructions attest (APRA 2015a). Options are only non-MySuper options if they meet certain asset thresholds, after taking into account the degree to which MySuper assets are held in that option. Options with very similar features can be identified as separate options for the same fund, and some options can be shared across funds, but are counted as different options when fund statistics are compiled. For instance, across the 43 000 open options identified in the Rainmaker data, there are more than 1100 ‘cash’ products, which by construction provide very similar returns. Similarly, there are more than 6100 ‘fixed interest’ products — again where the heterogeneity of assets is relatively low. Lying behind many of these assets, the same fund manager may manage an asset for more than one superannuation entity.

Third, many of the options are only available for certain types of investors. Confusion in choice for any one group can only relate to the options available to them. For instance, in the Rainmaker data, there are around 19 000 open options that are only available in the retirement phase to individuals and around 20 000 open options for individuals in the pre-retirement phase. There are several thousand more options only available to corporates and employers.

Nevertheless, no matter how the data are measured and aggregated, the degree of product proliferation is an undesirable feature (for members) of the superannuation system.

Nevertheless, there is no doubt that some funds offer a huge array of investment possibilities, and that they still account for a large number of members and asset values. The 2016 APRA financial data on registrable superannuation entities show that funds offering more than 100 options accounted for about one third of member accounts and total assets.¹² Moreover,

¹² Unfortunately, the available data does not provide comprehensive information about the value of assets in each product option. As noted by Rice Warner, some options are little used.

although SMSFs are not retail funds, they provide their members with options equivalent to the most complex retail funds and they now also account for a large share of total superannuation assets (chapter 1).

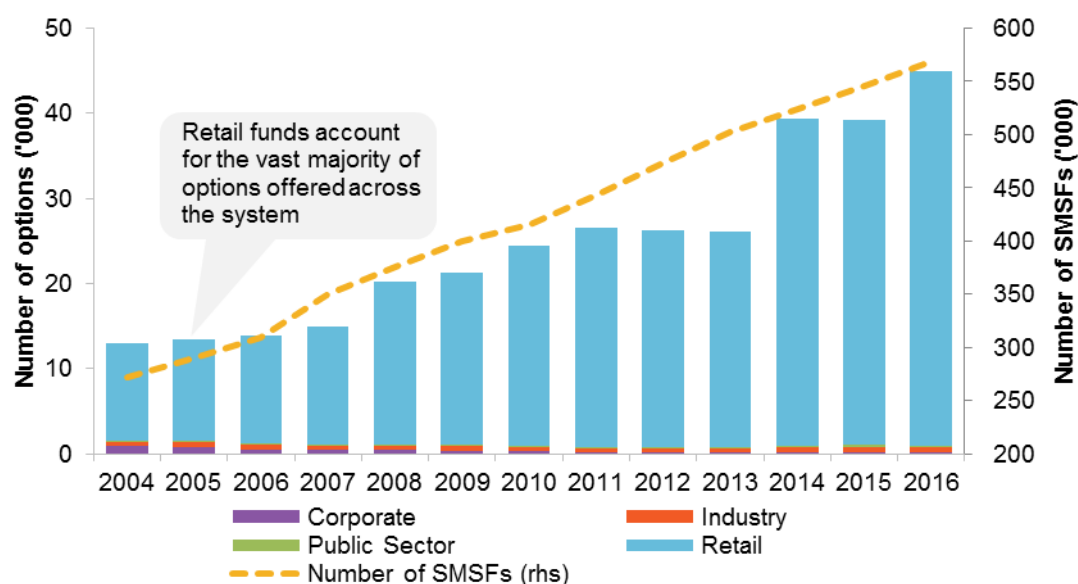
While retail funds tend to offer more investment options than other fund types, only some offer a very large number, suggesting that variety itself is a source of differentiation between funds, but not a requirement for fund success. Membership growth rates between funds with varying numbers of investment options are not systematically different. This provides some evidence that fund mergers and the need to continue supplying legacy products are unlikely to be a major driver of new options (which regardless remains a policy issue — section 4.2). There are no obvious significant size differences between funds with different option numbers once they are above ten — such as average member balances or member accounts.

While the data are poor, the evidence suggests that the number of options have been increasing over time (figure 4.5), with qualitative evidence from stakeholders also supporting this contention. The rapid growth in SMSFs also represents a widening of the investment options available to people.

Does product proliferation matter?

In contrast to many other industries, the presence of the extraordinary product diversity in the accumulation phase of superannuation is perplexing. During the accumulation phase, members' needs are *typically* similar. By their early 20s, around 80 per cent of Australians hold superannuation accounts (ABS 2017b, table 15.1) and will therefore have around 40–45 years in the accumulation phase. Members' balances at retirement are a function of any fees and the gross returns from the portfolio of assets held on their behalf. In general, holding a portfolio weighted towards growth assets with a modest share of low risk assets (bonds and cash), will maximise lifetime returns. Long-run historical data show that balanced funds have performed very well, even in comparison with more aggressive strategies (chapter 2). Safe investments in cash and fixed interest assets provide a low variance in returns, but equally a low rate of return. Indeed, over the long run, all but the very the worst outcomes for balanced portfolios outperform cash-weighted portfolios (chapter 2; tech. supp. 6). So even if the downsides occur, the average compound growth in balanced portfolios over a working life will mostly beat the safe strategy.

Figure 4.5 Option numbers appear to have grown over time, 2004–2016^a



^a Confidential data include options that are not reported in public data. Although coverage has improved in recent years, some funds do not report the number of investment options offered.

Sources: Confidential APRA data for funds and ATO data for SMSFs from <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/SMSF>.

The Commission’s members survey included a ‘choice experiment’, which sought members’ willingness to pay for various features of superannuation products (appendix C; tech. supp. 1). The results suggested that the capacity to control investment options was valued by older and more financially literate members (though note the evidence below about self-managed superannuation fund investors). This is consistent with the general desire by people to control their lives. It also accords with people’s varying appetites for risk at different stages of their life or for other aspects of investments (such as ethical investments). However, these preferences do not explain the extreme range between funds of the number of options they provide. The number of investment options needed to cater for any such variation in preferences is not great, a point emphasised by Rice Warner (2017d). Given the high levels of variance in returns across asset classes, it is not tenable that members can construct bespoke portfolios that are *likely* to produce better long-run returns than choosing among a relatively small set of off-the-shelf portfolios that span different asset mixes. Even large variations in asset mixes in a ‘balanced’ portfolio are associated with relatively small differences in long-run *gross* returns over 40–45 years (based on Productivity Commission simulations).

If people believe that, on average, greater control over assets and more options increases their net returns, the facts belie this.¹³ Based on analysis of APRA fund-level data, Industry

¹³ While we draw on the Australian evidence, similar results have been found in the United States (Keim and Mitchell 2016).

Super Australia (sub. 59) found that choice proliferation in superannuation was strongly associated with poorer financial outcomes for members (ISA 2017a, p. 3).¹⁴ In its own analysis of APRA data, the Commission found that, as measured by the 10 year compound rate, the *net* long-run returns are lower on average for funds that offer more options (after controlling for asset class allocation, fund status, and average benefits per member, which also affect returns).¹⁵ The average reduction in the rate of return compared with a modest range of options (around 10–15) and 300 or more options is around one percentage point per year.

Commission analysis of APRA data shows a positive relationship between the number of options and the ratio of fees to assets. Conservatively, the average ratio of fees to net assets (excluding costs relating to insurance) is around 0.5 percentage points higher for 300 or more options compared with 11–15 options. Such higher fees may reflect a fund’s capacity to charge a premium for access to variety, higher costs, or a combination of the two. APRA data for 2016 reveal no systematic relationship between the total operating costs of funds and the number of investment options. However, this is probably more a reflection of the difficulty of isolating the drivers of costs, than proof that no such relationship exists.

To give an idea of the implications of such a divergence in rates of return (as set out above), the difference in the superannuation balance at retirement at age 67 years for a full time male employee commencing work at age 21 years could readily fall in the range between \$140 000 and \$230 000 — a substantial penalty for access to a fund with numerous options. If the person was to make additional contributions to the fund, then the balance erosion could readily be greater than this.

The existence of a group of funds offering large numbers of options (while others do not) suggests that they cater for a subgroup of members for whom control and choice are especially important (for example, FSC, stage 1, sub. 29, pp. 18, 23; MLC, stage 1, sub. DR115). Some industry experts told the Commission that the expansion in the total number of options in the super industry reflects the competitive response of retail funds to the burgeoning growth in SMSFs, a view underpinned by the public statements of some funds (ASFA, stage 1, sub. 42, p. 17; Dixon Advisory, stage 1, sub. DR103, p. 12). Examination of the product disclosure statements of typical super funds offering large numbers of options (funds typically characterised as wraps and master trusts) shows that they are intended for people who want to implement individualised investment strategies similar to those obtainable through SMSFs. For example, one superannuation fund indicated

¹⁴ An important caveat to ISA’s (2017a) analysis is that only those funds with 10 year average returns were included in the analysis. This reduced the number of investment options in 2015-16 to 28 000.

¹⁵ A note of caution: these findings are at the fund level, not at the member level. It is possible that members who construct their own portfolios from funds offering multiple options obtain higher net returns. However, that is only reconcilable with the aggregate performance of such funds if other members obtain poor outcomes in funds that offer large numbers of options — which is not desirable either. Additionally, the results are averages across funds. Some funds with many options will have better returns than some funds with fewer options.

that its product ‘has been designed to deliver the same flexibility as a SMSF, without the administrative burden’ (AMG Super 2017).

Given the similarity between an SMSF and a retail fund offering hundreds or more options, it is likely that the same motivations are at play in members’ decision making. The Commission’s members survey found that the main reason for creating an SMSF was control over assets and investments, which complex retail products also do through creating many options and a 24/7 capacity to recalibrate asset choice. While the capacity to choose from a wider array of investment options was rarely the *main* reason for setting up an SMSF, it was the equal second most important motivation — again suggesting that this is salient for the complex end of the retail market.

These findings present a paradox. Control is valuable when it provides higher net returns or some other clear benefit that could not be otherwise obtained through access to a simpler product. Some people may simply enjoy managing their superannuation investment — but only a very few suggested this in the Commission’s members survey. For others, complex products and SMSFs may also offer advantages over typical institutional funds in that tax (and to the extent that they choose it, insurance) are calculated at the member level, not pooled across all fund members (Anne Street Partners 2015).¹⁶

It is possible that cognitive vulnerabilities may be at play in understanding the attractiveness of complex products to people, and why a fund is able to extract higher fees by offering them, even if on average, the gross return is not high enough to fund that premium. The literature on behavioural insights in finance highlights that people often believe that they have good skills in discerning optimal asset allocations, even when that belief is not well founded. One intriguing finding in behavioural literature is that ‘speeding tickets (a proxy for sensation seeking) and perceiving one’s intellect to be above actual intellect (a proxy for overconfidence) are associated with higher trading frequency’, accompanied by the high transactions costs and lower returns that this strategy involves (Frydman and Camerer 2016, p. 666).

Moreover, high levels of engagement does not *necessarily* equate with high levels of financial literacy. One survey of SMSF investors found that they had no better financial literacy than other superannuation members, but that 85 per cent rated their skill as at or above average (Bird et al. 2016a, 2016b). The Commission’s member survey found that SMSF investors had lower average financial literacy than other choice members because a smaller share got all the answers right.¹⁷

¹⁶ However, tax benefits were rarely given as the major motivation for establishing an SMSF — with the likelihood that the same would apply to those who take advantage of complex retail products.

¹⁷ However, the share of SMSF members getting at least *two out of the three* questions on financial literacy correct was the same as other choice members, where a choice member is defined as a member not in a default fund *plus* members who made an active decision to stay in (or join) their current default fund (chapter 5).

Overconfidence implies ironically that a share of those people who are highly engaged in superannuation may not be well served by it. In contrast, the disengaged often end up in the default segment with a net return that is likely to be superior (albeit accompanied by the risk that they could be allocated to a poorly performing fund that falls well short of the average performance of default funds). The implication is that engagement is most valuable when matched by readily accessible, salient and comparable information about the best choices (chapter 5).

Other concerns about excess variety

There may be other grounds for concern about product proliferation.

At the more banal level, one is simply the administrative and compliance costs of a system with so many options. APRA (stage 1, sub. 32) argued that 40 000 investment options generated substantial operational complexities and cumbersome and inefficient processes that ultimately disadvantage members. The costs of variety were not apparent in the fund-level statistics, but given all the other factors affecting costs, this is not surprising. Any acquaintance with APRA's reporting framework indicates that the large amount of variety must at least add to compliance and administrative costs, even if these are hard to discover at the aggregate level.

A further concern is that the large number of superannuation options makes it hard for people to make informed decisions (for example, AIST, sub. 39, p. 59). It is clear that many people are confused by product variety. Industry Super Australia and UMR Strategic Research (2017b, p. 4) found that 63 per cent of survey respondents either strongly agreed or agreed with the statement that 'the wide variety of superannuation products available in Australia means that it is hard to get a clear idea of which products are right for you'. (These results probably have little to do with the large number of options as defined in box 4.1 because these only become visible to people who have already selected a wrap or similar such product.)

Other than the effects of overconfidence, other behavioural biases may be at play in determining the sources of product variety and its impacts.

The demand for ethical investment products may reflect behavioural biases that give prominence to an emotional framing of an issue rather than a careful consideration of the actual products (Kahneman 2003). One risk is that funds offering such products can extract higher fees and make lower returns, though the evidence that this is systematically true is not strong (CHOICE, sub. 71 pp. 12–3; Farr 2017; Foo 2017; RIAA 2017). The bigger concern is that the word 'ethical' is a loose concept because people's views of ethical investments vary. The Responsible Investment Association of Australia has developed a certification system that provides some clarity, while some superannuation funds provide comprehensive disclosure. Nevertheless, it appears that such disclosure is not universal (Frost 2016a; Kollmorgen 2016). APRA (2013a, p. 8) has indicated that it expects an RSE licensee would be able to demonstrate to members the basis for its ethical investment strategy

and would be mindful of the risks to members (for example, from suboptimal diversification). It is unclear whether all of these expectations have been met.

There is also some evidence from the behavioural economics literature that excessive choice can lead consumers to select a default, experience frustration, or use faulty heuristics for decision making. The evidence for choice overload is generally strong (Chernev, Böckenholt and Goodman 2015). However, the concept is more nuanced than in its original formulation and some of the seminal studies have not been replicated (Scheibehenne, Greifeneder and Todd 2010). Regardless, one does not have to turn to behavioural economics to be concerned about the potential effects of product variety on consumer decision making. For people who are not well-informed about the relevant product characteristics, lack financial literacy or who find the terminology of finance bewildering, there are simply high transaction costs in making comparisons. Those costs will be most relevant for those people for whom the benefits of superannuation are most distant — the young. The evidence bears that out. Two thirds of ‘millennials’ (18–34 year olds) either strongly agreed or agreed with the statement about excessive variety cited above, compared with 58 per cent of ‘baby boomers’ (those aged 55 years and over).

The Australian Institute of Superannuation Trustees (AIST, sub. 39) were more generally concerned that the number of investment options outside the default market was primarily supply-driven and not member driven. This is probably over-simplistic in that clearly members are not required to choose complex products, and the fact that the market seemed to be responding to the consumer-initiated growth in SMSFs. Nevertheless, funds may sometimes be seen as accomplices to the behavioural vulnerabilities of some investors.

Regardless, the number of accumulation products and investment options is a good indicator of unhealthy competition in the system. Excessive variety can lead to choices that do not lead to best outcomes for members, or make them susceptible to poor advice. The potential under the current system that these costs may prompt people to choose default products with their typically higher returns may be a silver lining. However, a market in which widespread confusion is present does not meet people’s needs adequately.

In this respect, one of the key advantages of resetting default allocation is that it could create a better performance benchmark for the choice segment — which would make it easier for people to make decisions and to compare products. A reputable default product — where the features that are most valuable to consumers are signposted by a trusted intermediary (the Government and its agents in this case) — would provide consumers with an independently-based framework for making good choices.

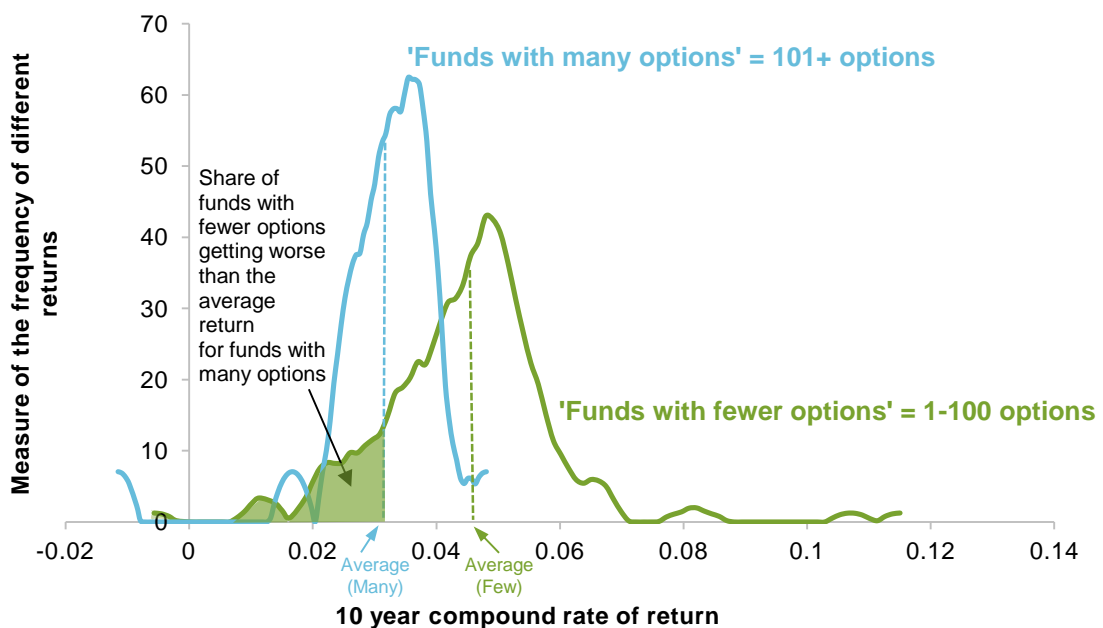
Changes that improve the capacity for members to make informed judgments (chapter 5) would reinforce the flow-on effects of policy improvements in the default product market to the choice segment.

Beyond that, it would be hard to justify prescriptive regulations that limit options and products, and given the ambiguities about the definition of an option (box 4.1), effective restrictions would not be easy to accomplish.¹⁸

Above all, a consistent message from the Commission’s analysis of the superannuation system is that ‘good’ or ‘bad’ *average* outcomes do not necessarily justify regulation. It is critical to assess the variation in outcomes across funds and members. For example, while funds with more than 100 options have lower average returns, many still outperform funds with few options (figure 4.6). Much of the variation in return rates is not explained by the number of options. That fact should not preclude APRA and ASIC to work together to monitor the effect of option numbers on costs and fees, as trustees have an obligation to their members.

Figure 4.6 Why averages can mislead

Some funds with many options beat some funds with few options^a



^a Densities were estimated using an Epanechnikov kernel.

Source: APRA confidential data.

¹⁸ Indeed, some suggest that certain types of accumulation products are missing. Despite product proliferation, there are no examples of pooling across members in the accumulation phase beyond legacy defined benefits schemes. In principle, such pooling has benefits, as they do during the decumulation phase (Ganegoda and Evans 2015). Internationally, there is increasing penetration of products that combine elements of defined benefit and defined contribution systems, such as ‘defined ambition schemes’ (Stanko 2015; Xu, Sherris and Shao 2015). Implementing these would be a major change to Australia’s system and has not been examined in this report.

DRAFT FINDING 4.2

Many members find it hard to make comparisons between the large numbers of superannuation products available. The substantial proliferation of investment options in the choice segment (some 40 000) complicates decision making and increases member fees, without boosting net returns.

A 'no frills' product with low fees that is allocated to a balanced (or balanced growth) portfolio is likely to meet the retirement needs of most Australians during the accumulation phase. A better designed and modernised default allocation could act as a trusted benchmark for better member decision making across the entire system.

Are product 'features' a problem?

Superannuation products also offer access to a range of different features, which are sometimes also seen as problematic. Apart from the inclusion of insurance as an opt-out feature (chapter 8), it is not clear that the large variety of features does much harm, and in many cases, they are likely to meet members' needs.

Many of the features are just the usual part of running a business that has an ongoing relationship with customers, and where product choice and communication is relevant to consumers — call centres, websites, online account access, investment choice, and consolidation services. These services were offered by funds to both retirement and pre-retirement personal members for nearly 100 per cent of products (based on Rainmaker and SuperRatings data). Mobile apps and social media had much lower prevalence rates (about 50 per cent of products). The Commission's choice experiment indicated that features where a member could communicate with funds — like call centres — were valued by members, so their almost universal presence is a good feature of the system. Similarly, the choice experiment showed that the ways in which funds engaged with members were valued (for example, newsletters, education seminars and webinars), albeit to a lesser extent than the features that allowed members to engage with funds.

The offer for financial advice was frequently included in products (to about 85 per cent of individual members) and in some instances, such as wraps, was a mandatory feature of the products. The value of this feature depends on the quality and cost of the advice.

Products included a range of promotional features — computer deals, shopping discounts and travel discounts — which are of dubious value and could act as a potential distraction from informed choice about superannuation. However, few products included these features (only 5 per cent based on Rainmaker data). While various financial services — health, car and home insurance, credit cards — were more common, most super products did not include them. Depending on the financial service, between 8 and 33 per cent of funds offered these services.

Overall, it would be deeply problematic if there were intense competition based on product features with little relevance to the key objectives of superannuation. However, the

Commission’s choice experiment suggests that people do not much value such features, and it seems therefore unlikely that they have much capacity to distort people’s decision making. While funds do not publicly reveal take-up rates of such features, the Commission also understands that the take-up rates of some features (for example, discounts on health insurance) are unlikely to be material — again consistent with their likely irrelevance to the decision making of most members.

In a broader context, even those features that members do find valuable (as discussed above) are not *that* valuable to them. The choice experiment suggests that in 70 per cent of cases, respondents chose the cheapest package in the menu of product and service characteristics, and were therefore looking for a no-frills, low-fee, high-returning product above all else. Another recent survey found that fees and investment returns were more important than technology credentials or ethical/green investments (ISA 2017c). While people have trouble understanding superannuation products, the ancillary features do not appear to transfix them.

Legacy products — is there a problem?

Product variety is partly a consequence of old products held by some members, but no longer on offer (‘legacy’ products).

There are two broad categories of legacy products in the accumulation phase.

Successor fund transfers (SFTs)

The first relate circumstances where members are transferred to another fund — a ‘successor’ fund — without a requirement for the consent of the members involved, as occurs in any merger. Several participants noted that the legally enforceable requirement on successor transfer funds to protect the ‘equivalent rights’ of members has led trustees to replicating investment options in their own funds (for example, MLC, stage 1, sub. DR115, p. 37).¹⁹ It appears that the problem may be resolving. APRA (2017f) released updated guidance on successor fund transfers in July 2017 that clarifies how trustees should interpret the equivalent rights assessment of product features and particular investment options. APRA noted that a ‘line by line’ comparison of every feature is unlikely to be necessary so that the product features of the proposed receiving fund would not generally be expected to be identical to that of the legacy product. Instead, a fund would consider equivalence in terms of a so-called ‘bundle of rights’, in which trade-offs are acceptable.

APRA indicated that a fund could generally expect to be able to transfer a MySuper member from an extinct fund to their own MySuper product (where that is a single investment strategy product). This is important because one of the benefits of the Commission’s policy

¹⁹ Trustees of the transferring RSE licensee also have an obligation to meet the equivalence requirement, which may add to the cost of a merger or exit. Equivalence is a somewhat ‘murky’ concept and does not relate to discretionary features of a transferring fund’s products that it could unilaterally change were the fund to have continued.

proposals is that they not only pull new members into the highest performing funds, but encourage the transfer of existing MySuper members to such funds. Notably, the ease of transferring MySuper life-cycle products is far less clear-cut because they can involve quite different features across different funds — a further reason for concern about such products (section 4.3).

APRA’s clarification of equivalent rights also has relevance to the non-default market because an outcome of the Commission’s improvements to default allocation is that they should create stronger pressures for poorer-performing funds of all kinds to exit or merge.

Own-fund legacy products — intra-fund transfers (IFTs)

The second type of legacy products are those developed by an existing fund and no longer offered.

Some suggest that some funds preserve poor value legacy products for their own self-interest (AustralianSuper, sub. 43). It is unclear whether this practice is widespread, but it would leave the fund trustees at risk of breaching their duty to look after their members’ interests. There is also a concern that legacy products can be carved out from disclosure requirements, which can make it hard to include them in product comparisons, notwithstanding evidence that they apparently have higher fees and costs (AIST, sub. 39, p. 34; Long and Cohen 2018). Whether additional regulation is warranted is uncertain. Under current arrangements, members are still able to compare the fees and performance of their existing products (based on their annual statements) against other products, so the *capacity* for making informed judgments is still available. While apathy is likely to limit such comparisons, mandating disclosure for legacy products so that comparison dashboards are more comprehensive is equally exposed to the same dilemma, and would be costly.²⁰

Others perceive regulation, not non-regulation, as the issue, claiming that regulations concerning IFTs inhibit product consolidation, raising costs to the disadvantage of members and also discouraging innovation if a fund is obliged to keep members in a novel product that is ultimately unsuccessful (ASFA, sub. 47, p. 20; PwC, sub. 62, p. 3; MLC and NAB, sub. 63). However, the obstacles to IFTs do not seem so significant that it is likely that they would have much effect on innovation in comparison with other factors, including previous regulatory barriers to annuity products (section 4.4). Indeed, in arguing for rationalisation of legacy financial products generally, the Financial Services Council argued that the ‘current rationalisation regime in superannuation works well from a consumer and producer issuer perspective’ and urged it as a model for other financial services (FSC 2017, p. 9).

²⁰ Notably, the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 carves out legacy products. The architects of the bill weighed up those who argued for and against their inclusion. The Bill if passed would include new design and distribution obligations in relation to on-offer financial products (except My Super).

Overall, the case for immediate regulatory change is not strong, especially as many legacy products will disappear as members using defined benefit products exit from the system. Nevertheless, some funds still express concerns, and there has been no systematic appraisal of the costs posed by legacy products, nor of the potential for these to change as funds develop new products and then close them. APRA should undertake such an appraisal. If evidence emerges that legacy products represent a significant compliance cost for super funds (and therefore an impost on the incumbents of such funds), APRA should revisit the conditions for member transfers, clarifying further the trade-offs implicit in the ‘bundle of rights’ underpinning the equivalence test. In the case of SFTs — the area of greatest concern to the Commission — careful oversight and good governance arrangements will remain essential, as emphasised by APRA.

What about the retirement phase?

Legacy products can also arise in the retirement phase, most particularly for products that offer some form of longevity insurance. As noted by the Financial Planning Association:

There is a history of longevity risk type products being developed with little consumer uptake, resulting in significant cost for product providers and creating a string of legacy products with few consumers invested. Examples ... include: Asteron longevity income stream (14 people in product when closed) — provided a longevity solution with lifetime guarantees but failed to qualify for the exemption on pension assets due to the methodology to share profits among the members of the fund [and] ANZ money for life — closed due to insufficient scale. (FPAA 2017b, p. 4)

Such legacy products appear to be rare. Indeed, the Commission’s analysis of SuperRatings data suggests there were no closed pension products in 2016.

However, product innovation and recent policy developments suggest that various forms of guaranteed income stream products will grow in prominence (section 4.4). At any given time, the form of those products will reflect tax and social security policy settings and the state of market development. As this context changes, or if innovative products fail to get a sustainable foothold in the market, some products may become obsolete, and be closed to new members (ASFA 2017b).

There is, accordingly, a strong risk that the incidence of legacy retirement products will rise. That could be accompanied by complex arrangements for transferring members from legacy to new products, the risk of high exit fees, and confusion for people — many of whom will be very old — about any new terms and conditions (for example, in relation to the payouts on withdrawal from the product, and any benefits that, on death, are transferred to a member’s estate). The Actuaries Institute (2017) has sounded an alarm over legacy products in comprehensive income products for retirement (CIPRs) in particular, such as those that arise from product failures.

There is no obvious problem yet, but the push for guaranteed income retirement products will require well-designed disclosure arrangements and monitoring by regulators to reduce

the risks for members, especially those with poor financial literacy or impaired cognitive capacity. As in many other areas of superannuation, good outcomes for members requires access to high quality, impartial financial advice (chapter 5).

4.3 Are products meeting people's needs in the transition to retirement?

The underlying volatility in asset returns as people accumulate their superannuation exposes them to increasing risk as they age (tech. supp. 6). The key driver of this is that earnings and thereby contributions rise over time. An unlucky outcome (from market volatility) in the last few years of accumulation can lead to significant losses in the total retirement balance — an outcome of sequencing risk.

Consequently, there is a received wisdom among some that fund members should give greater weight to less risky asset classes, such as cash and bonds, in the accumulation phase in the years approaching retirement (for example, CHOICE 2016, p. 13). Life-cycle products *automatically* re-orient a member's portfolio to defensive assets in the pre-retirement period, which typically produce less volatile, but lower, returns.²¹ In the vast majority of cases, life-cycle products are calibrated purely to the age of the member (Chant, Mohankumar and Warren 2014).

The Australian Government's 'Stronger Super' policy has legitimised the use of life-cycle products in the default market.²² In December 2017, 29 per cent of MySuper products had a life-cycle strategy, and these accounted for 35 per cent of MySuper assets (APRA 2018f, p. 8). In 2016, life-cycle products accounted for 31 per cent of member *accounts*, though there is no information of the number of members enrolled in such products (APRA 2017b, p. 23). All members covered by such products can expect lower retirement balances in exchange for reduced sequencing risks.

More generally, a shift to defensive assets as a person ages is not necessarily an optimal investment strategy. Under reasonable assumptions about the distribution of returns on a balanced growth portfolio, the chance that a person's fund balance will decline in the last five years of their working life is, at around 10 per cent, not that high. Where such sequencing losses occur, the mean loss represents around 9 per cent of their balances five years previously. The relatively low probability of a sequencing loss and its associated average loss rate has to be weighed against the expected gains forgone from relinquishing a more risky investment choice. As an illustration, if a fund were to switch a member from a

²¹ Life-cycle products are often referred to as 'target-date' products in the United States and are also marketed as such in the United Kingdom and other countries. High uptakes of target-date products has been reported for the United States, accounting for 25 per cent of 401(k) plans in 2015 (RRI 2016, p. 87). Their growing role appears to be a consequence of 'quasi-government' endorsement (Cooper 2011). Target rate funds performed poorly in the United States after 2008, with portfolios designed for people retiring in 2010 apparently falling by 25 per cent in value.

²² Many non-MySuper funds also offer life-cycle products as a choice among other investment options.

balanced portfolio to an asset class with a guaranteed 2.5 per cent real rate of return in the last five years of the member's working life, then the average retirement balance would fall by an expected 10.5 per cent or more than \$130 000 in this example.²³ Moving to a defensive strategy at earlier ages would accentuate such impacts. Rice Warner (2016b) noted that most life-cycle products are offered by the retail funds, and that these tend to dial down risk many years before retirement — some commencing at age 30 years. Data on the target risks by age group for various funds are shown further below.

Others have found qualitatively similar results. For example, one study found that life-cycle products offer expected returns of around one per cent less per year (after investment fees and taxes) compared with a balanced fund (Chant, Mohankumar and Warren 2014, p. 2). That study concluded it is an open question whether MySuper [with such products] leaves members better off.²⁴ Similarly, another experimental assessment concludes that life-cycle strategies only slightly improve results in the lower tail of simulated wealth returns, suggesting that life-cycle products are only suited to very risk averse investors (Truck 2016).

The expected loss from a life-cycle product acts like an insurance premium, whose value is determined by a person's risk aversion and their capacity to manage risks in other ways. Depending on its design, a life-cycle product in the accumulation phase is more valuable for someone who, all other things being equal:

- wants a certain, or at least a very likely, minimum cash sum at retirement to meet a need or aspiration that they cannot bear postponing (for example, the dream holiday or eliminating indebtedness).
- lies in the social security zone where some of the upside from maintaining a risky portfolio is effectively transferred to the Australian Government through greater withdrawal rates from welfare payments
- has high levels of loss aversion
- has little capacity for future labour market activity (or cannot rely on a partner to work longer to spread risk)
- cannot rely on family networks for assistance
- has no intention of giving a bequest, and so cannot vary the amount as a buffer against their own bad luck.

However, for others who do not fall into this category, maintenance of a riskier portfolio both before and, for a period, after retirement can make sense (Bell 2013). For instance, sequencing risk is less important if a person allocates a 'bucket' of their pension account to assets similar to those of a balanced fund and withdraws regular payments from a separate

²³ The extent of the impact of life-cycle products depends on the riskiness of the defensive strategy. Some life-cycle products do not shift asset allocations very far away from balanced portfolios. These will have a reduced impact on returns, but equally no longer qualify as a safe harbour for members' funds.

²⁴ Of course, in any given period, luck can play a role such that a life-cycle product could outperform more growth-oriented products.

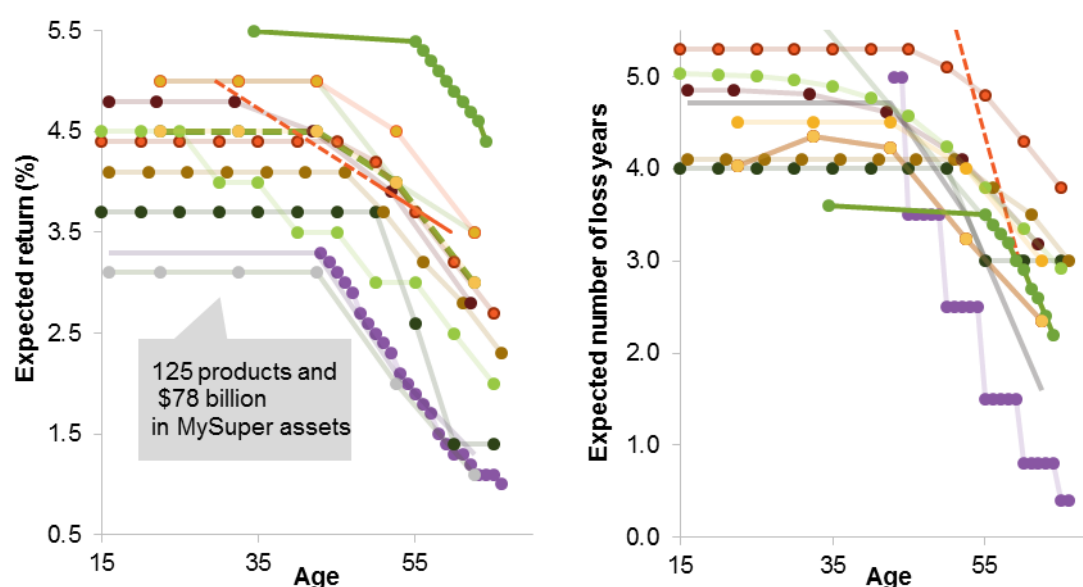
low-risk asset bucket for their regular income withdrawals. Several super funds offer such retirement products (for example, Sunsuper). Other than eliciting a member's preferences for the predictable component of their retirement income stream, the 'bucket' model does not require much information. Life-cycle products act as if the imminence of retirement is the trigger for a completely different investment strategy, when this will often not be the case.

In some cases, transition-to-retirement products (where a person beyond the preservation age draws a pension from a superannuation account, while still working) can also reduce any imperative for de-risking a portfolio prior to retirement.

Another reason for pause in using life-cycle products as a default is that they may not de-risk as much as expected. The number of negative years in a 20 year period of life-cycle products covering people aged around 55 years varies from under one to nearly five years, with an average of about three years (figure 4.7). Indeed, some products labelled as life-cycle have risk levels and returns at older ages that are much the same as balanced portfolios (and therefore cannot really reduce risk by much). Moreover, outcomes and expectations for apparent 'low' risk assets can vary significantly. Funds that were heavily invested in (apparently low-risk) pooled debt products in the United States prior to the global financial crisis suffered double digit percentage losses (Matterson 2013).

Figure 4.7 'Life-cycle' products come in so many forms that they cannot address members' concerns about sequencing risks^a

Expected returns and number of loss years across selected life-cycle products



^a Each line represents a particular product. The data relate to more than half of life-cycle MySuper products. The funds usually give an age range for a life-cycle product. For the purposes of this figure, the midpoint has been chosen for age. Results for people aged over the usual retirement age have been excluded, though some life-cycle products also include them.

Source: APRA (2018e, table 1b).

In addition, as members are enrolled 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. The choice segment has a greater capacity to determine the life-cycle product that best suits a given member compared with a 'one size fits all' MySuper life-cycle product offered by any given employer.

Accordingly, existing life-cycle products typically lead to poorer retirement balances, which is a sacrifice for very partial insurance against sequencing risk that many members would not willingly make were they aware.²⁵ Against this background, the legitimacy of 'one size fits all' life-cycle products in MySuper is questionable.

Shifting away from simple life-cycle MySuper products would involve some (surmountable) challenges, but a transitional period would be required. There would be few problems for younger people in life-cycle products because they are already typically allocated to standard MySuper investment portfolios. Older people allocated to low risk asset classes present a bigger challenge. While it would be in the interest of many to be re-allocated to a standard MySuper product, some process for obtaining consent would likely be required. One approach would be to provide such members with a capacity to opt out of an otherwise automatic shift to a single diversified investment option, but there may be other strategies for an effective transition.

Some have proposed a 'smart' life-cycle default product whose underlying investment strategy is customised to the needs of each member by taking into account their traits and likely preferences, going well beyond age as the chief criterion for setting risks (CIFR 2016; FFPL 2016; FSC and TTS 2017; LCC 2010; TTS 2016). Such products could consider eligibility of the member for the Age Pension, existing member balances, time to retirement, tax rates, and other household assets, among many other factors that would better match a product to the member.

A MySuper default of this form would represent a more sophisticated version of existing life-cycle products. In principle, there is merit in a smart option of this kind. However, the devil is in the detail.

- A well-designed product would require more detailed information about members than is often collected, desirably including factors such as other household assets (including any partner's superannuation) and future working intentions, which can be influential in determining the optimal investment strategy. Most funds do not currently collect such evidence at an individual level — a prerequisite for an individually-customised product.

²⁵ There are a number of somewhat more sophisticated default life-cycle products. For instance, QSuper's default product takes age and lifetime balance into account (though no other member characteristics). People with low balances are automatically allocated to higher returning assets at any given age. In line with this view, another super fund indicated to the Commission that that it chose *not* to offer a life-cycle product because nearly all of its members accrued low retirement balances, with the Age Pension acting as insurance against sequencing risk. Accordingly, it made sense to keep their members in growth assets.

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- From a regulator’s perspective, a complex product of this kind would require much more careful assessment than existing default products to ensure they were meeting members’ needs. Benchmarking relative fund performance would be difficult as could transfer of members between MySuper products (section 4.2). The algorithm underpinning the investment strategy for enrolled members would need to be tested to verify that its actual design benefited most fund members. Some have argued that proposed smart options have not verified their benefits (as cited in Stewart 2017).
 - There is an open question about how smart is smart? Conceptually, a smart default brings together two usually separated services — financial advice tailored to the person and an investment strategy. The ‘advice’ in this case would be based on an algorithm that matched asset selection to the (changing) traits and inferred or measured preferences of a person. However, it is far from easy to determine the marginal gains (and risks) from varying levels of smartness for highly heterogeneous members.
 - It would be very hard to explain such a product to a member, though that should not, by itself, preclude smart options.

Against that background, the Commission is cautious about recommending the replacement of simple life-cycle products with ‘smart’ alternatives at this stage. That does not preclude their use as a voluntary offering in the choice segment, which would provide an avenue for testing their value for members.

The choice segment already recognises that people have different preferences and traits. For example, among other funds, QSuper offers transition-to-retirement and life-cycle products, alongside other traditional products. However, even in the choice segment, members should be made aware of the possible implications of life-cycle products for their lifetime savings — as described above.

DRAFT FINDING 4.3

The inclusion in MySuper of life-cycle products is questionable given the foregone returns they pose for many members’ balances (with some foregoing higher returns by adjusting asset allocation as early as 30 years of age). Life-cycle products comprise around 30 per cent of all MySuper accounts, but are mostly suited to members who want to ‘lock in’ a lump sum for some immediate purchase after retirement. For other members, maintaining a balanced portfolio before and after retirement would maximise retirement and lifetime income. Life-cycle products are better suited to the choice segment.

INFORMATION REQUEST 4.1

Should life-cycle products continue to be allowed as part of MySuper? If so, do they require re-design to better cater for the varying circumstances of members nearing retirement, and how should this be achieved? What information is needed on members to develop a product better suited to managing sequencing risk?

4.4 Variety is needed in the drawdown phase

A superannuation system exists to contribute to funding consumption for members at the stage in life when the capacity to meet ongoing consumption through regular income from work is diminished. Given a maturing system, the financial stakes and the need to give more weight to the decumulation phase, any failures in this phase will be accentuated over time (chapter 1). The considerations relevant to the retirement phase are multifaceted and complicated (figure 4.8).

Superannuation is not the exclusive, or for many people, the most important, way to meet consumption needs and post-retirement risks (Daley, Coates and Parsonage 2016).²⁶ Home ownership can either act as another direct funder of consumption through equity withdrawal or downsizing, or provide a stream of rental equivalents. Refundable accommodation deposits were about \$22 billion in mid-June 2016 — an indication of the role of the home as a source of funding of consumption of aged care accommodation close to the end of life (ACFA 2017, p. xiv). Other assets, intra-family (in-kind and monetary) transfers, and the safety net played by the Age Pension, all contribute to the capacity of a person to meet their consumption preferences and act as shock absorbers for longevity risk, unplanned expenses, inflation, and market risk for any exposed assets.

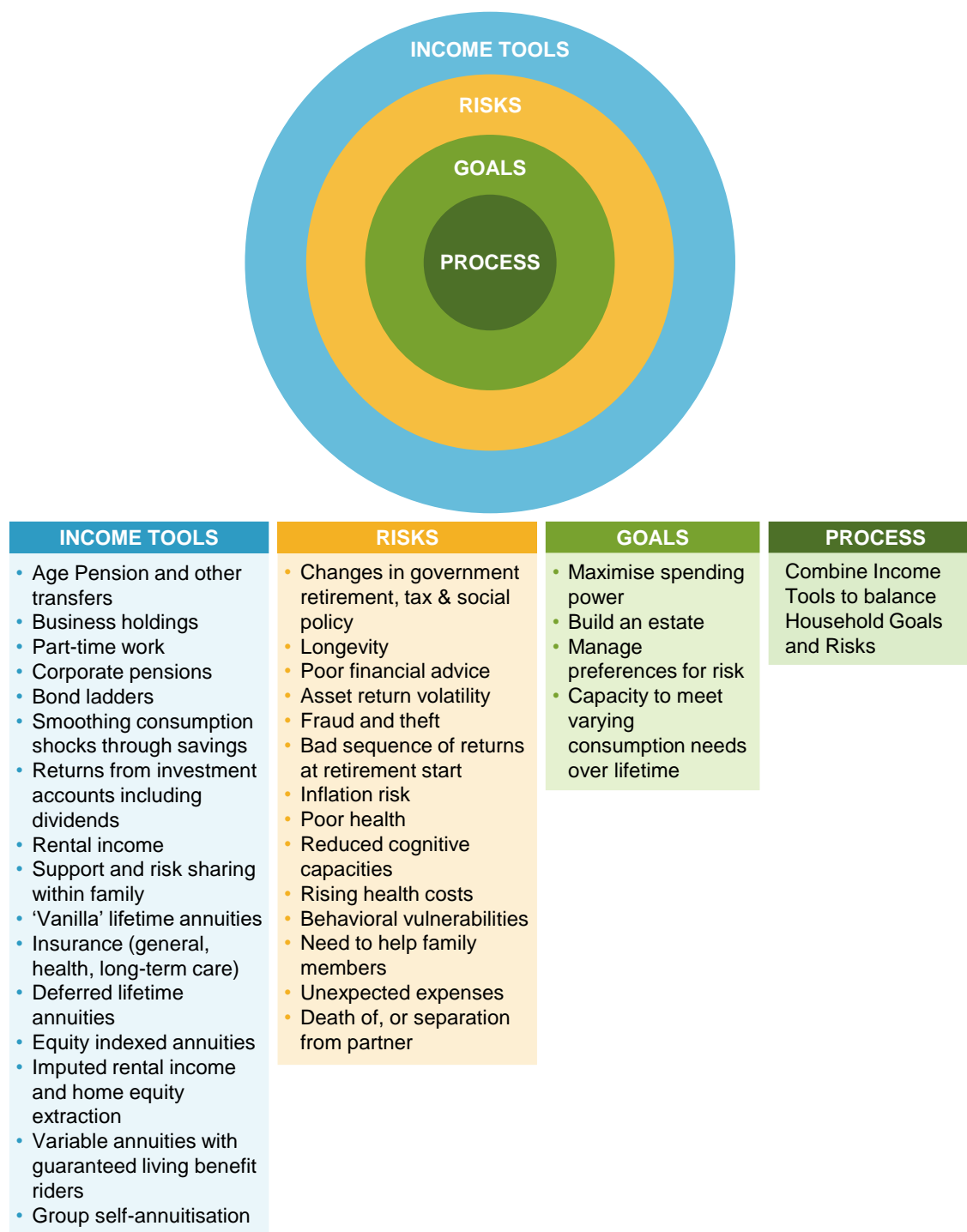
For example, about one third of people receiving regular income from superannuation receive more than 50 per cent of their total income from government pensions and allowances (ABS 2017b, table 15.6). More than half of those in receipt of term annuities were similarly reliant. Treasury projections suggest that though part pension rates will rise, there will be very little reduction in the overall use of the Age Pension, even in a system where the superannuation system has matured (Rothman 2012; Treasury 2015, p. 66).

Varying tax exposure, consumption preferences over time, behavioural norms, inter-generational altruism and risk aversion accentuate the need for people to determine their own best choices for managing superannuation balances. (These same factors affect the desirability of life-cycle products in the pre-retirement period.)

The empirical evidence substantiates that while retirees share some goals, they give considerably different weight to others (figure 4.9).

²⁶ Across the population, superannuation assets accounted for around 50 per cent of financial assets, but only 17 per cent of total assets (ABS 2017b, table 2.4).

Figure 4.8 The balancing act of retirement

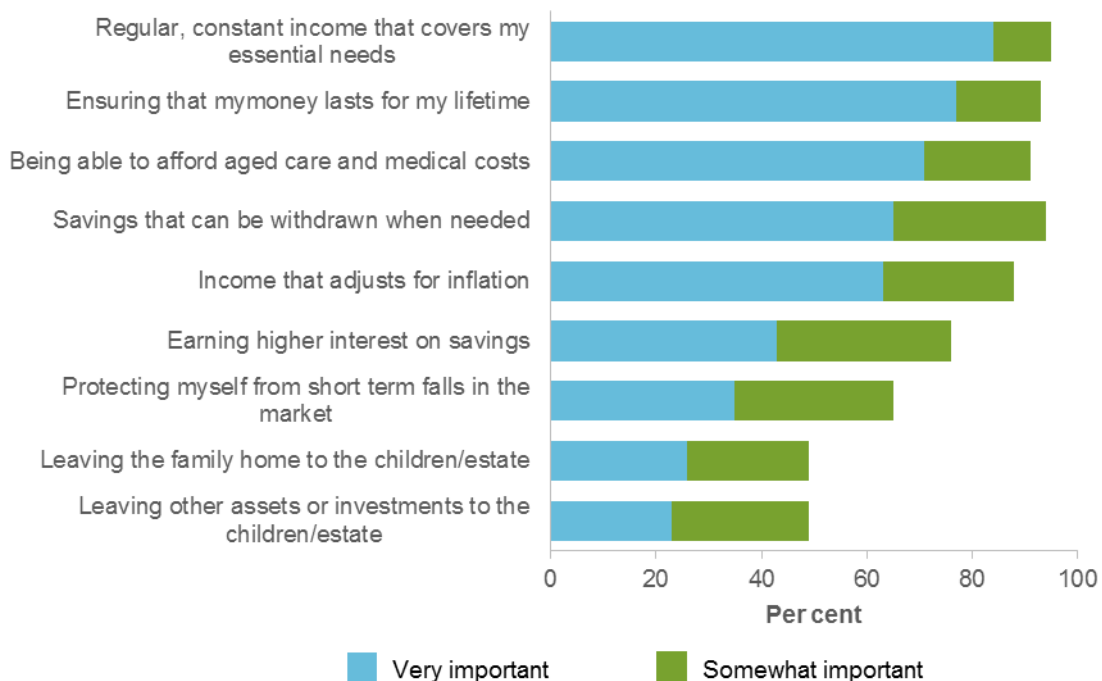


Source: A variation on Pfau and Cooper (2014).

Consistent with other data on peoples risk preferences, people *typically* reduce their exposure to riskier growth assets as they age. But 'typical' outcomes hide significant heterogeneity in risk preferences within any age group. About 25 per cent of superannuation members in the

choice segment aged 65 or more years have exposure to growth assets of about 25 per cent or *less*, while about 25 per cent have exposure of about 80 per cent or *more* (Rice Warner 2017a). People with the highest balances (of \$500 000 or more) tend to adopt less risky strategies than others, perhaps because the Age Pension is unlikely to ever be a feasible form of insurance.

Figure 4.9 Things that matter most about retirement finances
2017



Source: National Seniors Australia and Challenger (2017, p. 9).

Participants in the inquiry highlighted different strategies and concerns during the retirement phase:

Most people, as retirement approaches, realise they will need some cash as well as a pension. This is to buy that last car after a few years in to retirement, undertake inevitable home maintenance (painting, plumbing etc), funeral expenses, unexpected emergencies, and so on. They are very conscious of not having that hefty weekly salary coming in to sustain their living standards. This saved money they put in the bank and use the interest it generates to buy clothes or go on the occasional holiday etc. (Gregar, sub. 84, p. 5)

At some stage as my SMSF balance runs down, it will be no longer sensible or efficient to pay the costs of SMSF administration and the technicalities of transferring the balances to some simpler superannuation vehicle may be more than I want to have to deal with in my 80's. (Williamson, sub. 19, p. 1)

The implication of the above discussion is that the drawdown phase of the superannuation system should be re-conceptualised as the drawdown phase of *all* savings present at retirement. To that extent, a reflection on the performance of the superannuation system in meeting the drawdown phase is really an assessment of how people and the broader financial system manage retirement savings. In recognition of this, when a person's superannuation assets held captive by the system are finally released, people will often re-organise their asset holdings. The most common use of lump sum payments is to clear outstanding household debts and to purchase durables — which is simply the re-allocation of assets (ABS 2017b, table 15.7). It also follows that given the variety of people's circumstances, a vanilla MyRetirement equivalent to MySuper would be far from optimal. As noted by the Commission in 2015, in the drawdown stage, one size never fits all (PC 2015a).

Simple is wrong

If 'simple' is generally right in accumulation, it is wrong in the drawdown phase.

Simple financial planning approaches that are sometimes advocated, such as maintenance for life of a balanced portfolio and a fixed three or four per cent withdrawal rate, demonstrably fail to meet most people's needs, if for no other reason than people's consumption needs are not fixed over time (Pfau and Cooper 2014) and that they have other avenues for funding consumption. In any case, in an Australian context, the issue is moot given that regulated minimum withdrawal rates increase from 4 per cent for someone under 65 years old to 14 per cent for someone aged 95 years or older. The result is that average closing balances in funds fall from around \$300 000 to \$100 000 after 15 years of tenure in a pension account (Rice Warner 2017a).

It may be that a 'two bucket' approach — a safe bucket of assets for essential spending and a risky one for 'extras' and long-run returns — might be a reasonable heuristic for many, but it would still need calibration to individual circumstances, and there are other options that could achieve the same outcomes.²⁷ As noted by Barr and Diamond (sub. 74, p. 9) '... concern with consumption over a lifetime of unknown length is more complicated than accumulating wealth up to retirement'.

The implication is straightforward, if not necessarily easy to achieve: we should stock the retirement options supermarket with a large range, accompanied by disinterested and sophisticated advice to help elicit preferences and to match these to the available options. Given that many retirement product decisions are largely irreversible, the need for good quality advice and member protection is essential.

In that case, the key policy issue is whether the options and the advice are available. Chapter 5 examines the defects in information provision and financial advice, and the solutions to these. That leaves product variety.

²⁷ For example, an automatically re-balanced portfolio with the shares in safe and risky asset classes can achieve the same outcomes as a formal segregated investments strategy.

Is the product range in retirement wide enough?

There is little evidence that the product *range* is deficient per se, especially in light of the very flexible ways in which people can structure their income streams using SMSFs and the availability, if not the widespread use, of immediate lifetime annuities. Moreover, new hybrid annuity products are on the market that offer the capacity for deferred annuities, greater flexibility in payments, and the preservation of some bequests if people value this (for instance, Challenger 2017a).

In gauging whether people are making the ‘right’ choices among the suite of products, it is worth looking at revealed preferences, starting with people’s propensity to take lump sums. There is little to suggest that most people’s behaviour in respect of lump sums reflects a failing in the system. Notwithstanding popular impressions, most people do not convert all of their retirement benefits into a single lump sum (chapter 1), though many will convert *some* of their pension accounts into lump sums as they age. In 2015-16, about 18.3 per cent of people with superannuation coverage who were aged 65–69 years took a lump sum in the previous two years, with lump sum extractions falling rapidly in prevalence for older groups. The overall share of people taking some lump sum was 13 per cent for those aged 65 years or more. One quarter of lump sums were between \$500 and \$10 000 (ABS 2017b, tables 15.2 and 15.7). Of the people who did take lump sums in the previous two years, 80 per cent still had positive superannuation balances afterwards. This is a sign of a maturing system because in 2003-04, the figure was only 55 per cent. Those who tended to take most of their superannuation as lump sums had low initial balances (PC 2015a, p. 84). Given immediate consumption needs and debt obligations, and the transaction costs of maintaining a small balance, a tendency to convert small balances into lump sums is a rational strategy for lower-income households.

People allocate the overwhelming bulk of their assets to account-based (or allocated) pensions, which they draw down over time (Rice Warner 2017c; Treasury 2016b). Among those who receive regular income from superannuation, more than 70 per cent do so through account-based pensions (ABS 2017b, table 15.6). In part, this will reflect that such pensions provide considerable flexibility compared with traditional annuities because people can readily vary the drawdown rates and take lump sums when larger than expected consumption needs arise (PC 2016b, p. 228).

On the other hand, most retirees say they value the need for a regular income (figure 4.9) and that they prefer portfolios with less risk, while maintaining ownership of the family home (Spicer, Stavrunova and Thorp 2016). Pension accounts by themselves are imperfectly constructed to achieve that goal, especially if people face early sequencing risk, withdraw at high rates or there is any protracted period of poor returns.

The apparent preference for greater certainty has not been translated into any popularity of annuity products or CIPRs more generally *yet*. While the market for guaranteed income products has been growing (box 4.2), estimates suggest that these type of products represent only a small fraction of the overall superannuation retirement incomes market, with

Challenger remaining the dominant provider (PC 2016b). The modest role of such products may persist. Notably, in the United Kingdom, policy has gone in the opposite direction, with liberalisation of once restricted access to pension accounts. This has led to a much weaker role for the formerly favoured annuities and to retirement choices that are similar to Australia (FCA 2017). When given a choice, people graduate towards pension accounts.

Box 4.2 How important is the market for products that address longevity risk?

The Commission's funds survey asked about the number of retirement products with longevity risk management (LRM) and other features offered in 2012-13, and the number of new products offered between 2013-14 and 2016-17.

The results suggest that in 2012-13 a limited number of funds offered LRM products compared with retirement income products with other features. Five funds offered LRM products. In terms of products on offer, most offerings were in the retail segment; 28 LRM retirement income products were offered by retail funds (with 23 of them offered by just one fund), while industry funds offered a total of four products.

Since that time, the number of funds offering LRM products has grown, as has the number of LRM products on offer. Between 2013-14 and 2016-17, 19 funds indicated they offered new LRM products and 47 new LRM products were offered, three quarters of which were offered by retail funds. Twenty such products were offered by one retail fund, with the remaining LRM products offered by industry and public sector funds.

Source: Funds survey.

A key policy question is whether the dominance of account-based pensions is largely benign or reflects behavioural anomalies, rational behaviour given personal circumstances and preferences, or policy obstacles to the wider adoption of alternatives.

The Financial System Inquiry was unequivocal in its judgment that it was desirable to move away from account-based pensions and promote the use of guaranteed income products. It was claimed that this would address longevity risk, enable higher consumption during retirement and reduce the use of the Age Pension (Murray et al. 2014). The Financial System Inquiry suggested that some form of CIPR should be the default retirement product (MyRetirement), which the Australian Government Treasury is working on. The OECD (2017b) similarly urged policies that would promote annuities.

However, there is no unanimity on this issue, with the small size of the annuity market often referred to as the annuity puzzle. That there is a puzzle at all is not a reflection of a lack of explanations. On the contrary, like murder mysteries, the problem is that the population of perpetrators is very large. Just one review finds 19 rational reasons for the unpopularity of annuities and 17 irrational ones (O'Meara, Sharma and Bruhn 2015).

Some of the reasons for a weak annuity market are not amenable to direct policy action or where so, are not strongly justified.

- Unless CIPRs are mandated (which no one suggests in an Australian context), adverse selection of those who have a better knowledge of their longevity than the provider will raise the price of CIPRs, decreasing their attractiveness.
- The lack of long-term financial instruments to mitigate providers' risks, and investment strategies that favour lower-returning assets (O'Meara, Sharma and Bruhn 2015, p. 54) may put upward pressure on annuity prices, but it is not clear that the Australian Government has much scope to address this.
- There is compelling evidence that people overestimate the probability of dying at ages up to 85–90 years ('survival pessimism'). To the extent that people understand the concept of actuarial fairness,²⁸ this would raise the expected price of CIPRs well above their actual price, making them appear to be poor value (Gazzale and Walker 2009; OECD 2017b, p. 61; PC 2015a; SoA 2012; Sturrock 2018, pp. 23–24). Indeed, the very term annuity has such a poor reputation for value that even using its name for a retirement product reduces its uptake. Absent some form of mandated annuitisation, the best antidote for survival pessimism is likely to be access to independent high-quality financial advice that advises people on optimal drawdowns (chapter 5; Barr and Diamond, sub. 74; Rice Warner 2018), and marketing of the products that take account of people's ignorance of longevity risk and biases against the word annuity (a responsibility of the providers).
- People may live *below* their means (box 4.3). It is possible that by drawing down an account-based pension at the lowest regulated rate, a retiree will receive less annual income than a person who had purchased an annuity with the initial capital. This would reduce the retiree's wellbeing, while leaving a large bequest to beneficiaries. In some instances, it is claimed that people continue to spend less than their liquid income as they age. Longitudinal data suggest this does occur, but only for those households whose income is above poverty levels (AIST and ACFS 2016). Slow decumulation appears to be a stylised fact around the world, despite the large variations in financial instruments to fund retirement income (Wu et al. 2015). An annuity does not fully resolve any behavioural bias toward excessive frugality as a person can receive a guaranteed income and still save a portion of it.

²⁸ Given poor financial literacy among many people (chapter 5), the claim people are poor at longevity predictions but otherwise capable in actuarial assessments is debatable. The data on withdrawal rates do not appear to be consistent with people's beliefs they are going to die sooner rather than later. Moreover, the estimates of longevity that are relevant to retirement income planning should not include tenure in an aged care facility, since government subsidies and the family home are equally available sources of income.

Box 4.3 **Are the old too miserly?**

Miserliness is in the eye of the beholder. Financial institutions, people's uncles and governments often exhort the value of prudent spending. The narrative changes at retirement. The prime concern is that self-insurance for longevity risk denies consumption for people living shorter than their expected lives and pushes people into reliance on the Age Pension and lower incomes if they live longer than expected — problems that annuities can address. Commentators sometimes point to the divergence between the Association of Superannuation Funds of Australia standard of comfortable retirement incomes and actual incomes as further supporting the need for adding unintended bequests to an annuity risk pool.

On the latter score, the ASFA standard is more than many people spend even in pre-retirement (Daley 2017, p. 17). It is no more than an arbitrary benchmark that should be ignored in policymaking.

In addition, the empirical evidence for excessively conservative drawdown rates from account-based pensions is unclear because of defects in the drawdown data, but what evidence there is suggests the concern is overstated (PC 2015a, p. 95). Recent data from Rice Warner suggest that around 40 per cent of pensioners draw down above the minimum rate. Moreover, even if people did choose the minimum regulated amount, this does not amount to an obvious behavioural anomaly, as the analysis by Rice Warner (2017c, p. 1) suggested:

One of the advantages of the Australian superannuation system is that many retirees retain significant exposure to growth assets. Those who use a cash bucket for their pension payments can leave the rest of their benefit in a typical MySuper product. Generally, they are immune from short-term capital fluctuations as they are not taking money out when markets are down. If they top up their cash in good years and draw the minimum required pension payment each year, they will end up with more money ten years into retirement than they had at the time of retirement. The exposure to growth assets will take the sting out of their longevity risk and they can then plan the balance of their retirement years with more security. This is a much smarter strategy than holding assets in life-cycle products or low-income products such as bonds or annuities.

In any case, to the extent that people do not withdraw 'enough' from pension accounts, it may be better to advise them of the impacts of different withdrawal rates, as has recently been done by Rice Warner (2018). This would leave people with the option to choose their desired rates on an informed basis, which would be preferable to a default annuity product that would often not match people's preferences. And *if* there is compelling evidence that behavioural biases remain intractable (which is not clear), then higher regulated minimum withdrawal rates may be a better option than CIPRs.

Moreover, the idea that, as a group, retirees do not spend enough also implies that their bequest behaviour is irrational. For people reliant on income from accounts, bequests act as the primary risk buffer for longer than expected lifespans or poor asset returns. Consequently, the value of bequests will imperfectly match their intended level — sometimes higher, sometimes lower. Whether this is a 'problem' depends on the extent to which donors value their own consumption ahead of the recipients. Indeed, to the extent that a bequest leaves the donor with 'a warm glow', a bequest is a consumption good for the donor (Andreoni 1990). The role of bequests in the decumulation phase can be expressed much more positively than as the detritus from poor management of longevity risk. People want to give them, but if longevity risk materialises, are willing to cut into their value (Bray 2013).

Leaving a bequest remains 'very important' to 'somewhat important' for around half of Australian seniors (figure 4.9). That few wished to pass on all of their savings to the next generation does not mean that the bequest motive is no longer important (as claimed by NSA 2017, p. 4). Experimental work has also found that 55.8 per cent of individuals without children were willing to select a CIPR, compared with 50.3 per cent of those with children (Hiscox et al. 2017), consistent with the value of bequests.

The overall perception that immediate lifetime annuities represent poor value has some validity, though this may change. Estimates of the present value of annuity payments to their current price are well below one in Australia — and sometimes even below 0.7. Commission analysis of the annuity stream offered by some contemporary products found instances where the average present value of the annuity stream was around 0.8 (though the realised value would be greater for those lucky enough to live longer and lower for those who die prematurely). People therefore have to weigh up the price of insurance (20 cents or more in the dollar of any investment) for the reduction in longevity risk. It may be that some other products, such as deferred annuities, may provide insurance at a lower price. That market is in a fledgling state.

Retirement products — are there any policy dollars on the pavement?

CIPRs already play a role in the retirement income system, and they are growing in significance. Amendments to the Superannuation Industry (Supervision) Regulations 1994 (SIS Regulations) were implemented from 1 July 2017 and have reduced tax and regulatory barriers to the development of new retirement income products. Retirees seem to be receptive to their uptake under current policy settings, especially if the product is carefully explained to them. A recent large-scale survey suggested around 50 per cent were willing to accept a CIPR if it were offered to them in the future (Hiscox et al. 2017, p. 6), though it is hard to see that anything like that penetration would occur in real world settings (Rice Warner 2017b).

The primary remaining concern is that the income and asset tests of the social security system treat different forms of retirement income products non-neutrally, with the particular concern that this discriminates against some forms of CIPRs (AIST, sub. 39; ASFA, sub. 47).²⁹

The Australian Government has proposed new social security means test rules for CIPRs (DSS 2018) and the Australian Government Actuary (AGA) has examined the impacts of these on income outcomes for households with the same balances at entry into the retirement income system. The evidence shows that significant non-neutralities persist after application of the rules, with the magnitude of the impact dependent on the household type, product and income.

All other things being equal, neutrality is a sound principle. However, as in all things super, there are many trade-offs between the competing goals of the system that suggests privileging one should be informed by a clear analysis of the impacts on the others (Barr and Diamond 2006). Policy should not aim to stimulate the CIPR market as a goal in its own right.

²⁹ Some have argued that the taxation of reversionary beneficiaries adversely affects annuities. However, this would seem only to apply for some categories of beneficiaries (Challenger 2017b), and it is not clear in any case, that the tax is distortionary.

The implication is twofold. While the changes may be worthwhile, non-neutrality is an inescapable reality in Australia's tax and transfer system. Second, even after changes to social security arrangements, it is not possible to design a 'one-size-fits-all' default retirement product that would not disadvantage a significant number of households. There is no 'typical' Australian household, and more so in retirement.

Beyond these preliminary remarks, the Commission has not analysed the 'best' social security treatment of retirement income products. Regardless, changes of the kind envisaged would likely increase the observed product diversity in the retirement stage of people's lives.

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A 'MyRetirement' default is not warranted. The diversity in household preferences, incomes, and other assets when approaching, and in, retirement means there is no single retirement product that can meet members' needs. The most important task remaining is to improve the quality of financial advice to guide members among the various complex products, especially where members may decide to make the mostly irreversible decision to take up a longevity (risk pooled) income product.

4.5 Innovation and quality improvement in the system

'Data is the new black'

The above statement from a super fund encapsulates the growing understanding of the role of data in product innovation (BNPP and AIST 2015, p. 16).

Suppose that the decisions about the sale of clothes between customers and retailers were made with no information about age, sex, size, and colour preferences. Some impractical and amusing outcomes would ensue. The importance of data to the determination of the best products applies with even greater force to superannuation because the financial stakes are so much higher. That and the bewildering complexity of the products, disengagement, and behavioural anomalies, means that superannuation funds should be active in collecting data and using it to design and price products that meet member needs. This is particularly relevant to the transition to retirement and decumulation phases, where member needs are so diverse.

The degree to which funds collect and use data is contested. For instance, Tailored Superannuation Solutions was critical of many funds' approach to using member information:

Trustees' Investment Strategy Committees rarely even consider member demographics, let alone members own projected retirement outcomes. They typically concern themselves with 'which investment' and 'by whom' decisions. There is a void in considering long-term outcomes for members. (sub. 16, p. 6)

A survey of 10 large superannuation funds suggested that contemporary methods for using data were lacking:

As the industry transitions to a customer-centric approach, many funds are recognising that their existing operating models are not designed to capture and leverage data. Funds have traditionally encouraged low transaction, low engagement relationships, with few opportunities to collect new analytical insights or monitor member behaviour in depth. (MetLife 2018, p. 4)

In contrast, AIST said:

AIST member funds report that they consistently use member data such as age cohorts, account balances and the current investment patterns of members to develop their key investment and insurance strategies. For example, one fund has an over-representation of female members of child-bearing age who take time out of the workforce, and so is particularly mindful of downside protection. Other funds provide varying insurance defaults tailored to the needs of members who are self-employed, or those likely to be in casual or contract employment who do not receive employment benefits like paid sick leave. (sub. 39, p. 109)

Some funds also suggested that the funds were engaging more with members to provide better products — though sometimes this appeared to be more about educating members and eliciting their general preferences, rather than using data to develop new products (MLC and NAB, sub. 63).

While such subjective views are useful, there are some more objective measures of the industry's use of data, which suggest a less rosy picture.

In 2013, APRA expressed strong reservations about data integrity in the industry, indicating that 'RSE licensees' attention to the issue of data integrity and to the key drivers of data integrity risk has tended to be quite poor' (Ellis and Brown 2013, p. 33). For example, they found that 22 per cent of member records had an error in one or more audited fields (p. 35) — hardly conducive to good analysis of member needs or more general risk management.

The Commission's funds survey showed that funds often failed to collect data on their members (table 4.1; figure 4.10). Of the 10 member traits examined by the Commission, the most common outcome was that funds collected just one item. Even where funds did collect data on member characteristics, they often did not use it to design or price products. Funds with higher member numbers were much more likely to collect information, an overlooked 'economy of scale' relevant to the desirability of efficient processes for fund mergers.³⁰

There are some signs that data management and use is improving. By December 2016, the data integrity error rate described above had fallen to less than 8 per cent (ASFA 2016, p. 9). That still meant that 240 000 member records had issues with core data such as tax file

³⁰ Funds indicated several obstacles to gathering high quality data including various regulatory impediments (such as the *Privacy Act 1988*, sole purpose test), the limited (and sometimes inaccurate) data provided by employers via SuperStream, the costs of collecting and protecting the data, the presence of disengaged members, and members from a non-English speaking background.

numbers, date of birth and address (p. 3). Some smaller funds had error rates of around 35 per cent (p. 4).

Table 4.1 What data do funds collect?

Share of responding funds^a

<i>Type of information</i>	<i>Directly collected (%)</i>	<i>Indirectly collected (%)</i>	<i>Not collected (%)</i>	<i>Correlates</i>
Age	73.2	15.2	11.6	Higher for industry funds
Personal income	24.1	17	58.9	Higher with greater fund size
Personal wealth	9.8	16.1	74.1	Higher with greater fund size
Household income	7.1	13.4	79.5	Higher with greater fund size
Household wealth	7.1	6.25	86.6	None
Education	3.6	6.3	90.2	Higher with greater fund size
Profession	26.8	15.2	58	Higher with greater fund size
Marital status	15.2	8.9	75.9	None
Dependents	14.3	6.3	79.5	None
Smoker	21.4	2.7	75.9	Higher for size and zero association for public

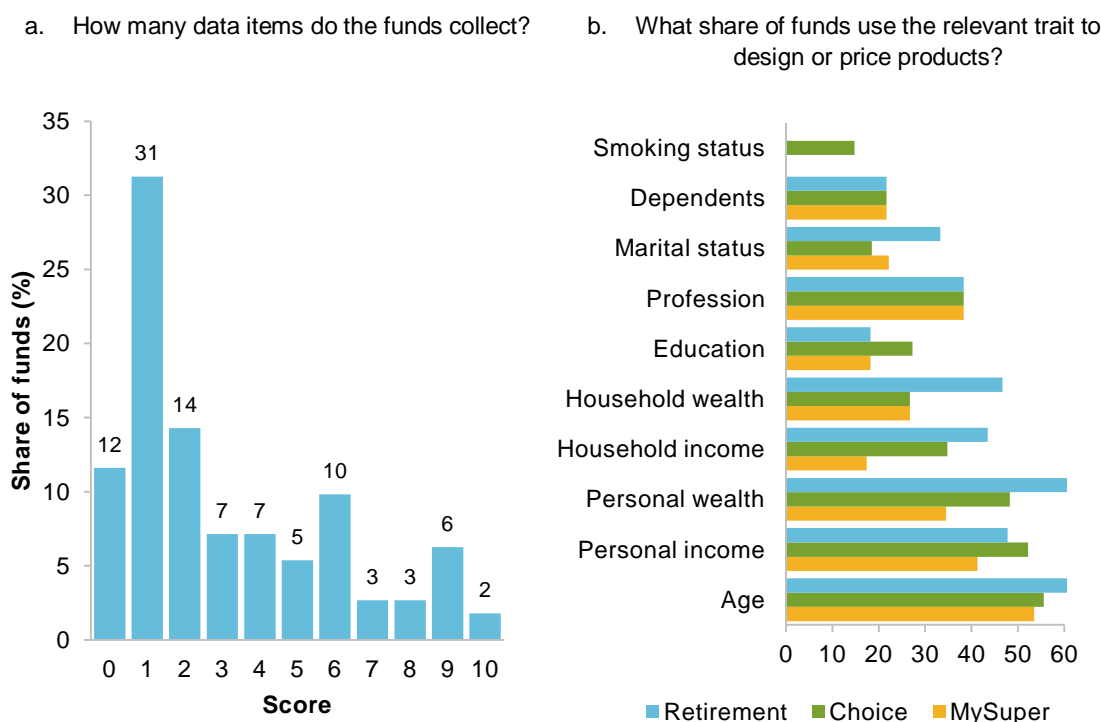
^a 112 valid responses from funds for shares and 108 valid responses for logistic regressions of each of the dichotomous version of the member variables (1=collected in any way, 0 not collected) against dummies for retail funds, industry funds, corporate funds and the log of member numbers.

Source: Funds survey.

APRA's review of the industry's approach to stress testing their liquidity also has precipitated further advancement in data collection about members (APRA 2016b; BNPP and AIST 2015, p. 16). Other data initiatives by government also appear to have been influential. SuperStream — a package of proposals developed by the Australian Government for electronically lodging employee superannuation guarantee contributions to superfunds in a standard form — has been seen by the Financial Services Council as the 'most significant technology project undertaken by the superannuation industry since its inception' (FSC and TTS 2017, p. 18).

Tools for data analytics *are* being developed and used by the industry. For example, Empirics (2018) developed over 400 items into a superannuation model, including improved integration of data from employers, transactions, call centre information, seminar information and emails, and then use this for product tailoring (among other uses). However, the market penetration of data analytics is not known. A recent survey found that the industry expected exploitation of data to be a key technical focus over the next decade (BNPP and AIST 2015, pp. 15, 19, 30). Robust data management was seen by the industry as the second most important thing that could improve the future of the superannuation industry.

Figure 4.10 Most funds have little information about their members^a



^a In panel a, the ‘Score’ relates to the number of traits that a fund collects across the 10 categories. A score of 10 means that a fund collects data on all of the 10 traits and zero means none are collected. In panel b, the results reflect the share of funds in each product category that use the information collected on the various traits to design or price products. The results exclude those funds that collected no information on a given trait or gave a null response. For example, information on personal wealth is used by about 60 per cent of those funds that collect such data to design or price retirement products.

Source: Funds survey.

It would be a mistake to see each fund’s own data as the exclusive vehicle for product development. Data available across funds can provides insights into product design. For example, the Rice Warner data used by the Commission is useful at revealing the drawdown behaviour of different cohorts and income groups. Similarly, data sets that have not been collected for the superannuation industry — like HILDA — provide insights into retirement and savings behaviour. The industry is now tapping such resources (AIST and ACFS 2016). Low-cost imputed data are also being used for the design of the insurance products that often accompany superannuation products (chapter 8). However, the extent to which funds exploit such data approaches is patchy.

Finally, actuarial analysis based on the underlying distribution of asset returns, the tax treatment and social security treatment of assets and income, and demographic data can be used to determine the types of products that are suited to different member groups. The recent debates about CIPRs have often drawn on such analysis. Combined with data on any given fund’s members, this allows better matching of products to people (or strategies for attracting different customer groups to a choice fund).

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Superannuation funds make insufficient use of their own (or imputed) data to develop and price products (including insurance). This is particularly problematic for designing products for the retirement and transition to retirement stages, because this is when different strategies have the biggest payoffs for members.

Data aside — where else is the innovation?

The Financial Services Council has characterised innovation in the industry in bleak terms:

The world is changing fast, driven by rapid technological advances. However, the \$2.1 trillion superannuation industry in Australia looks much the same as it did when universal super was legislated 25 years ago — it has simply increased in size. (FSC and TTS 2017, p. 4)

This is an overly pessimistic perspective. It may be imperfect, but data management has improved. Processes that allow easier engagement with members, such as mobile apps and online access, are relatively common (chapter 5), and yet did not exist at all in 1993. ASFA (sub. 47) provided examples of innovations across the retail and wholesale markets, including: digital delivery of disclosure material; member self-service; robo advice; education and engagement; more targeted, bespoke products; cloud computing; service providers; distribution; and electronic binding nominations. While still in a fledgling state, tax and regulatory changes have encouraged the development of new annuity products, and new entry into an area almost entirely the preserve of one fund. There is a greater awareness of the importance of member engagement. Some novel experiments using behavioural insights have suggested better ways of presenting information to change member behaviour (Hiscox et al. 2017). The industry has generally highlighted areas where innovation has, or is, occurring (box 4.4).

There are some gaps. The translation from member and financial data to informed decisions is haphazard and primitive. For example, empirical studies identify multiple medical factors influencing expected longevity (Sijbrands, Tornij and Homsma 2009), yet other than standard life tables by gender and age, few (if any) financial advisors have access to more sophisticated data or the statistical expertise to use it for considering personalised longevity risk. Innovation that exploits new forms of data analysis with new software tools could make a significant difference to the development of tailored longevity insurance products (without relinquishing the capacity for risk sharing among subgroups with similar predicted risks). Chapter 5 sets out some of the prospective developments.

Impediments to innovation

As discussed in chapter 7, competition is deficient in some areas of the superannuation system, and in other cases, competition can foster excessive product variety without creating much value — ersatz innovation. The Commission's policy recommendations are likely to intensify genuine competition, and with it, innovation.

Box 4.4 Participants' views on innovation and quality improvement in the system

AIST said:

Funds which market on 'bells and whistles' and large funds will have capacity and desire to develop 'innovative service delivery mechanisms', even if this entails higher cost to members. (sub. 39, p. 61)

AustralianSuper submitted an example of an innovative tool (to help members make informed decisions) based on member information to inform its design.

Our key innovation tool is one of the largest member listening programs in Australia. In the 2016/17 financial year, we heard directly from more than 100,000 members. To incubate innovations, we perform 'test & learn' experiments to create primary data, we test member offers to see if they're viable and listen to the voice of current and future members. These experiments allow for decision making and innovation of new products that creates, or avoids the destruction of, value for members.

Based on changing member needs and preferences, AustralianSuper has introduced new channels to assist members including:

- A mobile app, that allows members (accumulation and draw down) to check their balance, transactions, insurance cover as well as change investments and update details)
- Click to chat, which allows members to conveniently communicate with a service agent in real time from the website, and
- Webcasts, which allow us to conduct education sessions that can reach more remote parts of Australia that we otherwise could not have reached in person. (sub. 43, p. 15)

The ACTU argued that while competition may not have driven innovation, collaborative benchmarking processes across industry funds had helped to drive efficiency:

These approaches have driven issues like cost reduction in investment fees and custodian fees and are now driving administration approaches which adopt best in the world approaches to drive cost efficiency. (sub. 50, p. 10)

MLC and NAB said:

In terms of accessing distribution channels, rapid technological developments and extensive adoption of innovative digital tools has enabled newer entrants to move into the superannuation system. ((sub. 63, attachment, p. 9)

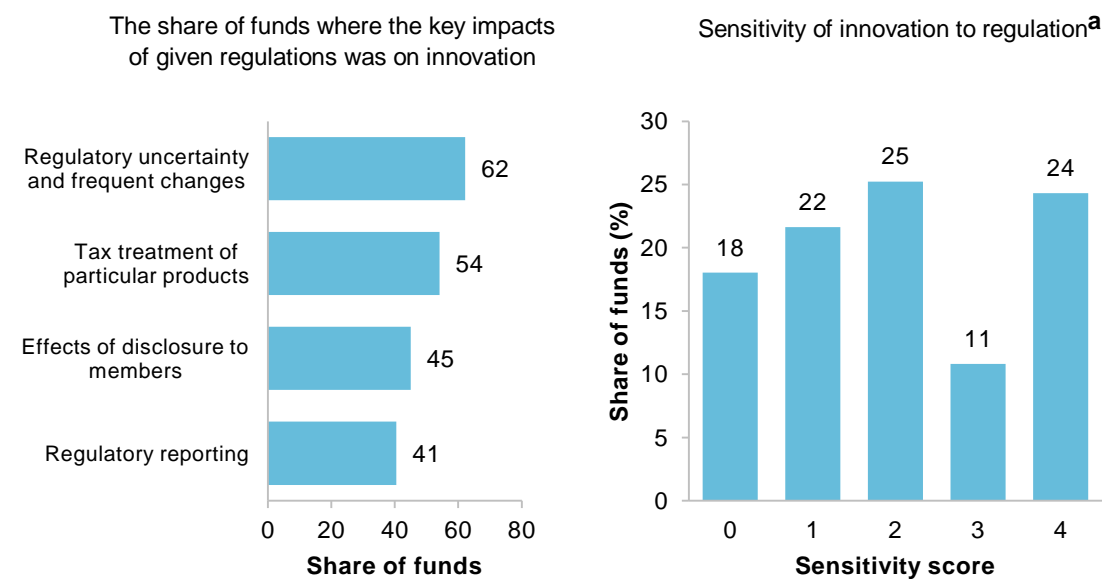
Some are more sceptical that the industry involves much innovation:

A shortcoming of the superannuation system is that it has failed to engage its consumers, largely due to the compulsory contribution (via employers payroll) structure (which has an inbuilt mandated FUM growth strategy, without ever having to think what to do for individual beneficiaries), and this has stifled competition and in turn innovation. This disengagement facilitates both the lack of investment in innovative products and limited quality improvement in the system. (Tailored Superannuation Solutions, sub. 16, p. 8)

Aside from these market forces, regulation itself appears to be a constraining factor, and was raised in these terms by several participants (ANZ, sub. 73, p. 3; MLC NAB Wealth, sub. 63, attachment; FSC and TTS 2017). Regulation can have adverse effects on many aspects of a fund's performance. The Commission's funds survey considered four regulatory problems and three performance areas affected by these — higher fees, lower returns and impediments to innovation. Funds reported that regulation had the greatest adverse impacts on innovation. For example, more than 60 per cent of funds claimed that the key impact of regulatory uncertainty and frequent changes was on innovation (figure 4.11). An index of the sensitivity of innovation to regulation revealed that about one quarter of funds considered that adverse

impacts on innovation was the key problem for all four of the regulatory problems. Econometric analysis suggests that innovation in funds offering choice products were more adversely affected than others. Of course, the fact that regulations may impede innovation does not necessarily mean that the regulations are unwarranted. Moreover, some of the barriers to innovation — such as the tax treatment of certain products — appear to have been largely resolved through recent policy changes.

Figure 4.11 Regulation can inhibit innovation



^a The sensitivity score is the sum of the instances across the four categories of regulation when a fund nominated innovation as the key adverse effect. The results above did not vary significantly across fund type, with the exception of choice products. Based on logit and ordered logit regression, funds in the choice segment were more likely to say that regulatory uncertainty and changes adversely affected innovation, and more generally, their sensitivity score were considerably higher than other funds. The results exclude any funds that gave null responses. Results are based on 111 observations.

Source: Funds survey.

5 Member engagement

Key points

- Many Australians find superannuation complex and are disengaged from decisions around their retirement savings. But for many members in the accumulation phase, low engagement is rational. Several factors drive disengagement, including the: compulsory nature of superannuation, complexities involved, various behavioural biases that affect people's decisions about their retirement savings, costs of engaging, and presence of intermediaries and trustees (who are charged with acting in members' best interests).
- Member engagement remains generally low. It tends to be higher among those approaching retirement, those with higher balances and owners of SMSFs; while engagement is lowest for the young and those with relatively low balances.
- For those who want to be engaged, it is *informed* engagement that matters. Around a quarter of members have low financial literacy, and while most members know the 'basics' of super, many lack the understanding needed for informed engagement.
- While it is neither efficient nor feasible for all members to be constantly informed and engaged, sufficient engagement is needed to promote healthy competition. But demand-side competitive pressure in the superannuation system is relatively weak. Active members (or their intermediaries) have not exerted material competitive pressure on funds.
- Most people do not switch funds (estimates of annual fund switching rates sit below 10 per cent). And around half of this switching is passive — it occurs because members change employer or their employer changes funds. For members who switch to improve their financial wellbeing, evidence shows that the expected improvement has not occurred for a significant minority.
- Overall members need better, not more, information — a simple case of 'less is more'. Regulators should play a critical role: regulating financial advice; ensuring complex information in the superannuation system is accessible and easy to understand; and ensuring disclosure is meaningful. However, product dashboards remain a work in progress; they suffer from the pursuit of false perfection at the expense of the possible. Dashboards need to be salient, simple and accessible to be effective — and most are not. Moreover, access to impartial guidance (especially for pre-retirees) remains elusive for many, and the quality of advice provided — including to some owners of SMSFs — is questionable.
- Despite funds being required to disclose information on costs and fees to help members make better decisions, many members appear to lack an understanding of fees and charges, investments and insurance in superannuation. Members are generally more satisfied with the product offerings of their fund than the information their fund provides.
- Potential improvements to the system include: ASIC without delay settling on simple and salient product dashboards and publishing them on a centralised website, ASIC proactively setting and enforcing standards for the meaningful disclosure of information to members on superannuation products (including insurance), and the Government requiring the ATO to nudge superannuation members (when they reach 55) to visit ASIC's MoneySmart website and DHS' Financial Information Service website.

In most competitive markets, consumers are informed and engaged and make decisions in their own best interest, exerting healthy competitive pressure through demand for the goods and services they value. But there are good reasons why many members disengage from the superannuation system (PC 2016b). Hence, even in an efficient superannuation system a sizable group of disengaged members would be expected. An efficient super system would also enable members to choose to engage should they desire to do so (and take some responsibility for their choices), along with access to high quality information and advice to support their decision making. Governance arrangements and regulatory safeguards applying to members would be set so as to ensure that members' best interests is the primary focus of intermediaries who act on behalf of members as well as those providing members with information and/or advice.

The chapter begins by examining the levels of engagement among superannuation members (section 5.1). Evidence on the effect of engagement on competition is discussed in section 5.2. Section 5.3 then assesses whether the system is providing the type of information and advice that is needed to help members make decisions, identifying several problematic areas (with associated recommendations presented in chapter 13).

The chapter also provides evidence, in whole or in part, on the following three assessment criteria from the Commission's stage 1 study.

- Is there informed member engagement? (C1)
- Are active members and member intermediaries able to exert material competitive pressure? (C2)
- Is the system providing high quality information and intrafund financial advice to help members make decisions? (E6)

Many of the indicators relevant to this chapter are based on data from the Commission's survey of superannuation members (box 1.5). Further details about this survey are in appendix C while a set of summary statistics and results from the members and funds surveys that support the analyses in this chapter are contained in technical supplements (tech. supp.) 1 and 2, respectively.

5.1 How engaged are superannuation members?

Engaged members are those who are interested in how their superannuation is tracking. They can be expected to be willing to make decisions about their superannuation fund, their superannuation account and their insurance policy, when needed.

Competition in the superannuation system relies on members being engaged but healthy competition requires that this engagement be informed. Informed members are those who know the basic details of their superannuation (or outsource this knowledge to a reliable financial adviser) such as (in approximate) their balance, their projected retirement income, the fees they pay (including premiums for insurance) and how their current fund and product

compares to other broadly comparable options. Informed members are also much more likely to appreciate that ‘past performance is not an indicator of future results’. Informed but unengaged members will not exert competitive pressure and uninformed members who engage will incentivise funds to compete on dimensions not relevant to member outcomes — such as potentially misleading advertising campaigns or unnecessarily complex product design (chapter 4). In a system dominated by informed and engaged members, funds are more likely to compete to provide better products (for example, lower fees, more appropriate insurance) in order to retain or grow market share. In markets where informed engagement is uncommon, such as superannuation, government intervention in some form is necessary to ensure private entities act in the interest of members.

The optimal level of informed member engagement is hard to determine and there is no single widely accepted measure of engagement, nor of informed engagement. The Commission’s stage 1 study (PC 2016b), however, established a range of indicators to help measure and assess informed engagement. These include direct measures of engagement as well as measures of informed and high quality decision making. Other measures contributing to observed engagement levels include the costs of engagement.

Historically, member engagement in superannuation has been low

Consistent with the experience internationally, and for a range of reasons, member engagement in Australia’s superannuation system has typically been low but many members become engaged when it matters — when they reach retirement age and/or have large balances (PC 2016b). Several major reviews (Cooper et al. 2010a; Murray et al. 2014; Treasury 2009) within the past decade formed this view.

... and a mix of factors have contributed to low engagement

Many factors affect engagement.

- Compulsory contributions coupled with a complex system mean that, for many members, there is little incentive to engage, especially at a young age. Consequently, disengaged members are less likely to move away from higher cost and/or underperforming funds, substantially reducing incentives for superannuation funds to merge.
- Cognitive constraints and behavioural biases also contribute to disengagement. Examples include myopia, complexity of long-term decision making, loss aversion, reliance on mental shortcuts, a tendency to procrastinate and general apathy (Benartzi and Thaler 2007; Kahneman 2011; PC 2016b, 2017d).
- In turn, many members are disengaged because they lack the confidence to make big financial decisions and/or they trust their fund to do the right thing (Bateman et al. 2012, 2012, 2014; Butt et al. 2015).
- And it can be costly to engage. Making choices involves costs, such as the costs of time and learning, costs of monitoring the decisions of providers, and the costs of switching

products or funds or taking action regarding insurance. These costs often lead to widespread procrastination (Barr and Diamond, sub. 74).

- Further discouraging engagement, a proportion of members may be constrained from making an active choice (Clare 2010). In this context, the Financial System Inquiry (Murray et al. 2014) considered that removing remaining restrictions on the choice of fund receiving Superannuation Guarantee contributions would remove a barrier to member engagement. The Australian Government has drafted legislation to remove this barrier (O'Dwyer 2018).
- The presence of a range of intermediary 'agents' (for example, unions, employers, advisers) and trustees (who are required by law to act in members' best interests) also reduces incentives to engage. That said, some of these agents may face conflicts of interest which materially detract from achieving the best outcomes for members. For example, employers could potentially be selecting funds based on low administrative requirements rather than on net returns to investment (chapter 9).
- A lack of comparability of fees and performance information has also been identified as a factor influencing the observed weak levels of member engagement (Murray et al. 2014).

Many participants acknowledged these various factors.

The combined effect of these different factors means that engagement may vary with different member characteristics. It is well known that younger people, on average, are less likely to engage with superannuation (Super Guru nd). And many members approaching retirement with reasonable-sized balances have greater incentives to engage. The Australian Institute of Superannuation Trustees (AIST, sub. 39, p. 38) observed that 'members with balances between \$100 000 and \$250 000 were by far the most likely to contact the fund'.

Nonetheless, not all older people can be expected to increase their level of engagement. A qualitative study commissioned by CHOICE (Souvlis et al. 2017) recently found that less affluent retirees (which comprised around 20 per cent of 65 year olds in 2015): regarded retirement as daunting; faced heightened anxieties around planning for retirement; felt disempowered about superannuation; and were cynical and insecure about superannuation funds and superannuation advisers. As a result, instead of engaging with superannuation these types of retirees were often 'paralysed into inaction' (p. 27). That said, many retirees have previously made sensible decisions given the policy environment and system they have faced (chapter 4; PC 2015a).

While low engagement is often rational, there are consequences

Due to the wide range of factors outlined above, it is often not possible nor rational for members to be continually engaged. For instance, for some individuals the time costs associated with engagement mean that it is not rational to be continually engaged — especially when trustees are required by law to act in members' best interests.

However, there are a range of negative outcomes associated with low engagement. Members may: not choose the investment option or insurance product that best meets their needs; have multiple accounts leading to balance erosion; and/or remain in underperforming superannuation funds.

Some level of informed member engagement is needed for competition

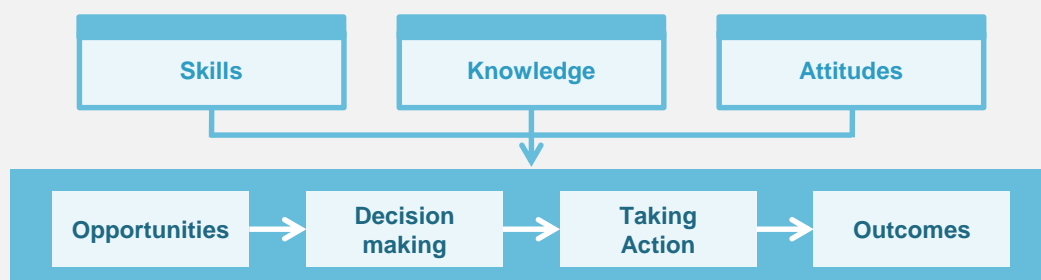
An efficient superannuation system needs to deliver efficient and competitive outcomes for those members who choose to remain disengaged. While the Australian Government's MySuper reforms have made some inroads, more could be done (chapters 11, 12 and 13).

Moreover, some level of member engagement is necessary to create a competitive discipline on funds (section 5.2). But, increasing member engagement — through, for example, enhancing skills, knowledge and attitudes (box 5.1) — is not enough to effectively act as a discipline on funds. Engagement also needs to be well-informed with pertinent, accessible and comparable information.

Box 5.1 What do members need to engage effectively?

To effectively engage with the superannuation system, members require knowledge and skills. However, knowledge and skills are not useful if there is no motivation to engage. Conversely, as outlined in the figure below, a preference for engagement may not translate into good outcomes if members do not have the necessary knowledge and skills.

Skills, knowledge and attitudes to engagement are all important



Source: Figure adapted from ASIC (2013b).

To engender optimal and well-informed engagement of members in a competitive and complex market such as superannuation, a range of consumer aids is required. These could include: readily comparable information on products and services; easy access to the key metrics that matter in making decisions; and access to affordable and impartial guidance and advice. In this regard, funds and other system participants (such as regulators) — and the design of the system itself — can have a decisive influence over levels of member engagement, its effectiveness as a discipline on funds' behaviour, and, ultimately, whether members are able to achieve outcomes that meet their needs. Section 5.3 identifies several areas where improvements are needed.

Insights from the Commission's members and funds surveys

The Commission previously divided engagement measures into two types: passive (monitoring) and active (taking action) engagement (PC 2016b). Responses to the Commission's members and funds surveys show that levels of passive member engagement appear to be moderate for many members but levels of active member engagement appear to be low. (Whether low active engagement matters is discussed in section 5.2.) Furthermore, as expected, both passive and active engagement levels are higher among some groups: those approaching retirement, those with higher balances, and among owners of a self-managed superannuation fund (SMSF).

Engagement is mostly passive

Most members have some form of contact with their fund, but it tends to be in the form of passive account monitoring activities (figure 5.1),³¹ which is potentially a sensible decision if a member is in a well-performing fund.

- Fund websites were by far the most popular means of contacting a fund, with call centres the next most common. Rates of passive account monitoring do not seem to differ by age but are higher among male, higher income, higher balance and choice members³² (tech. supp. 1).
- Consistent with the expectations of the Commission, members who are older, members who have higher incomes and balances, and choice members are more likely to have used an online calculator (another indicator of passive account monitoring, that potentially informs subsequent active engagement) (tech. supp. 1).

Active engagement is generally low, but some are more active than others

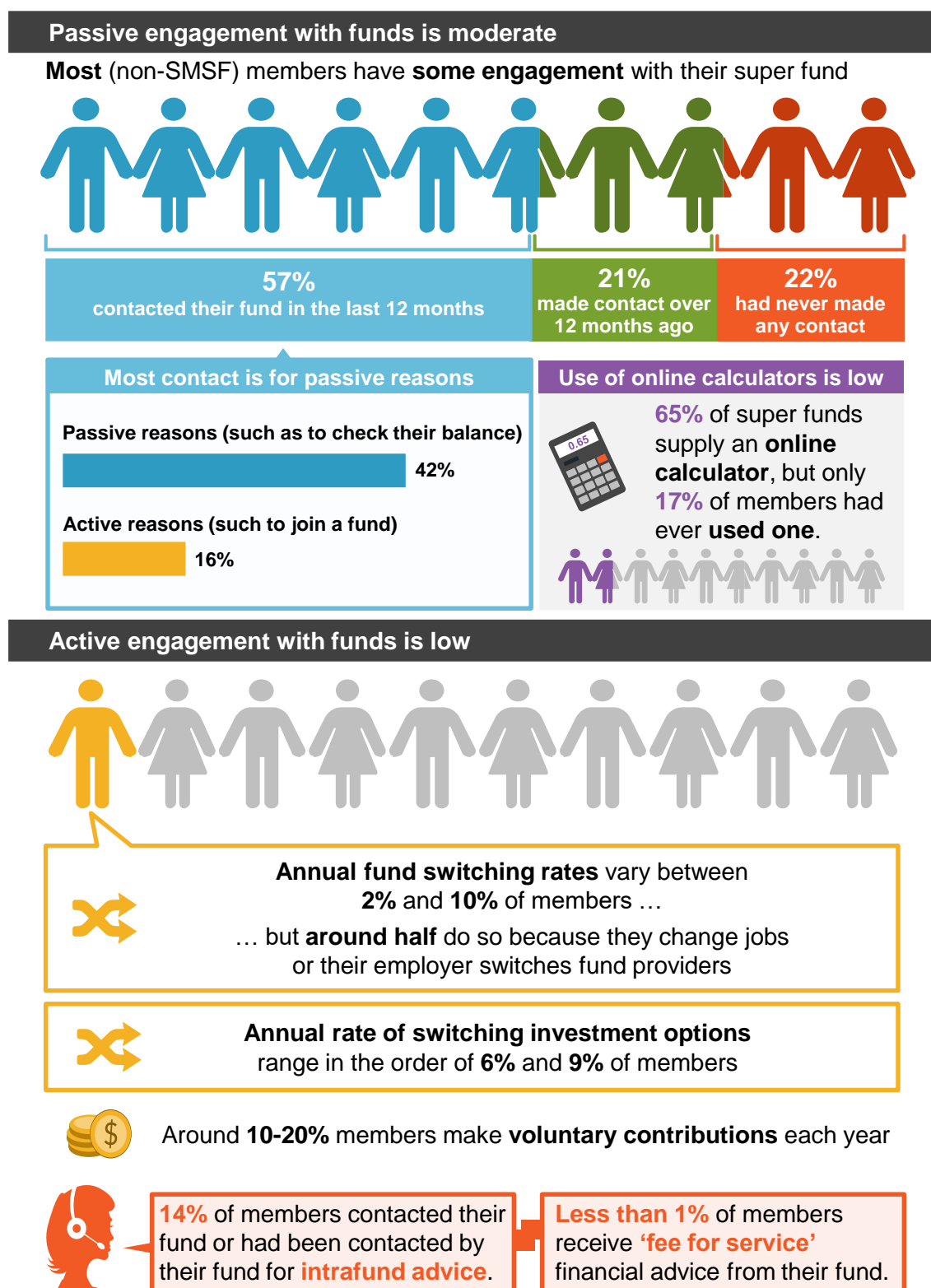
While fund and investment switching rates (figure 5.1; section 5.2) point to relatively low levels of active engagement, other measures³³ indicate the presence of more active engagement, especially among older, wealthier and choice members. The members and funds surveys provide the following information on:

³¹ Measures for passive account monitoring in the members survey include members checking their fund balances, fees and charges, tax rates, rate of return, or risks that apply to their own superannuation account, discussing a query regarding their super statement and/or amending their details.

³² In this chapter, choice members are defined as a member not in a default fund *plus* members who made an active decision to stay in (or join) their current default fund. Unless stated otherwise, choice members include SMSF members.

³³ Other measures of active engagement include checking or changing investment or insurance options, making voluntary contributions and using intrafund advice.

Figure 5.1 Patterns of member engagement



Sources: Members survey and funds survey.

-
- *voluntary contributions* — between 11 and 21 per cent of accumulation members (excluding SMSF members) made voluntary contributions in the year prior to the survey (figure 5.1).³⁴ Members more likely to make voluntary contributions are: members aged over 50 years, those on higher incomes (noting that this does not take into account the amount contributed), choice members, and members with account balances over \$350 000 (tech. supp. 1)
 - *intrafund advice*³⁵ — 14 per cent of members (excluding SMSF members) contacted their fund or had been contacted by their fund (or both) for intrafund advice in the 12 months prior to the survey (figure 5.1). The likelihood of contact is higher among members aged over 50, higher income and higher balance members, and choice members (tech. supp. 1).

Another indicator of active engagement is the use of fee-for-service financial advice from a fund. The Commission's funds survey suggests that less than 1 per cent of members receive such financial advice from their fund in a year. However, this proportion differs by fund type: 3 per cent of retail fund members had received such advice in the 2016-17 financial year compared to less than 1 per cent of industry fund members (tech. supp. 2).

Active member engagement from another perspective: establishing an SMSF

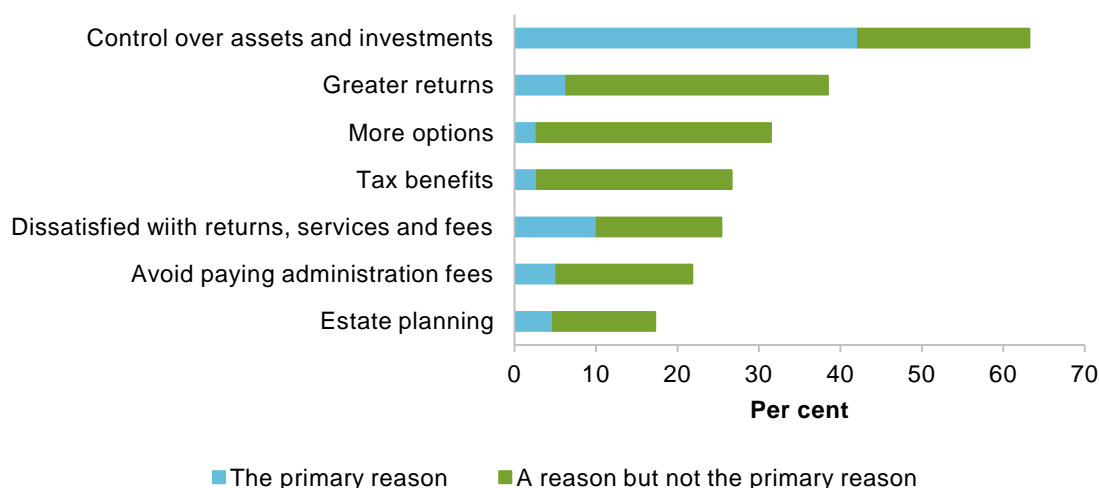
Another signal of active engagement among members in the system is the number of people establishing SMSFs. Between 2008 and 2017 the number of SMSFs increased from about 380 000 to 600 000, now representing around 30 per cent of funds under management (chapter 1) and around 4 per cent of member accounts (APRA 2017i; ATO 2013, 2017b).

Consistent with the comparatively higher engagement levels of SMSF members, the members survey suggests that the desire to 'gain greater control over my superannuation assets and investments' is the leading motivation for the establishment of SMSFs. Two in three SMSF members cite it as a factor, and over half of those cite it as their main reason (figure 5.2). However, while SMSF members appear to be highly engaged, this engagement also needs to be informed if such engagement is to be effective. Evidence in chapter 4 shows that highly engaged members (including owners of SMSFs) who are not well-informed often make poor decisions.

³⁴ If SMSF accumulation members are included, the estimate of voluntary contributions from the members survey increases to 23 per cent of members (tech. supp. 1).

³⁵ The Financial Planning Association of Australia (FPAA) noted that under intrafund advice rules, a fund 'cannot provide advice on switching super funds, or advice on financial products outside super, or advice on general retirement planning unless the full 'know your client' process is conducted by a licensed individual' (FPAA 2017a, p. 3).

Figure 5.2 Gaining control is a key motivator for establishing an SMSF^a
Reasons for establishing an SMSF among members of an SMSF^b



^a Data is weighted using Commission weights. ^b The Commission classifies a reason as 'primary' if it is the only reason listed for establishing a member's SMSF in Q12a or if it is selected as one of multiple reasons in Q12a and selected as the main reason in Q12b.

Source: Members survey.

What factors affect informed engagement?

Financial literacy

Poor financial literacy often results in poor economic decision making (Lusardi and Mitchell 2014). An efficient superannuation system would enable those who lack financial literacy skills to obtain trustworthy advice and guide their choices.

Broadly speaking, Australians are less financially literate in matters relating to superannuation and retirement planning than in financial matters generally (PC 2015a). Studies have found that while most Australians have a reasonable standard of financial literacy for simpler matters and are capable of making informed decisions, a sizable minority encounter difficulties (PC 2016b). Previous research has found that Australian consumers frequently misunderstand risks relating to financial products. Souvlis et al. (2017) concluded that the interaction of poor financial literacy with the complexity of superannuation often results in avoidance behaviour and cognitive dissonance when it comes to superannuation.

Across a range of surveys, the evidence suggests that around 25 to 30 per cent of Australians lack an understanding of basic concepts (such as risk-return trade-off, investment diversification, how share market movements can affect superannuation balances and knowledge of superannuation) (Agnew, Bateman and Thorp 2013; ANZ 2015; ASIC 2016b; Mercer 2013). The Australian Securities and Investments Commission (ASIC 2013a)

surveyed industry participants, consumers and financial literacy specialists and found that 45 per cent of respondents believed that consumers did not understand that higher reward often meant higher risk, and 71 per cent believed that consumers failed to completely understand the risk involved in complex products.

Further, previous studies have found that certain groups display lower levels of financial literacy on average, such as: young people, women; people with low incomes, wealth and education; and Aboriginal and Torres Strait Islander peoples (Agnew, Bateman and Thorp 2013; ANZ 2015; Bateman et al. 2012; Mercer 2013; PC 2015a). Evidence on the levels of financial literacy of SMSF members is mixed (Ali et al. 2014; ANZ 2015; Bird et al. 2016b). Bird et al. (2016b) found that while SMSF members on average did not show financial skills that were significantly different to non-SMSF members, they expressed a higher tolerance for risk and a more trusting attitude to financial professionals.

Even if a member's financial literacy is low at a point in time, efforts to enhance it rest on their cognitive abilities. While cognitive ability generally declines with age and cognitive decline in *very* old age can significantly affect the quality of financial decision making (Agarwal et al. 2009), Earl et al. (2015) found a positive link between levels of cognitive ability and financial literacy among older trustees of SMSFs.

Results from the Commission's members survey are broadly consistent with these observations. Analysis of the financial literacy questions from the members survey suggests that about two thirds of members correctly answered two or more of the three questions designed to test their financial literacy (figure 5.3). The survey also suggests lower levels of financial literacy among members who are young, in default funds, with low incomes and with low account balances (figure 5.3).

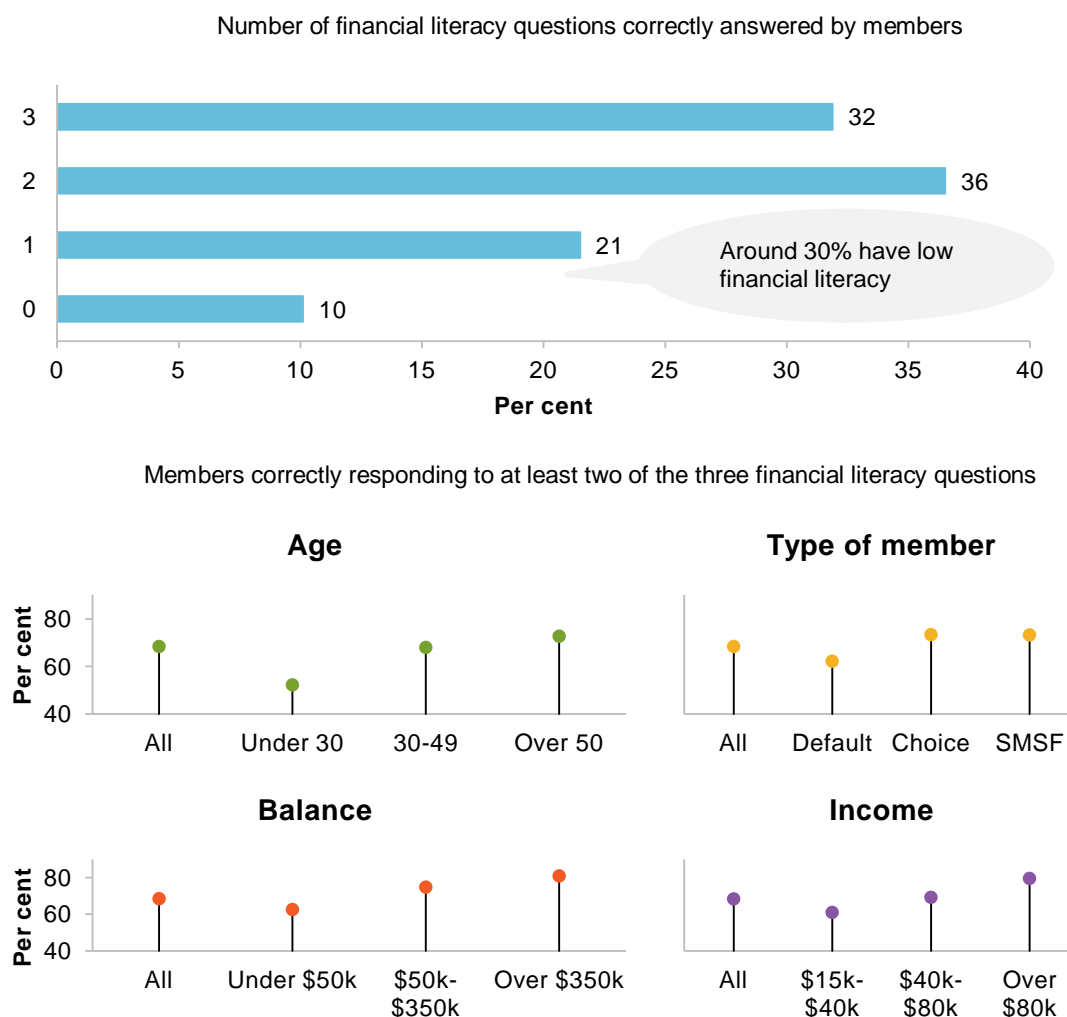
Superannuation literacy

Most members have a good broad knowledge of superannuation ...

As part of members' capacity to engage, knowledge of the system is also required. Previous studies have consistently found that:

- women tend, on average, to have lower levels of knowledge about superannuation than men, and are more likely to report that they find dealing with money to be stressful (ANZ 2015; Mercer 2013)
- young people tend to have less knowledge of the superannuation system (Ali et al. 2014; ASIC 2016b; Worthington 2008). Financial knowledge generally increases with age, but there is evidence that it then tends to decline in *older* age (Earl et al. 2015; Finke, Howe & Huston 2016).

Figure 5.3 **Members have moderate financial literacy^{a,b}**



^a Responses are weighted using Commission weights. ^b Responses of 'Don't know' are treated as incorrect responses.

Source: Members survey.

The members survey tested respondents' knowledge of a range of statements about the superannuation system. The statements that were mostly answered correctly were: the requirement of employers to make superannuation payments, and the option for employees to make voluntary contributions (table 5.1). However, there were some statements that relatively few members correctly identified (either as true or false) or did not know the answer. Members had relatively low levels of understanding about: the relative tax treatment of superannuation, insurance in superannuation, preservation age, whether employers can give investment advice related to an employee's choice of fund, and the current level of the Superannuation Guarantee.

Table 5.1 Most statements testing knowledge of some basic characteristics of superannuation were correctly identified^a

Per cent

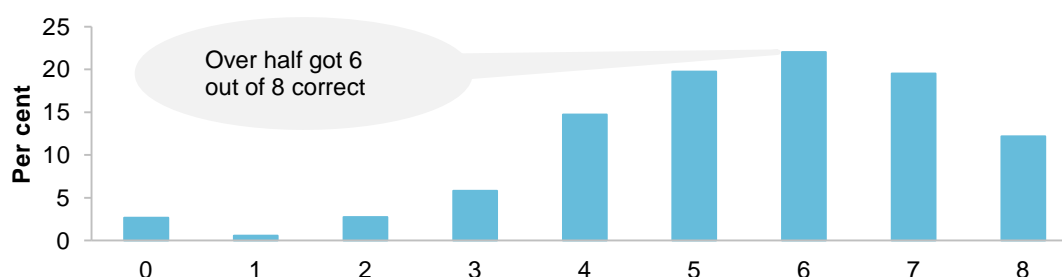
	TRUE	FALSE	DON'T KNOW/ CAN'T SAY
Employers are required by law to make superannuation payments on behalf of their employees	93.4	1.9	4.6
Employees cannot contribute into their own superannuation funds – only an employer can make contributions	4.0	90.0	6.0
Superannuation is taxed at a lower rate than other investments (except for owner-occupied housing)	62.7	5.8	31.6
Members can't change their investment options after joining a superannuation fund	6.3	82.7	11.0
All new members of superannuation funds are automatically given cover for life insurance, and total and permanent disability insurance.	32.9	30.8	36.2
Employees can select a fund of their own choice (and need not stay with the employer's default fund)	85.5	7.2	7.3
Members can access their superannuation after reaching the age of 50	14.2	54.9	30.9
Employers can provide investment advice to employees on which super fund an employee should select	20.6	45.9	33.6
The current rate of Superannuation Guarantee contributions (i.e. compulsory employer superannuation contributions) is 10%	26.8	40.1	33.1

^a Shaded cells denote the correct responses.

Source: Members survey.

Figure 5.4 Most members know the basics of super^{a,b}

Proportion of correct responses to eight statements testing understanding



^a Responses are weighted using Commission weights. ^b The eight true-false statements are listed in table 5.1. The fifth statement in table 5.1 is not included in this figure due to interpretability concerns.

Source: Members survey.

Just over half of members correctly identified six of the eight reliable³⁶ measures of members' basic knowledge (figure 5.4). Put another way, members on average correctly identified 5.5 of the eight statements. Members aged below 30 years tend to correctly

³⁶ The Commission's Cronbach's alpha analysis of member's responses to the nine statements suggests that the fifth statement should be excluded as it is not a reliable measure of members' knowledge of basic characteristics of superannuation.

identify fewer than the overall average. Older members and members with higher incomes and higher balances were correlated with higher numbers of correctly identified statements, and SMSF and choice members scored higher than default members (tech. supp. 1).

... but many lack understanding of superannuation

While most Australians have good broad knowledge of the superannuation system, many lack detailed understanding and knowledge of superannuation (often necessary to effectively engage). Members survey results (based on respondents' self-assessment of their understanding) suggest that overall:

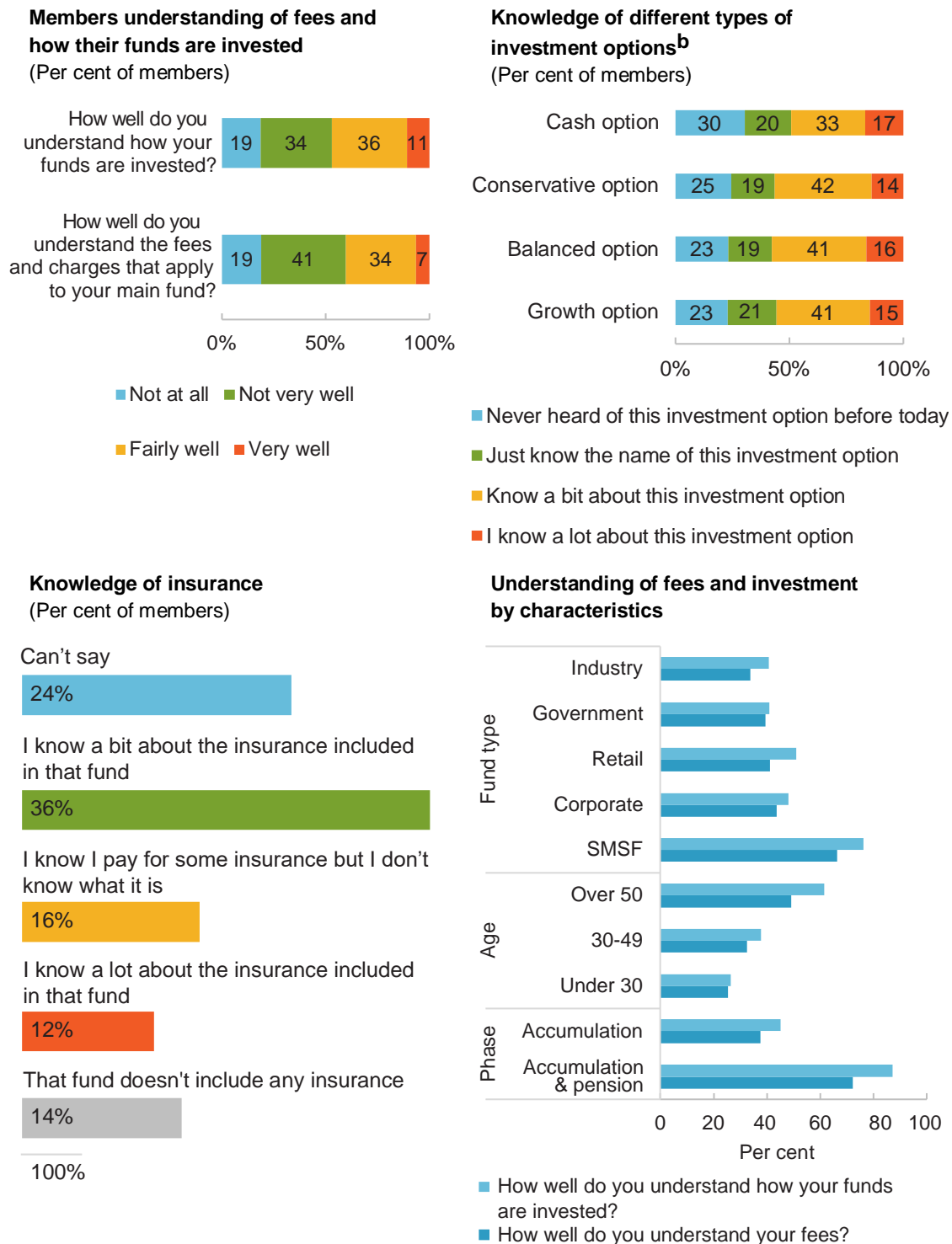
- about 40 per cent of members understand 'fairly well' or 'very well' the fees and charges applied by their main fund
- less than half of members understand 'fairly well' or 'very well' how their money is invested by their main fund
- almost 60 per cent know 'a bit' or 'a lot' about the different types of investment options (growth, balanced and conservative) and 50 per cent know 'a bit' or 'a lot' about the cash option
- about half know 'a bit' or 'a lot' about insurance in their main fund
- SMSF members, older members and members with both accumulation and pension accounts claimed to have relatively more understanding of their fees and investments (figure 5.5).

Further, about 7 per cent of members did not know how many superannuation or pension accounts they held. This suggests campaigns to alert members to the importance of consolidating have to work in clever ways to target some very hard to reach groups. Souvlis et. al (2017) suggested there were subtle differences between different types of disengaged members; which is useful when developing and targeting member education and engagement strategies. Building on a model of engagement (the 'car taxonomy') developed by Souvlis et. al, and the evidence gathered in this inquiry, the Commission has developed and quantified estimates of engagement for five different categories of members (box 5.2):

1. 'drivers' are actively engaged and well-informed — they are in control of the direction they're travelling in
2. 'front passengers' are not currently actively engaged but are well-informed — they could take over driving if and when they need to
3. 'backseat drivers' are currently actively engaged but either moderately or poorly informed — they need to learn more about driving
4. 'backseat passengers' are disengaged and moderately informed — they are happy to let someone else drive to an unknown destination
5. those 'in the boot' are disengaged and are poorly informed — they are in the dark and want to stay there.

Figure 5.5 Many members lack understanding of superannuation^a

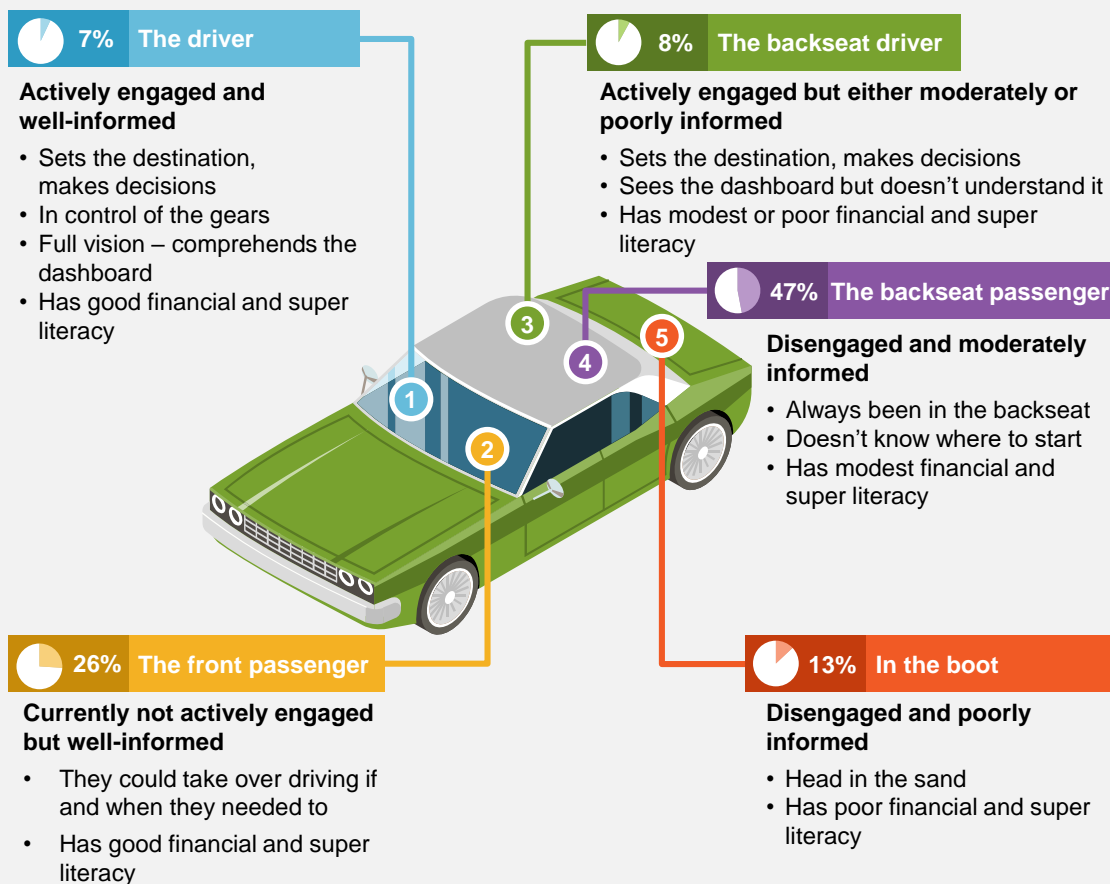
But some claim to have more understanding than others



^a Weighted using Commission weights. ^b 'Never heard of this investment option before' includes 'can't say'.

Source: Members survey.

Box 5.2 Characterising member engagement^{a,b}



^a The Commission's approach to defining and quantifying these characterisations is in tech. supp. 1.

^b Percentages sum to more than 100 per cent due to rounding.

Source: Commission estimates adapted from Souvlis et al. (2017, p. 9).

Costs of engagement

Engagement is not costless. There are costs in terms of time and learning, monitoring the decisions of providers, and switching products or funds or taking action regarding insurance. Higher costs increase incentives to use advisers to help make decisions (section 5.2).

Tentative evidence from the members survey (based on a relatively small number of respondents who had recently changed funds) suggests that for those who switched their balance into another fund:

- just over half spent less than 2 hours and just over three quarters spent less than 4 hours gathering information for switching to another fund
- 66 per cent were not charged an exit fee (tech. supp. 1).³⁷

³⁷ MySuper products are allowed to charge exit fees but regulations restrict them to being charged on a cost-recovery basis.

Further information on exit fees and other costs associated with switching are in section 5.2.

As discussed in chapter 8, while most members find amending insurance cover or taking out new insurance cover to be at least somewhat easy, nearly half of members do not find it easy to opt out of insurance cover. An unresolved question is whether claiming is more or less difficult than claiming on insurance held outside of superannuation.

DRAFT FINDING 5.1

Across a range of indicators, member engagement remains low on average, though it is not realistic or desirable for members to be engaged all the time. Engagement tends to be higher among those approaching retirement, those with higher balances and owners of SMSFs. Engagement is lowest for the young and those with relatively low balances.

While many Australians have good broad knowledge of the superannuation system, many lack the detailed understanding necessary for effective engagement. Low financial literacy is observed among a sizable minority (about 30 per cent) of members.

5.2 Are active members and member intermediaries able to exert material competitive pressure?

The low levels of engagement in superannuation represent challenges for maintaining demand-side competitive discipline on funds. Ideally, the system needs ‘enough’ engagement to provide demand-side pressure. As occurs among consumers in many other markets, a critical mass of active members exercising informed engagement may not only get the best deals for themselves but also pressure funds to improve their offerings in order to attract and retain members, improving the outcomes for all members. However, as noted at the outset, it is impossible to specify ex ante a benchmark size for an ‘engaged’ group that would influence broader outcomes, nor is it easy to predict the effect of such engagement on the outcomes of other members (PC 2016b).

Fund and investment switching rates are modest

A range of evidence indicates that fund and investment switching rates are modest. Estimates of annual fund switching rates vary between 2 and 10 per cent of members. While there are fewer estimates of the annual rate of switching for investment options, they range widely in the order of 6 to 9 per cent, with up to one third of members having ever switched (box 5.3).

Box 5.3 **Estimates of fund and investment switching rates**

Fund switching

- The Commission previously found very few members switched to another fund in any given year, with less than 2 per cent likely to do so voluntarily (PC 2016).
- Commission analysis of APRA data reveals that 7 per cent of member accounts switched to another fund in 2015-16.
- Rice Warner's (2017f) analysis of their member-based dataset showed that during 2014-15, 5 per cent of members changed their superannuation fund.
- A recent survey by Customer Service Benchmarking Australia and the Fund Executives Association of around 6000 members from 34 Australian superannuation funds found that around 10 per cent intended to move away from their current fund in the 12 months following the survey (Wootten 2017).
- The Commission's members survey suggests that in the year prior to the survey about 6 per cent of members switched to another fund.
- The Commission's funds survey suggests that around 6 per cent of member accounts switched in the past year, with switching rates higher in retail funds than in industry funds (tech. supp. 2).

Investment switching

- Estimates of the proportion of people who have (ever) switched investment options within their superannuation fund vary, though most suggest that it is less than a third (PC 2016, box B.6).
- The Commission's members survey suggests that about 9 per cent of members switched investment options in the year prior to the survey.
- The Commission's funds survey suggests that around 6 per cent of members changed their investment options in a given year. This rate is highest among retail funds and lowest among industry funds (tech. supp. 2).

Factors associated with switching funds

Most people do not switch funds. Roughly two thirds of people become default members on entering the workforce or changing jobs, and half of all accounts are in the default product (MySuper) (chapter 1). Further, an estimated 1 million members cannot exercise a choice of fund even if they wished to do so (O'Dwyer 2018).

The rate of switching funds tends to vary with member characteristics and by fund type. Rice Warner's (2017f) report found that in 2014-15:

- males were slightly more likely to switch funds than females
- the majority of fund switching is concentrated around age 30, then tails off before peaking again just prior to retirement age
- the likelihood of switching funds reduces the longer a person has been with a fund

-
- the retail sector had the highest share of exits across all balance types and was also the primary destination of most fund switches. That said, there was some variation in the likelihood of switching by type of fund. The prospect of switching into an SMSF increased with size of members' balances. In contrast, the prospect of switching into an industry fund was higher among those with lower balances. The chance of entering a retail, corporate or public sector fund, however, varied little by size of balance.

The Commission's funds survey asked respondents to rank the main obstacles faced by members when they decide to switch to their fund. Funds generally agree, regardless of segment, that the time to understand and evaluate options is a greater obstacle than the availability of information, which is in turn a greater obstacle than administrative costs. Funds also provide a range of options to facilitate members switching to and from their funds; requests for joining a fund are allowed via writing, email, call centre and online methods for at least 64 per cent of funds. For each of these options, the majority of funds will allow the entire process to be completed via the selected method. Industry funds are more likely and retail funds less likely than the average of all funds to offer each of these major options. Funds responded similarly when asked about the options for moving from their fund (tech. supp. 2).

Results of the members survey indicate that (of those who switched to another fund in the year prior to the survey) most were in the accumulation (rather than transition) phase, and aged under 50 years, and nearly half switched into a retail fund while just over one third switched into an industry fund (tech. supp. 1). The greater propensity to switch into a retail fund (irrespective of whether the member is in a retail or an industry fund prior to the switch) is also seen in funds survey data (tech. supp. 2).

Reasons for members switching funds vary but are largely based on members seeking to improve their outcomes.

- Wootten (2017) cited survey data which showed that of those who intended to switch, around one third proposed to do so to achieve better financial returns or lower fees. Another one third planned to switch due to a change in employment, seeking better customer service or to consolidate multiple superannuation funds.
- Commission analysis of Rice Warner's member-based data indicates that a substantial proportion of fund switching in 2017 was motivated by an active decision — of those who switched, 46 per cent was due to consolidation and 37 per cent was due to a decision by the member to switch their balance to another fund (chapter 7).
- The Commission's members survey suggests that just over half (56 per cent) of members switching funds in the year prior to the survey had done so because they had changed employer or the employer had changed funds, with the balance doing so for personal reasons (including being advised by an adviser) (tech. supp. 1).

However, members' desires for improved outcomes have not eventuated for some. Rice Warner's (2017f) analysis of member-level data suggests that around half of those switching into an industry, corporate or a retail fund end up paying higher fees (of around \$83, \$101

and \$263 per year, respectively) and a hefty proportion (over 80 per cent) of members switching into retail funds experienced lower returns (based on four year investment performance to 30 June 2015). Further, in a recent ASIC study of vertically integrated financial advice providers, 10 per cent of the files reviewed raised significant concerns about the impact of non-compliant advice on customers, as switching to a new superannuation platform had resulted in inferior insurance arrangements and/or a significant increase in ongoing product fees without additional benefits being identified (ASIC 2018a). This evidence is consistent with other evidence (chapters 2, 3 and 4) that competition in the choice segment has not always resulted in improved long-term outcomes for all members, suggesting that active members (or their intermediaries) have exerted insufficient competitive pressure on funds.

Factors affecting investment switching rates

Previous studies have found that some members are more likely than others to switch investment options. They include: males, members with higher balances and higher incomes; older members; more financially literate members; and those with higher risk tolerances (PC 2016b, box B.6).

The Commission's members survey suggests that (of those who switched investment options in the 12 months prior to the survey):

- members with an SMSF, in a retail fund, aged more than 50 years and with higher incomes and balances, and choice members were more likely to have switched options
- almost two thirds had switched to an investment option that they had chosen themselves. Of those (non-SMSF) members who switched to an option chosen by themselves, 72 per cent had switched after undertaking their own research or obtaining advice while around 12 per cent had been persuaded by their fund's marketing or advice to switch to the new investment product/option (tech. supp. 1).

Exit and other costs are not a large barrier to switching or engaging

Exit fees faced by members can dampen their incentives to switch funds and/or investment options. Based on a survey of their members, CHOICE stated:

A number of respondents mentioned exit fees as a barrier to switching. Exit fees on newer products are typically insignificant compared to the increased earnings expected in moving from a poor performing to a good performing fund. ... It is also possible many of the responses came from older consumers on legacy products where exit fees tended to be higher. (sub. 71, p. 8)

More than a decade ago ASIC found that just over half a million Australians had purchased so-called 'old style' accounts from life insurance companies (before the introduction of the Superannuation Guarantee in 1993) that may be subject to significant exit or termination fees (ASIC 2005).

Today, while exit fees faced by members are relatively common, on average they are not large. The Commission's analysis of SuperRatings data (based on a member with a balance of \$50 000 in 2016), suggests that 52 per cent of assets and 61 per cent of members are in products that include an exit fee.³⁸ In products with an exit fee, the average exit fee faced by members is small (around \$50 on a \$50 000 balance). However, there is a wide dispersion in fixed dollar exit fees, ranging from small nominal amounts up to around \$180 in 2016. These data also show that percentage-based exit fees exist but are rare, confined to legacy products in retail, and comprise around 1 per cent of assets (chapter 3).

Nonetheless, there is evidence that some exit fees in choice products remain above cost-recovery levels (chapter 3). The Commission is recommending extending the existing cost-recovery restrictions on MySuper exit fees to new members in new accumulation and retirement products.

There are also indirect fees and factors that can affect members' switching decisions in both the accumulation and retirement phases. They are often not explicit fees but may manifest later in a pecuniary form (for example, when moving products triggers a capital gains tax event, or conditions in a long term savings policy or annuity product). The type and extent of indirect fees and factors, however, is unclear.

As the presence of very high exit and switching fees could preclude switching in existing and legacy products to a more appropriate product, more concerted regulatory oversight will be required. This includes ASIC reviewing whether such fees are unrelated to the underlying performance of the product or unreasonably impede members switching to better products.

Alongside any exit and switching fees, the time spent researching and gathering information to make changes can affect incentives to switch funds or investments.

Results from the members survey (albeit from a modest sample size) suggest that just over half of members spent less than 2 hours gathering information related to switching to another fund. However, just over one fifth (22 per cent) spent more than 4 hours. The small number of observations also meant it was difficult to accurately determine the size of planner/adviser fees among those who used a planner/adviser in their decision to switch to another fund or establish an SMSF.

³⁸ These data suggest some differences between the likelihood of exit fees on MySuper and choice segment assets and members: 63 per cent of assets and 52 per cent of members in the MySuper segment are in products with an exit fee; and 47 per cent of assets and 64 per cent of members in the choice segment are in products with an exit fee.

DRAFT FINDING 5.2

Demand-side pressure in the superannuation system is relatively weak.

- Most members in the accumulation phase let the default segment make decisions for them, at least when they enter the workforce.
- A significant minority of members (an estimated 1 million) are barred from exercising choice even if they wanted to.
- Fund and investment switching rates are modest, suggesting that active members (or their intermediaries) have not exerted material competitive pressure on funds.

Proposed legislative changes to prohibit restrictive clauses in workplace agreements on members' choice of fund are much needed.

5.3 Better (not more) information and advice is needed for meaningful engagement

A range of information and advice is required by members

In a well-functioning superannuation system, suitably framed, simple, accessible and comparable information from a trusted source, and impartial and affordable advice would be expected. Reflecting this, Merton (2014) stated:

... an effective retirement system must guide savers to good retirement outcomes through clear and meaningful communication and simplicity of choices, during both the accumulation phase and the postretirement payout phase. (p. 11)

Overly complex information and/or advice will adversely affect members' financial wellbeing and the system's efficiency. The long tail of poor performing products (chapter 2) means that the poorly engaged, and less knowledgeable and financially literate members are perhaps more vulnerable to making poor decisions from lower-quality information and advice than others.

While suitable default and governance arrangements, and prudential regulation, can help to safeguard the interests of members, no matter how engaged, knowledgeable and financially literate they are, the system still needs to help all members' decisions to be *well informed*.

Merton (2014), however, cautioned against simply providing members with more information to help them make decisions. And in recent research commissioned by CHOICE, the authors concluded that 'people don't want more information — they want help to make decisions' (Souvlis et al. 2017, p. 32).

The Commission's choice experiment (tech. supp. 1) suggests that members, especially those aged 35 to 54 years, are much more willing to pay for forms of contact that allow for personalised assistance such as online chats than fund-provided measures, such as newsletters and seminars. Susan Bell Research (2008) showed that consumer understanding

was improved when financial product information was disclosed in shorter documents that were well signposted, and used plain English and graphics. Bateman, Lai and Stevens (2012) showed that graphical representations of risk resonated better with people of lower financial literacy than numerical measures. Murray et al. (2014) pointed out that digital communication channels offered more opportunities for engaging messages when compared with paper-based disclosure. Stage 1 study participants also submitted that the majority of members wanted access to simple, lower-cost advice (rather than comprehensive advice).

The need for well-designed information and advice also varies across members with different characteristics, and over the life cycle — with disengaged members often needing very little while different types of engaged members have a variety of requirements (box 5.4). A well-designed and efficient system will cater for these different needs across different types of members at different stages in their lifecycles in the most cost-effective way.

Box 5.4 Information and advice: each to their own

Information and advice requirements vary by type of member

When members are disengaged

... they require little as they rely on the default system to choose a fund and then select investment options and some features (mainly insurance) on their behalf.

When members are engaged

... they require (and use) more information and advice to help them navigate the system and make optimal decisions about their retirement savings, including: those leaving the default system (CHOICE, sub. 71); those contemplating creating and while running an SMSF (Kingsley, sub. 22; Bird et al. 2016a, 2016b); those changing jobs; and financially literate members (PC 2017c).

... and over a member's life

Early on

... when choosing a fund, information on the set of products (including insurance), investment options, associated risks and fees is important (for those engaged members who wish to access this type of information). When deciding on which fund to choose, younger people tend to value input from financial advisers, employers, and friends and family more than older groups (PC 2017c).

Approaching retirement

... information about how different accumulation products trade off various risks and combine a member's expected income needs with the need for continued investment growth becomes paramount (PC 2016b; First State Super, sub. 37).

At retirement

... deciding how to draw down their balance is a key life cycle decision for each member. Given its inherent complexity, many retirees need and use advisory services to help make this decision, especially when choosing some largely irreversible longevity risk products (chapter 4).

Funds, regulators and government all play a role in ensuring meaningful information and impartial advice

Superannuation funds are required to disclose information on investment performance, costs and fees to help members make better decisions. The funds survey suggests that funds *believe* they provide adequate information to a ‘reasonable’ member,³⁹ with industry funds being more confident of this than retail funds (tech. supp. 2).

In addition, funds provide different types of advice services to their members. The Commission’s funds survey suggests that responding funds spend an estimated \$154 million annually (representing around 0.02 per cent of their total assets) on different types of advice and tools to help members plan, with most on general and superannuation advice and least on planning tools (tech. supp. 2). Some funds have been embracing online and digital capabilities and tools to do this (Australian Super, sub. 43; REST Industry Super, sub. 49; and IFAA, QIEC and Club Super, sub. 53). Although still in the early stages of development, a few funds had begun to recognise the benefits of digital advice, partnering with digital advice platforms to rollout the capability to their members (Chong 2018).

Three regulators — APRA, ASIC and the ATO — are the most prominent regulators of superannuation (chapter 10). They also seek to make sure that meaningful information and impartial advice is provided to members.

- The Australian Government’s Future of Financial Advice reforms in 2013 (box 9.2) included a ‘best interest’ duty to prioritise the interest of the client over those of the adviser or related parties. In 2015 ASIC (which administers these laws) introduced a Financial Advisers Register (ASIC 2017d).
- Regulators and government agencies have an important role in increasing transparency and reducing the complexity of information relating to the superannuation system through reporting standards and disclosure requirements on funds (ASIC 2017a, 2017e; PC 2016b; chapter 9). Presenting relevant information in an accessible format for all members (and their advisors/agents) is also a key strategy. For example:
 - the ‘Superannuation and Retirement’ section of ASIC’s MoneySmart website provides information on superannuation and retirement, including a *Financial Decisions at Retirement* booklet and the recently developed Financial Advice Toolkit (to help people evaluate financial advice they receive) (ASIC 2017b)
 - the Department of Human Services (DHS) provides the Financial Information Service, which presents information and guidance online, through regular public seminars, a call centre and via one-on-one sessions (ANAO 2016; DHS 2017)
 - for prospective and current SMSF owners, complementing the ATO’s information (ATO 2018c), is ASIC’s information sheet (ASIC 2015a).

³⁹ In the funds survey, a ‘reasonable’ member is defined as someone with an average level of financial and superannuation literacy.

How well funds and regulators perform these different roles and/or achieve these aims is considered below.

Finally, improving the financial literacy of members to enable informed engagement is another role often undertaken by government and regulators as well as some non-government organisations. The Australian Government's National Financial Literacy Strategy (ASIC 2018b) (administered by ASIC) is the most substantial among the abundance of financial literacy programs operating in Australia at any one time (PC 2015a). The Commission concurs with the Financial System Inquiry's (Murray et al. 2014) conclusion that improving financial literacy is not a panacea for improving informed member engagement. Reducing the complexity of the system in tandem with implementing a set of complementary measures, including modernising default arrangements, is of greater value to members and supportive of member engagement.

But gaps remain in the quality and provision of information

Superannuation information is complex and overwhelming for many members

Previously, the Cooper Review (2010) and the Financial System Inquiry (Murray et al. 2014) identified problems related to the shortcomings in disclosure coupled with low member engagement, inertia and an over-reliance on financial literacy. Participants in the stage 1 study (PC 2016b) acknowledged that while there have been improvements in the quality of information provided to members in recent years, there was scope for further improvement in multiple areas including: more consistent reporting on fees and returns across a wider range of products; more granular reporting of costs and fees; and other revisions to dashboard measures to enhance their meaningfulness to members. Finally, ASIC's recent work on members' experiences with super funds raised a number of concerns relating to information, such as: poor disclosure of insurance details to members; the low prominence of product dashboards; and inconsistencies between funds in the contents of dashboards (ASIC 2017e).

Despite funds being required by law to disclose information on costs and fees to help members make better decisions and meet the aims of regulators (see above), a range of evidence and submissions suggests that superannuation information remains complex and overwhelming for many (Bucknell, sub. 16; AIST, sub. 39; Australian Super, sub. 43; IFAA, GIEC Super and Club Super, sub. 53; CHOICE, sub. 71; AIA Australia, sub. 76). Further confirmation is provided in results from the Commission's members and funds surveys. The unhealthy product proliferation found in chapter 4 is a key factor contributing to members feeling swamped by too much information.

Many members need more help to understand fees and investment options,

As discussed above, close to 60 per cent of members do not understand their fees and charges, and around 40 per cent lack an understanding of investment options. Given its effects on long term net returns for members, this lack of understanding (especially when

combined with the contrary member satisfaction ratings in these two areas) is concerning. It may also indicate that being satisfied with information provision may not reflect a genuine understanding of the products on offer.

As it is difficult to materially improve financial literacy (see above), framing information in a way that guides choices is likely to be more helpful to members. The way default arrangements are modernised (chapter 12) will also help to simplify choice for everyone in the system.

... to compare fund offerings and for funds to better understand their needs

The members survey suggests that higher levels of net satisfaction are observed among some product-related features while lower levels of net satisfaction by members are observed on several information-related elements, including: how funds engage with members to better understand their needs, providing information to make comparisons with other funds, and the level of information on how members' superannuation money is being invested. That said, members' net satisfaction is the lowest when considering the level of fees charged (a product-related feature) (figure 5.6). On average, younger members are generally less satisfied with these elements of their main superannuation fund (tech. supp. 1). This is concerning as younger members stand to benefit more in the long run from informed engagement.

While net satisfaction levels in the funds survey cannot be directly compared to those of the members survey, a comparison of the relative ranking of net satisfaction across some common elements suggests that members' and funds' perspectives of members' net satisfaction are broadly similar (tech. supp. 1).⁴⁰

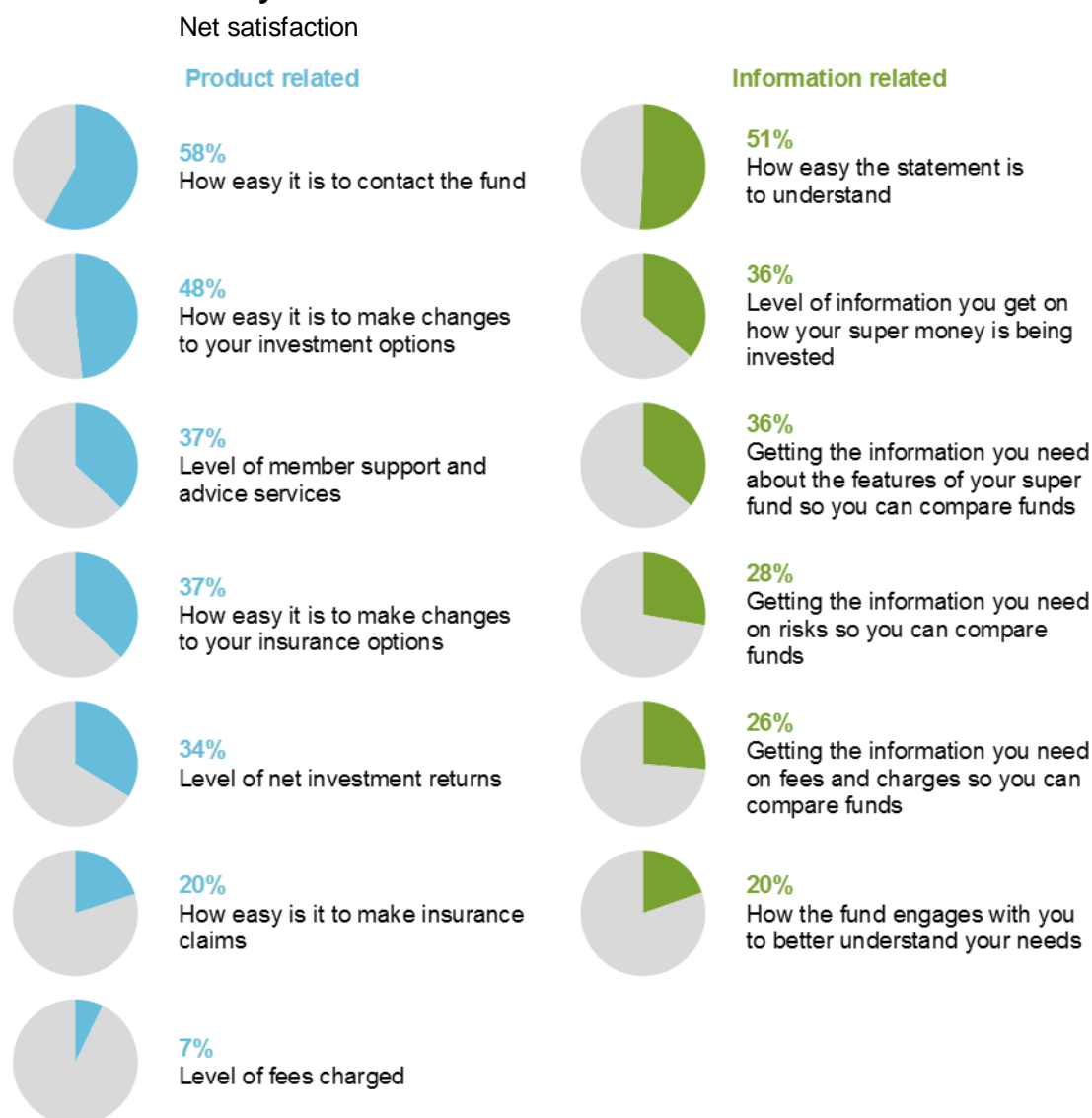
Members also want greater transparency

The results from the members survey point to a desire for greater transparency across a range of aspects — from the administration fees charged by their fund to the risks involved in investing in superannuation (tech. supp. 1). The proportion seeking information specifically on how to consolidate accounts (16 per cent) appears comparatively low, although perhaps not surprising given that the majority of members in the survey (77 per cent) indicated they held only one account.⁴¹ (Although 6.5 per cent said they did not know how many accounts they held, and of those who held more than one account, just over one fifth did so deliberately (tech. supp. 1).)

⁴⁰ The funds survey results suggest that funds use different sources of information to gauge their member's satisfaction, and that industry funds use surveys of their members combined with other sources of information (such as focus groups or member feedback) while retail funds make comparatively limited use of these sources (tech. supp. 2).

⁴¹ This compares with a figure of 60 per cent based on ATO data (figure 6.4). This difference illustrates members' lack of awareness of unintended multiples and the likely margin of error in survey data.

Figure 5.6 **Members' net satisfaction across different elements varies widely^{a,b,c}**



^a Responses are weighted using Commission weights. ^b Note that some questions were not asked of members whose main fund is an SMSF. Members with no superannuation fund (that is, those only holding retirement products) were not asked these questions. ^c Net satisfaction is calculated as the proportion (excluding those giving 'can't say' responses and those not asked) who stated they were 'highly' or 'somewhat' satisfied, less those who stated they were 'highly' or 'somewhat' dissatisfied.
Source: Members survey.

Compounding these are the problems identified with dashboards

Even though information on different products and their features (including often complex insurance options within superannuation) is available on many funds' websites or through ratings agencies, gathering intelligence on a large array of products (including product disclosure statements) to compare the different options available is no easy task.

While product dashboards aim to enable members to simplify the comparison of superannuation products, they remain (at best) a work in progress.

Dashboards for choice products were scheduled to become mandatory from 1 July 2015. Delays with finalising the necessary legislation and regulations have seen the start date pushed out at least twice. As of 1 June 2017 the start date is 1 July 2019 (ASIC 2017a). AIST (sub. 39) noted that these delays coupled with Australian Government plans to amend the law so that funds would only need to produce dashboards for their 10 largest choice options mean that:

Members of choice products/investment options do not have a dashboard and so cannot easily compare their returns, fees or costs with MySuper products. ... [and], dashboards will not be required for most choice investment options. (p. 33)

Meanwhile, dashboards for MySuper products (mandatory since 31 December 2013) have attracted criticism (box 5.3; PC 2017c). Not least, information from a 2017 ASIC assessment of 14 funds indicated that some dashboards are missing mandatory elements and some are unduly difficult to locate (ASIC 2017e). ASIC drew similar findings from a 2014 review, prompting provision of further guidance to trustees about their obligations (ASIC 2014). Moreover, MySuper products (which are meant to be ‘no frills’ type products) are increasingly difficult to compare with the approval of more life-cycle MySuper products over time (chapter 4).

Dashboards also need to be *salient* to be effective. The Commission understands that ASIC’s surveillance work on dashboards has revealed that MySuper dashboards are often buried several clicks away from the homepage (ASIC 2014). The Commission’s funds survey suggests that retail funds report an average of 1.9 ‘clicks’ are required to go from their homepage to access product information, compared to 2.4 ‘clicks’ for industry funds (tech. supp. 2).

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While there is no shortage of information available to members, it is often overwhelming and complex. Dashboards should be a prime mechanism to allow for product comparison and need to be salient, simple and accessible to be effective — but most are not.

Addressing information gaps through better dashboards and disclosure

Given the complexity of superannuation and the number of people with increasingly sizable assets in superannuation, good quality information is vital. By establishing an easy-to-understand and credible benchmark against which members can compare alternative funds and options (and switch if desired), the Commission’s default proposals (chapter 12)

will go a long way to making engagement less costly and more member friendly. And while the quality of information reported to APRA and ASIC could be improved (chapter 9), more can also be done to improve the suitability of what is reported to members.

Improving product dashboards to enable better comparisons

As noted earlier, choice dashboards have yet to be implemented and MySuper dashboards have been subject to criticism. While producing dashboards is not costless to funds, so is not providing salient, good quality, standardised information to members.

One way to improve the saliency of dashboards could be to have them centralised and presented in one online source. CHOICE (sub. 71) advocated for a centralised data base via the Australian Government's myGov website 'to help all consumers assess products and switch to more competitive offers' (p. 4). While the comparisons could be directly posted on the myGov website, that website could also point to another credible website. For example, a purpose-built website (such as 'superdashboards.gov.au'), ASIC's MoneySmart website or another trusted site which is validated by the Australian Government through ASIC. Validating the information is necessary to support trust in the information by consumers.

Consideration of proactive prompts on myGov to stimulate greater member attention to the alternative website would also be worthwhile. Drawing on the lessons of behavioural economics, its knowledge of basic member characteristics and digital matching capabilities, ASIC and the ATO (while drawing on relevant experts) could conduct randomised control trials to establish what prompts work best. For example, some types of members may respond to a prompt which says 'Did you know that your fund has performed below average over the last 10 years when compared to the average of other funds?'. Others may respond to a prompt which says something like 'Take a minute to check how your fund compares'. These types of prompts may also spur the rump of existing default members — who are not directly subject to the Commission's default proposals (which apply to new superannuation members) — into action.

Even so, presenting complex information in a simple way is highly challenging. Guiding member choice, rather than simply providing more information, is often a more effective approach to empowering consumers. As noted by Gabaix (2017), much of behavioural economics reflects the need to account for limited human attention; the costs of keeping track of a flood of information and the fact that people tend to economise in different ways. Hence, behavioural economics points to the importance of keeping it simple to draw the attention of members. To help guide the development of dashboards, ASIC has published several rounds of consumer testing (ASIC 2013b, 2015b). An example of more robust testing is the survey experiment undertaken by the Behavioural Economics Team of the Australian Government (BETA) in retirement income planning (Hiscox et al. 2017). In simplifying the metrics displayed in dashboards, ASIC should also consult with independent experts and consumer organisations.

Given these challenges, there are always likely to be shortcomings in dashboards. However, perfection should not be a barrier to the possible.

More effective product disclosure

The industry needs to lift its game on disclosure (particularly around insurance offerings) (chapter 3 and 9) with a re-orientation from risk aversion to helpfulness. There is much scope for ASIC, as the primary regulator in this area, to revise and more proactively enforce disclosure requirements for superannuation funds (chapter 9). The overarching objective should be *meaningful* disclosure — information should be simple, comparable and easy for members to understand. Members should be able to access basic information without being overwhelmed by its volume.

Dashboards can help, but some information (notably insurance in superannuation) is not included in dashboards. As discussed in chapter 8, the *Insurance in Superannuation Working Group Voluntary Code* is seeking to standardise information on such insurance.

And some members need more guidance around advice services

Problems related to deficiencies in financial advice (stemming from conflicted remuneration structures within the financial planning industry) have been previously identified (Cooper et al. 2010a; Murray et al. 2014). However, while there are a number of advice services available, evidence suggests that many superannuation members need help to guide them to make their own decisions, while other members (who wish to obtain professional financial advice) often need to know what to be aware of when purchasing such advice.

Intra-fund advice is unlikely to be holistic

The Commission's members survey suggests that just over two thirds of members who received intrafund advice from their main fund in the 12 months prior to the survey are somewhat or completely satisfied (tech. supp. 1). However, as financial advice rules limit the scope of intrafund advice, such advice is unlikely to be holistic.

Accessing impartial quality financial advice on super can be fraught ...

Based on over 250 000 interviews over five years, Roy Morgan Research (2015b) found that most people seek advice when they switch their superannuation fund, and an increasing proportion use financial advisers/planners. Those who did not seek advice tended to have lower balances and lower incomes. Those switching into an SMSF or retail fund tended to acquire advice from financial advisers or accountants while those switching into industry funds were most likely to obtain advice from an employer or friend/family.

However, acquiring *impartial* superannuation advice can be hit and miss. As noted earlier, ASIC's (2018a) review of financial advice in vertically integrated institutions suggested that some financial advice services lack impartiality and caused material detriment. The general quality of financial advice services has been called into question by ASIC at the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Financial Services Royal Commission), with inappropriate advice in superannuation identified as being most prevalent currently in relation to switching funds, advice to establish an SMSF and advice that results in balance erosion (ASIC 2018e).

In a qualitative study commissioned by CHOICE, the authors identified that:

... a gap has opened up for a safe place to go for independent, unbiased advice that will work in people's best interest. There is a need for a trusted adviser with no self-interest that will break down the jargon and help people make decisions quickly and easily. (Souvlis et al. 2017, p. 18)

Many recipients of financial advice may not know whether the advice they are receiving is good or bad (ASIC 2012), and finding affordable financial advice may also be tricky. The FPA (2017a) stated that 30 per cent of consumers (who had not sought financial advice and did not intend to do so in the future) said that the high cost was a key reason for not seeking advice. While not all of this unmet need for impartial quality financial advice is in relation to superannuation, given that a large proportion of Australians have assets in superannuation and over half of the revenue of financial advisers relates to superannuation (including self-managed super) (PC 2018, figure D.7), a fair proportion is likely to include demand for advice on superannuation-related aspects.

... and the quality of advice to SMSF owners is questionable

SMSFs owners are major users of advice services and are most satisfied when they actively collaborate with a trusted adviser (SMSFA and CommBank 2017). Some participants appeared happy with advice/support to SMSFs (Ayliffe, sub. 18; Williamson, sub. 19).

As the cost of establishing an SMSF is relatively high (chapter 3) good advice is imperative. However, a range of evidence raises questions about the quality of the advice provided to SMSFs. Previously, ASIC (2013d) found pockets of poor advice had been given to SMSFs. While the process of establishing and growing an SMSF builds trust between the adviser and SMSF members, evidence suggests that clients who form favourable views of advisers tend to maintain those views even when the quality of the advice does not justify their decision (Agnew et al. 2018; ASIC 2012; Mullainathan, Noeth and Schoar 2012). Bird et al. (2016b) also found that current and former SMSF members were significantly more likely to trust their advisers and hold them in high esteem compared with non-SMSF members (including those who were thinking about establishing an SMSF). The latter group were more sceptical, rating advisers as self-interested and influenced by commissions. Other evidence shows there has been a sharp increase (albeit from a small base) in complaints to the FOS about financial planning advice for SMSF owners (Collett 2017). Based on ASIC's testimony at the Financial Services Royal Commission, Butler (2018) reported that forthcoming ASIC

research ‘... showed that, nine times out of 10, advisers failed to take into account the best interests of their clients when giving advice about setting up self-managed super funds’ (p. 1). Further, ASIC (2018e) stated that pending research concluded that in 10 per cent of the SMSF client files reviewed, the client ‘risked being significantly worse off’ and a further 19 per cent of clients were ‘at an increased risk of suffering financial detriment’ (p. 18).

Policies to address poor quality and conflicted financial advice are discussed in the Commission’s Competition in the Australian Financial System inquiry. And there is promise in digital advice (also known as robo-advice) as an alternative source of impartial and affordable advice (box 5.5).

Box 5.5 Digital advice: an emerging potential source of impartial and affordable advice for superannuation members

Some commentators have forecast that digital advice is likely to be the next digital disrupter in the Australian superannuation system, with ‘products that targeted specific demographics, such as millennial savers or self-directed retiree investors’ (Kendell 2017, p. 1; North 2017). The Australian Treasurer and the UK’s FCA also expected that, due to its lower cost and convenience, digital advice could become more popular in retirement income markets (FCA 2017; Morrison 2017).

However, digital advice requires good design. Based on their small study of people’s attitudes and preferences for superannuation advice from a person or a computer, Duenser and Reeson (2017) suggested that while many want emotional support and motivation from a human, rather than cold hard facts from a computer, digital advice could prove useful to those who need it most by making them feel more competent and in control. Chong (2018) reported that SMSF members are increasingly using digital advice to tailor assistance according to their financial goals and risk tolerance.

And improving the quality of services to members by harnessing these technological advances is not costless for funds (or members) (First State Super, sub. 37).

In its submission to the *Competition in the Australian Financial System* inquiry, ASIC (2017g) suggested that while digital advice had the potential to disrupt the financial advice market there were also risks. Further, the complexity of superannuation products — along with the complexity and lack of standardisation in insurance products in super (chapter 8) — and the large volume of products, means that the task of writing algorithms to accurately portray the full offerings will be considerable. Moreover, to provide good quality automated advice, some key information on people’s individual and household financial circumstances and their risk profile will need to be acquired.

More guidance to help pre-retirees navigate an increasingly complex maze will be needed

The Murray Inquiry (2014) was critical of the services on offer to help retirees through the maze. The Council on the Ageing (COTA) Australia (2014, p. 6) stated that ‘consumers report to us that they feel deserted ... once they reach the retirement phase, particularly if they have relatively small balances’. National Seniors Australia (nd) echoed these sentiments

and suggested that a coordinated approach to consolidating government information and supports into one location — utilising appropriate communication channels — was needed. And the Commission’s previous study on *Superannuation Policy for Post-Retirement* (PC 2015a) canvassed a broad range of evidence on the difficulties encountered by older Australians in understanding information about superannuation. That study also found that many individuals lacked knowledge on where to seek advice, and when they did receive advice, not everyone was well catered for.

Most retirees have made sensible decisions in relation to retirement income products to date (chapter 4; PC 2015a). However, in future, as members retire with higher balances and the diversity of options available expands, the need for guidance to tailored advice is expected to grow. Before members commit to largely irreversible longevity risk pooling products, the Commission regards impartial advice as a ‘must have’ — especially for those with a balance of less than about \$250 000.

Gaps in guidance services are also common internationally. For example, gaps in providing suitable guidance for pre-retirees and retirees in relation to retirement income products have been identified by the United Kingdom’s (UK) Financial Conduct Authority (FCA 2016, 2017).

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The quality of financial advice provided to some members — including those with SMSFs — is questionable. Knowledge of the guidance and supports available to pre-retirees is generally lacking. In future, as members retire with higher balances and the diversity of options available expands, the need for tailored advice will grow.

Simple dashboards and better guidance to existing advice services

Making dashboards salient and simple, and establishing easy-to-understand and credible benchmarks as part of the Commission’s default proposals will provide much needed points of reference to help simplify and improve (and reduce the prospect of poor) financial advice in this complex area (chapter 10). However, more could be done to guide people to make their own decisions or access *impartial* financial advice — especially members who are approaching retirement and prospective SMSF owners.

To minimise confusion by consumers and ensure adequate protection, the Commission’s draft report on *Competition in the Australian Financial System* (PC 2018) suggested that the term ‘advice’ (in the context of financial advice) should be limited to effort that is undertaken on a client’s behalf by a professional adviser (and not used to describe general promotional or marketing efforts about different products). This is especially important in the complex and highly regulated world of superannuation.

Barr and Diamond (sub. 74) argued that better information should be provided to retirees based on potentially different family circumstances, as happens in the UK Government's workplace pension (superannuation) scheme (NEST 2018), the UK Government's Pension Wise service (UK Government nd), and the government-aided, independent The Pensions Advisory Service (TPAS) (TPAS 2018).⁴² In relation to improving information and guidance in the drawdown phase, Barr and Diamond (sub. 74) also proposed that annuity providers should be compelled to provide directly comparable price and design details through a government-run website, like the one in Chile (and soon to occur in the UK (Department for Work & Pensions and HM Treasury 2017)).

However, while the Chilean arrangement has raised annuity payments to members (Morales and Larrain 2017) it is less relevant to Australia (PC 2017c). This is not to say that providing comparable information on different types of retirement income products would not benefit members, but comparing between different types of retirement income products is highly challenging.

Improving the guidance to pre-retirees and retirees has been recently examined in the UK as part of the FCA's (2017) *Retirement Outcomes Review: Interim Report*. Following 2015 reforms that gave UK consumers greater freedom to use their pension savings, the FCA required providers to direct their customers to free, impartial pensions guidance in the UK Government's Pension Wise service (FCA 2016).⁴³ A recent evaluation of this service suggested that customer experience had been highly positive, with Pension Wise appointments in particular leading to customers making informed decisions (including talking to pension providers, shopping around for quotes, looking into tax implications and charges and considering investment options) (Department for Work & Pensions 2017). However, the FCA (2017) found that many retirees made decisions without turning to their accumulation fund provider or Pension Wise for help, giving rise to concerns that many retirees were making uninformed choices that may result in them paying too much tax, choosing a product that was unsuitable for their needs or having an inappropriate withdrawal strategy. The FCA (2017) proposed several potential remedies to address these concerns, including: making it easier for consumers to compare and shop around for retirement income products; and making existing information on drawdown more impactful and effective.

The Commission considers that more prominent guidance would enable pre-retirees and prospective SMSF owners, to better understand and access impartial advice when they most need it.

⁴² Following a review of public financial guidance in 2016, towards the end of 2018 the UK Government will merge the Pension Wise service, TPAS and the Money Advice Service to become a Single Financial Guidance Body (SFGB) (Department for Work & Pensions and HM Treasury 2017). The SFGB will amalgamate guidance on pensions and money, and debt advice to ensure UK citizens have 'access to high quality, impartial financial guidance from one single source' (p. 3) and 'simplify the existing government sponsored financial guidance landscape' (p. 4). The body will also be responsible for strategies to improve financial literacy, reduce problem debt and support the better coordination of financial education initiatives. The SFGB will be largely funded by industry levies.

⁴³ These rules will be updated with reference to SFGB in due course.

There are already several sources of guidance for pre-retirees, including ASIC's MoneySmart website and DHS' Financial Information Service, as well information provided by the Council of the Ageing (COTA), the Financial Planning Association of Australia (FPAA) and National Seniors Australia. In the lead up to members' retirement, the ATO should be required to nudge them to the 'Superannuation and Retirement' section of ASIC's MoneySmart website —which includes its *Financial Decisions at Retirement* booklet and Financial Advice Toolkit — and DHS' Financial Information Service to better guide members towards accessing impartial advice.

6 Erosion of member balances

Key points

- There is much unnecessary erosion of member balances in the system. It is typically regressive and costs members billions each year.
- Unintended multiple accounts (and particularly multiple insurance premiums) are by far the most egregious driver of balance erosion. Unnecessary balance erosion is also caused by delayed and unpaid superannuation, trailing commissions and suboptimal tax management.
- Policy plays the dominant role in unnecessary erosion by setting the underlying structures (by linking member accounts to employers and not employees). As such, much (but not all) unnecessary balance erosion is beyond funds' control.
- Unintended multiple accounts are a significant problem. They represent around one in three member accounts and annually cost members around \$2.6 billion (\$1.9 billion in excess insurance premiums and \$690 million in excess administration fees). Importantly, these direct costs further erode member balances over time in the form of foregone compound returns.
- A typical worker with two accounts across their working life will be over 6 per cent (or \$51 000) worse off at retirement compared with a worker holding just one account.
- Recent policy initiatives have made inroads, but the stock of unintended multiple accounts remains large and current policy settings are making slow progress by treating the symptoms and not the structural cause.
- A centralised online service would offer a much needed circuit breaker for unintended multiple accounts. Upon new employment, existing members would be presented with their existing fund, or could select a new fund. The service would facilitate consolidation of multiple accounts and the member would be nudged to do so.
- Under directive from the Australian Government, the ATO has been building the capability for such a service through Single Touch Payroll and MyGov infrastructure. This work should be accelerated as a priority, and online completion of the standard choice form made universal.
- Clearing the legacy stock of lost (\$14.1 billion in 629 000 accounts) and unclaimed (\$3.75 billion in 5.4 million accounts) accounts is still much needed. This should be a priority for an empowered ATO. Accounts should be sent to the ATO when they first meet a lost definition for auto-consolidation with a matched, active account.
- Unpaid super remains a significant cause of erosion — around \$2.8 billion per year (5 per cent of all SG contributions). It especially impacts low income and young workers. The new regime for employers and funds to report to the ATO (with some important as-yet unlegislated elements) is needed to make monitoring and enforcement simpler and effective.
- Further, at least two per cent (or 636 000) of member accounts are subject to (grandfathered) trailing adviser commissions, costing members at least \$214 million annually.

Beyond maximising long-term net returns and competitive fees, an efficient superannuation system would be one that inherently minimises unnecessary erosion of member balances. In such a system, unintended multiple accounts would not be created, and no accounts would become lost or unclaimed (or, if these situations did arise, they would be rectified quickly). Further, an efficient system would see all Superannuation Guarantee (SG) contributions made in full and on time, and returns would not be compromised by trailing commissions or suboptimal tax management.

Against these benchmarks, the current system does not perform as well as it should. Balances are eroded in a number of ways, and this erosion can have a material impact on member balances and, ultimately, retirement incomes — particularly once foregone compound returns are taken into account. Erosion is typically regressive in impact — disproportionately affecting younger members, those with low incomes and those with limited financial literacy.

Broadly, erosion of member balances can occur in three ways (figure 6.1). First, when unintended multiple accounts are created, or accounts become lost or unclaimed. Second, through unpaid or delayed SG payments. And third, due to poor governance (including trailing commissions) and tax (mis)management. Policy design is the underlying cause of erosion, and the number of accounts and size of balances affected is significant.

While balance erosion from multiple insurance products is covered in this chapter, issues associated with erosion from insurance premiums are dealt with more comprehensively in chapter 8.

Figure 6.1 Policy design the primary driver of balance erosion
Balance erosion by who initiates it, the underlying cause and the magnitude

	Who?	Underlying cause	Magnitude
Multiple, lost and unclaimed accounts	Member	Inefficient default arrangements	\$1.9 billion (premiums) and \$690 million (fees) per year, ^a and foregone returns. 6% lost over the lifetime of a typical member
Unpaid SG	Employer	Inefficient compliance regime	\$2.85 billion annually, plus foregone returns. 7.6% lost over the lifetime of a typical member
Trailing commissions	Financial advisers and funds	Grandfathering arrangements	At least 636 000 accounts, costing potentially \$214 million per year
Tax management	Funds	Principal-agent problems	Unknown

^a An estimated \$161 million of these fees and premiums is attributable to lost accounts.

This chapter spans the following two criteria from the Commission's assessment framework (PC 2016a).

- Is the system effectively managing tax for members, including in transition? (E4)
- Are other leakages from members' accounts being minimised? (E5)

6.1 Multiple accounts

The primary source of balance erosion lies in multiple accounts

Members can create multiple accounts if they default (upon new employment) or otherwise open a new account, and do not rollover their existing account. While in some cases this outcome may be intended by engaged members,⁴⁴ more often than not, the creation of multiple accounts is unintended (tech. supp. 1). These unintended multiple accounts erode members' balances via multiple sets of fees and insurance premiums, and often end up as lost, and then unclaimed, accounts. Commission estimates suggest that there could be about 10 million unintended multiple accounts⁴⁵ (35 per cent of total accounts held by funds) associated with \$690 million and \$1.9 billion annually in excess administration fees and insurance premiums, respectively (figure 6.2). This estimate of unintended multiple accounts is consistent with work by Minifie (2014) and Clare (2007). These authors' estimates translated into unintended multiple account shares of 38 per cent and 36 per cent, respectively.

This erosion is exacerbated by the foregone compound returns on fees and premiums that would have otherwise been invested.

The incidence of multiple accounts has been falling, but remains high

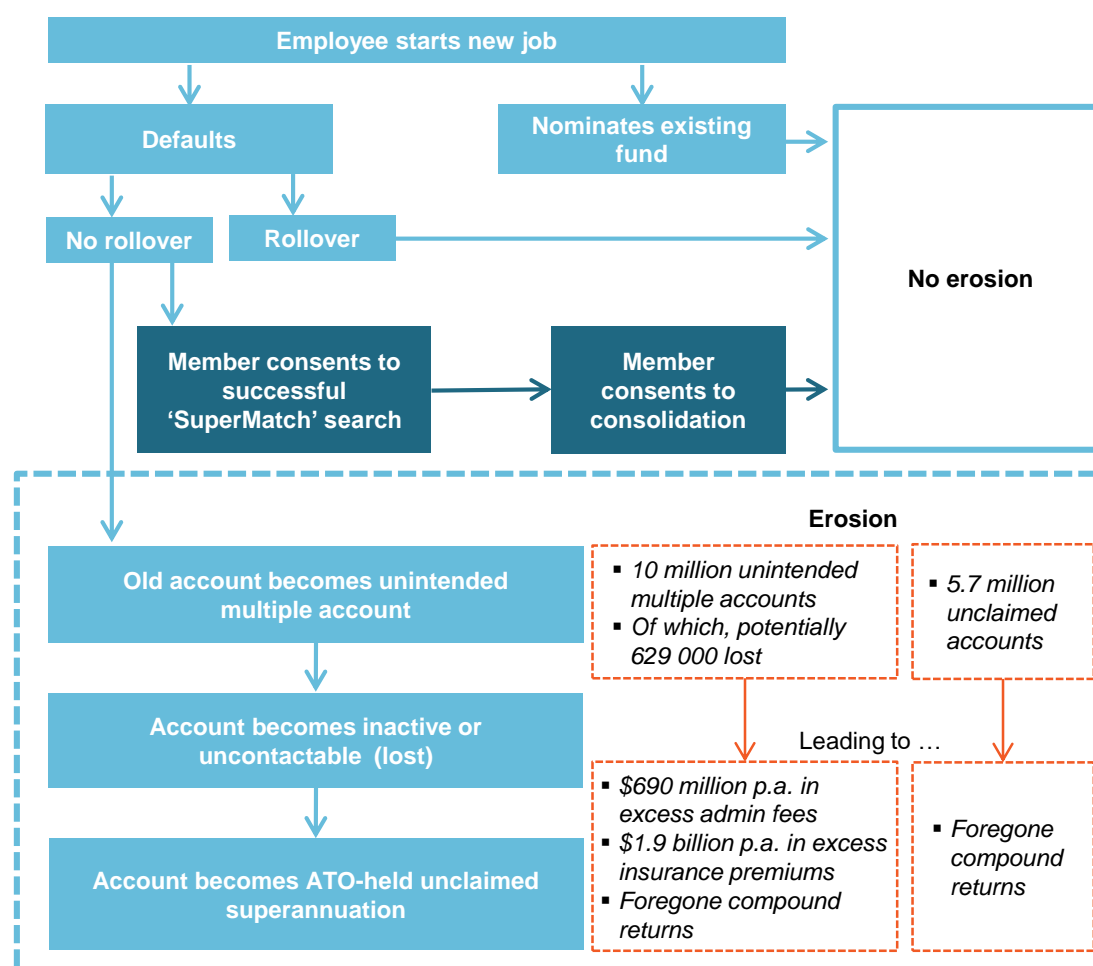
Evidence suggests that the incidence of unintended multiple accounts has fallen in recent years. The total number of accounts and the average number of accounts per member have fallen by 12 and 28 per cent, respectively, from a peak in 2009 (figure 6.3). High labour force movement and the introduction of 'choice of fund' legislation in 2005 worked to accelerate the proliferation of multiple accounts in the 2000s. In recent years, the growing

⁴⁴ Participants have suggested that most members intentionally holding two accounts are SMSF members maintaining a second account for insurance purposes, or individuals contributing to a defined-contribution account while maintaining a separate defined-benefit account (Cbus, stage 2, sub. DR74).

⁴⁵ A portion of Australian Tax Office (ATO) held unclaimed accounts (discussed below) are also likely to be unintended multiple accounts, so this figure is an underestimate. Although these accounts are not subject to fees and insurance premiums, if they are claimed they only attract a rate of return consistent with the increase in the consumer price index while the ATO has held the account.

use of tax file numbers (TFNs) as unique identifiers, and easier search and consolidation tools,⁴⁶ have helped reverse the trend (ATO 2017g).

Figure 6.2 Multiple accounts lead to significant member balance erosion^{a,b}



^a This figure is stylised and abstracts away from some (less common) situations. For example, it assumes that all lost and unclaimed accounts start off as unintended multiple accounts. There are cases where this may not be true (for example, temporary workers). These abstractions do not impact erosion estimates.

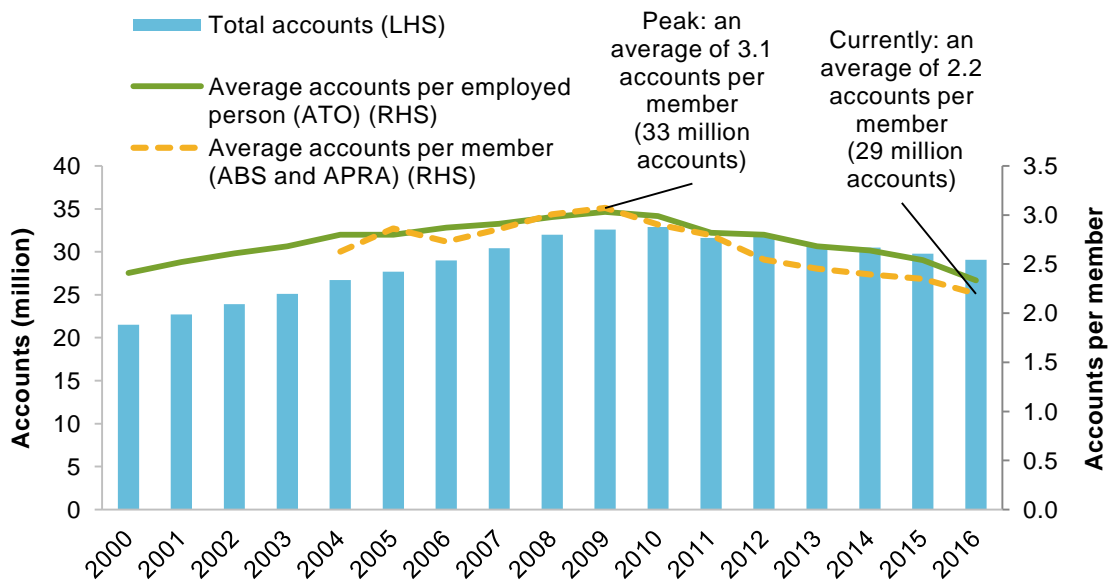
^b Unintended multiple accounts are estimated as 77 per cent (members survey) of total excess accounts (total accounts (APRA) minus number of members (ATO)). This is multiplied by the average MySuper fixed admin fee (\$69 – APRA) to get excess admin fees. It is then multiplied by an average insurance premium (\$340 – Rice Warner) to get excess insurance premiums, after adjusting for the estimated 45 per cent (ATO) of accounts that do not have insurance.

Sources: ABS (*Household Income and Wealth, Australia, 2015-16*, 6523.0); APRA (2017b, 2017i, 2018e); ATO (2017e, 2017g, pers. comm., 15 February 2018); Chant West (2016a); members survey; PC Analysis of Rice Warner data.

⁴⁶ Members can search and consolidate via MyGov, and funds can search and consolidate with member consent using the SuperMatch facility maintained by the ATO.

The share of members holding just one account increased by 5 percentage points from 2013 to 2016 to 60 per cent (figure 6.4), and the share of members with three or more accounts fell by almost 4 percentage points. As indicated above, not all of this duplication is unintended, but it is likely that most members deliberately holding multiple accounts would hold no more than two. This further suggests that the incidence of unintended multiple accounts has been in decline.

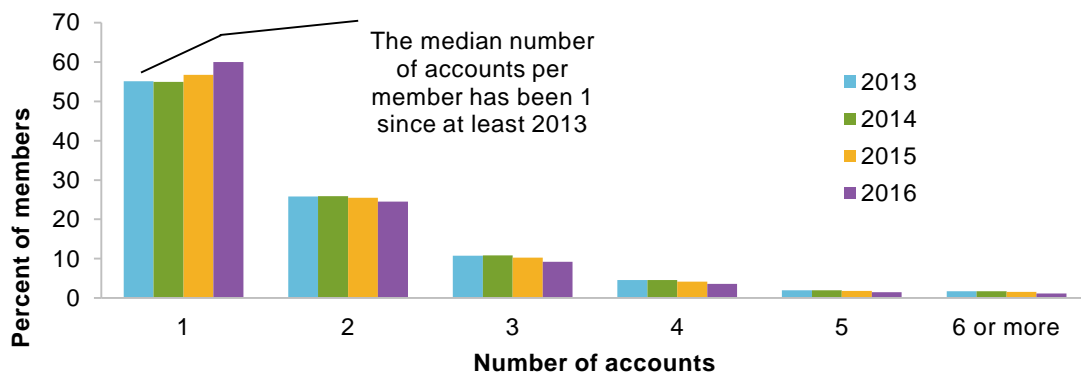
Figure 6.3 Multiple accounts — improving but stubbornly problematic^a
Total accounts and average accounts per member, 2000–2016



^a ATO estimates per employed persons are less precise, but are included for a longer time series.

Sources: ABS (*Household Income and Wealth, Australia, 2015-16*, 6523.0); ABS (*Labour Force, Australia, Nov 2017*, 6202.0); APRA (2017b), ATO (2017g).

Figure 6.4 Fewer people are holding multiple accounts
Per cent of all members by number of accounts held, 2013–2016



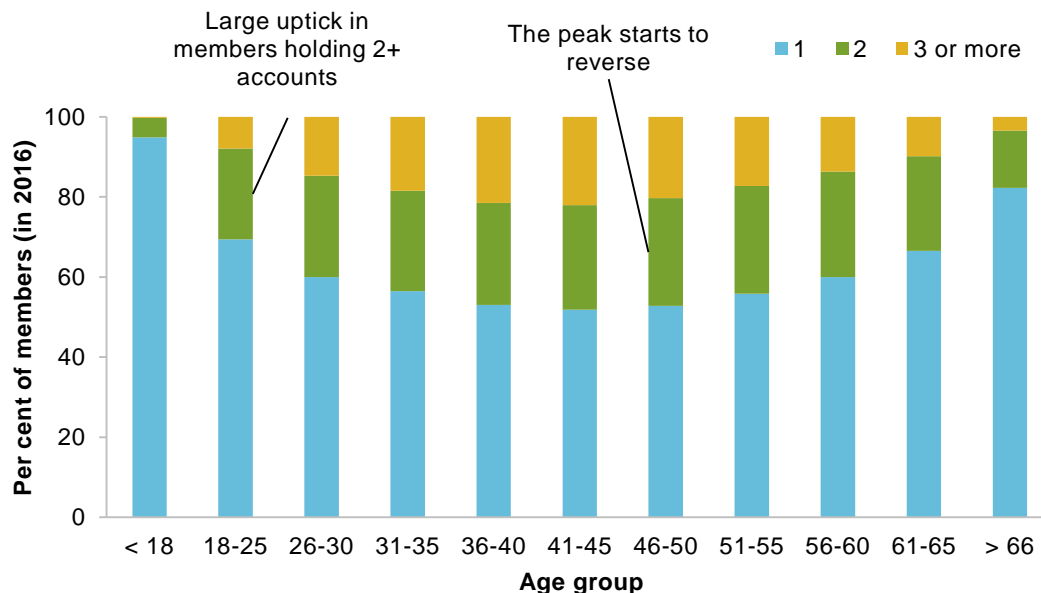
Source: ATO (2017g).

Account proliferation happens early, and persists with significant life-time cost to members

Account proliferation appears early in adulthood and persists well into middle age (figure 6.5). The largest increase in individuals holding two or more accounts happens between the ages of 18 and 25. This finding is consistent with the widely held view that young people continually default as they move through various casual jobs. The creation of multiple accounts peaks for members in their early to mid-40s, when nearly 50 per cent have two or more accounts (although it is worth noting that members in the middle-age groups are more likely than those in younger ones to have intentional multiple accounts). This illustrates the significant length of time that multiple fees and insurance premiums can work to erode balances.⁴⁷ It is also important to note that, in the absence of action, account proliferation may be worse in the future if modern workforce developments see a more fluid labour market create more opportunities for individuals to default (chapter 4).

As the peak reverses, the decreases are relatively small until the over 66 age group, where the percentage holding two or more accounts drops markedly to 18 per cent. It is plausible that the residual in this group is mostly made up of intended multiple accounts — individuals transitioning to retirement with one accumulation and one pension account, for example.

Figure 6.5 Proliferation happens early, and persists
Per cent of members by number of accounts by age group, 2016

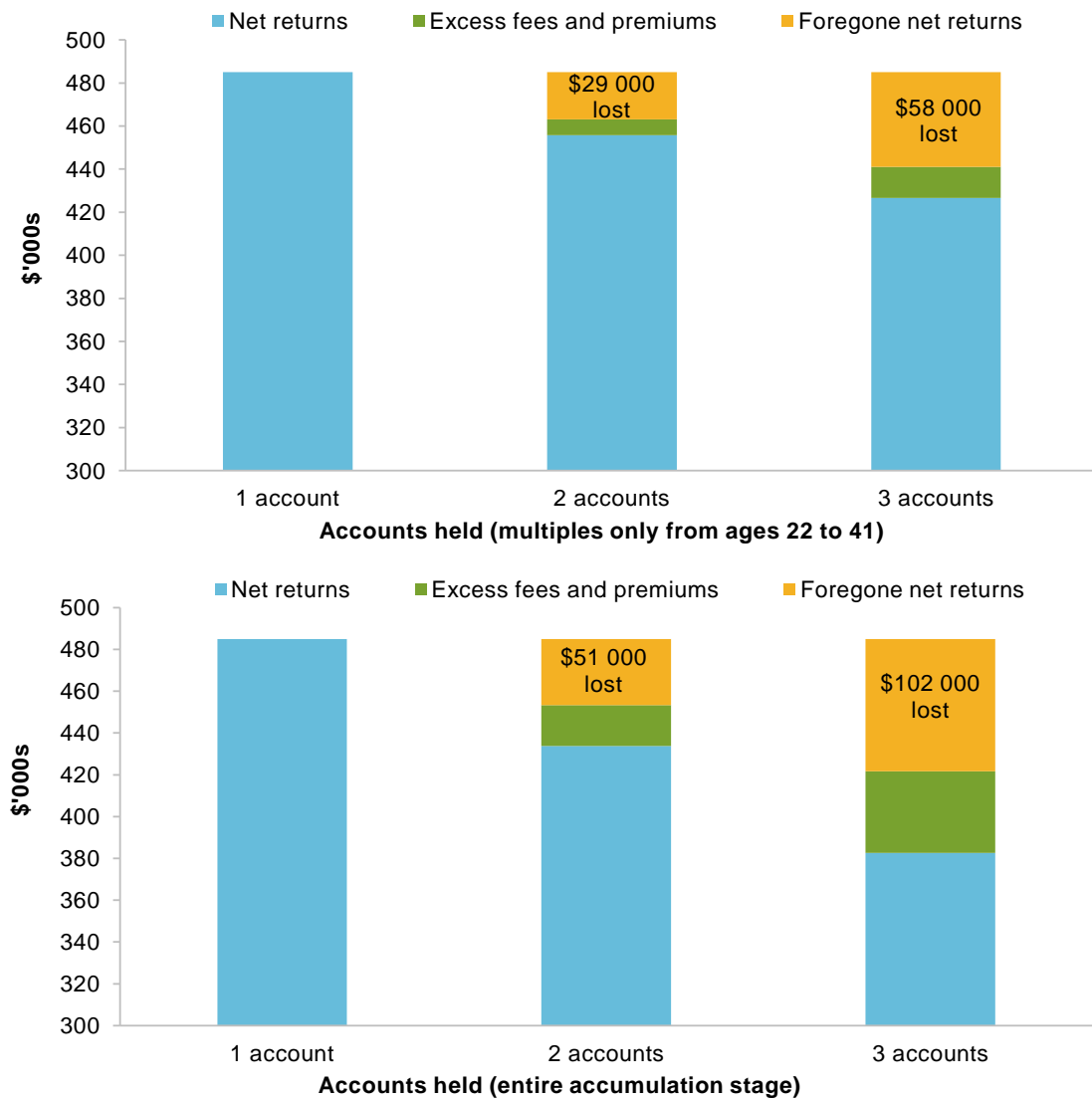


Source: ATO (2017e).

⁴⁷ Although it should be noted that this is current cross-sectional data, and the typical path of an individual member may be different depending on when they entered the workforce.

The excess fees and premiums paid by individuals with unintended multiple accounts have a detrimental impact on balances at retirement, especially once foregone compound returns are factored in. The Commission's cameo model (chapter 1) illustrates the average cost of holding unintended multiple accounts for an individual who holds a single multiple account from ages 22 to 41 compared with an individual who does not hold a multiple account at any point. The multiple accounts holder could be \$29 000 (3.5 per cent) worse off at retirement. This balance erosion worsens to \$51 000 (6 per cent) if the multiple accounts are held over the entire accumulation phase (figure 6.6).

Figure 6.6 Multiple accounts — a heavy penalty on retirement^a
Projected returns on contributions by number of accounts held^b



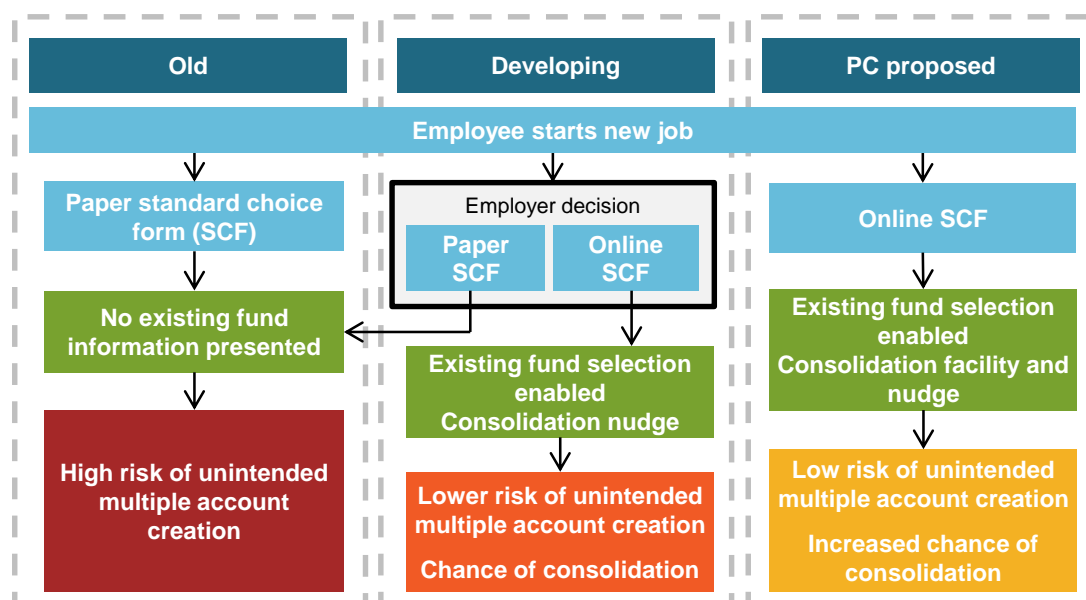
^a The assumptions underpinning this cameo are set out in chapter 1. ^b Returns on contributions of about \$350 000 over the members working life.

Defaulting once — a much needed circuit breaker

To date, the problem of unintended multiple accounts has been addressed primarily by initiatives treating the symptoms and not the structural cause. These initiatives have targeted both members and funds. In recent years, engaged members have been able to easily consolidate multiple accounts online on MyGov, and funds have been able to search for multiple accounts in members' names via SuperMatch. Between 2013 and 2016, 1.38 million accounts (4.5 per cent of all accounts in 2013) were consolidated online via member requests (ATO 2017g). However, it is worth noting that not all funds use SuperMatch due to the setup costs associated with using the software (ATO, pers. comm., 5 Feb 2018). Further, the follow-through rate from (unintended multiple) 'accounts found' to 'accounts consolidated' on MyGov has been relatively low — an average rate of 21 per cent over the three years 2014–16 (ATO, pers. comm., 24 January 2017, 15 February 2017).

At present, members, whether engaged or not, can default and create multiple accounts. The Commission's recommendation for default superannuation accounts to only be created once for people that are new to the workforce and do not already have a superannuation account (chapter 12, chapter 13) would significantly stem the flow of future unintended account proliferation. The centralised online service to facilitate this change would also assist with consolidating existing multiple accounts (figure 6.7).

Figure 6.7 **Account proliferation — a digital solution^a**
The old, the developing and the Commission's proposed frameworks



^a This figure is stylised and abstracts from some complexity. For example, the exact specifications of the developing online standard choice form (SCF) are a work in progress, and the ATO is exploring the potential for it to include a consolidation facility.

This service would draw on the existing Single Touch Payroll (STP)⁴⁸ and MyGov infrastructure that allows businesses and individuals to interact with the Government online when someone starts a new job (ATO 2017d; PC 2017c). This infrastructure stems from a stated Government priority to ‘introduce streamlined processes for individuals commencing employment’ (O’Dwyer 2015b). In particular, a voluntary online standard choice form is being developed (ATO, pers. comm., 5 Feb 2018). This work should be accelerated as a priority, with a view to making the online standard choice form a requirement for all new employees. Many participants expressed general support for such a universal mechanism (ASU, sub. 28, p. 6; FSS, sub. 37, p. 13; Nicholas Barr and Peter Diamond, sub. 74, pp. 2, 6; PwC, sub. 62, p. 6; ACTU, sub. 50, p. 12).

This service should present new employees with a list of their existing funds to select from, alongside the option of nominating a new fund — whether that be one personally selected or the relevant default product/s on offer. New workforce entrants should be presented with the relevant default product/s on offer, as well as the opportunity to choose a different product. Consolidation of multiple accounts should be facilitated, with nudges for members to do so. More broadly, architecture around the service and the whole employment commencement process should contain features that nudge new employees to actively engage.

It would be a rare occurrence under such arrangements for an employee to create an unintended multiple account. Previous Commission estimates suggested that switching to such an approach could produce savings to members in the order of \$150 million annually by stemming the creation of new unintended multiple accounts (PC 2017c). This figure would be further amplified depending on the degree to which the current workforce uses the online service to consolidate the existing stock of unintended multiple accounts.

In a modern economy, digital processes are increasingly becoming the norm. Therefore, over the medium to long term, making such processes universal should not create an undue regulatory burden for small- and medium-sized enterprises.

However, importantly and perversely, realised savings from reducing unintended multiple accounts will likely be lower than the figures cited above because average fees may increase as unintended multiples are removed. This is for two reasons. First, the cost of administering an inactive account is much lower than that of an active account, meaning inactive accounts are cross-subsidising active accounts. Removing inactive accounts would remove this cross-subsidy. Second, and more fundamentally, fewer accounts at a fund means the fixed costs of administration are spread thinner (chapter 3). Even so, removing unintended multiple accounts from the system is ultimately in members best interests and should be pursued.

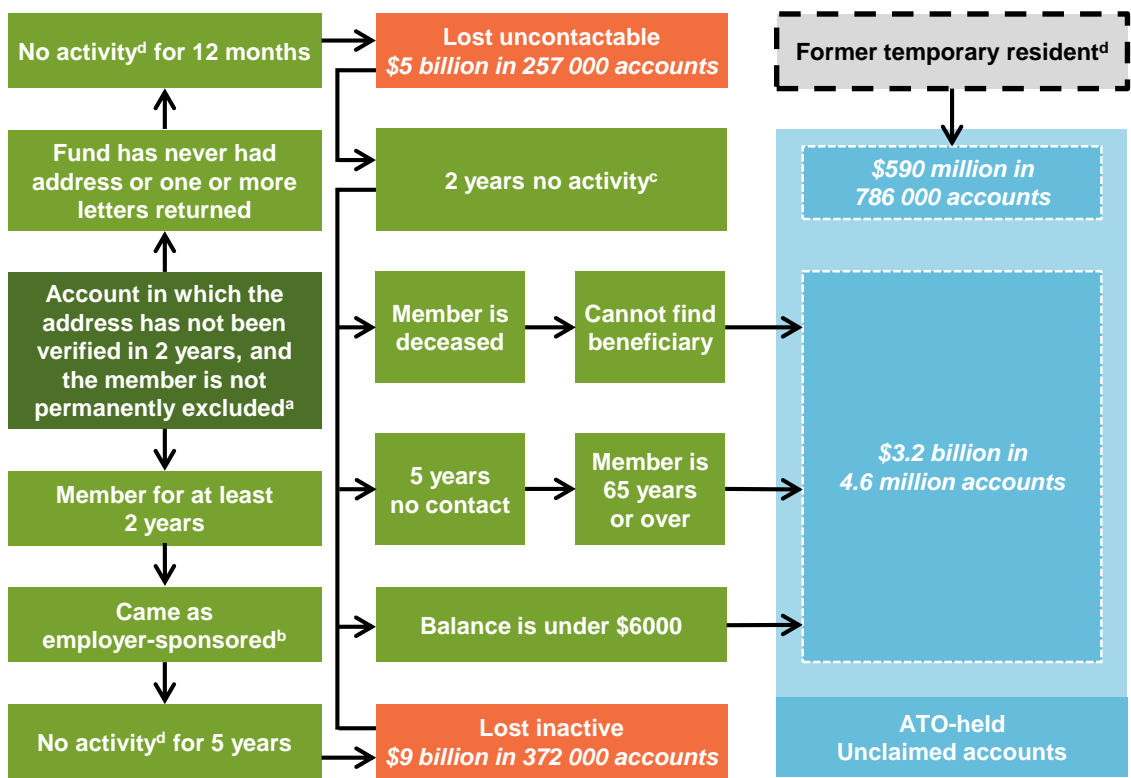
⁴⁸ STP is a broader reform package that aims to streamline employer reporting of salary and wages, PAYG withholding tax and superannuation information to the ATO as they occur. STP for employers with 20 or more employees has been legislated, and takes effect from 1 July 2018. STP for smaller employers has been announced to take effect from 1 July 2019, but is yet to be legislated.

A different strategy is needed to address lost and unclaimed accounts

Rules leading to the creation of these accounts are complex

The lost and unclaimed superannuation accounts framework is complex (figure 6.8). There are two types of lost accounts — ‘lost inactive’ and ‘lost uncontactable’ — distinguished by different thresholds for activity and contact, and each is subject to certain exclusions. Many funds send their lost (or on the path to being lost) accounts to an ‘Eligible Rollover Fund’ (ERF), although there are not strict rules around when and why this must occur (box 6.1). Unclaimed superannuation is lost superannuation⁴⁹ that satisfies at least one of three other conditions. Unlike lost superannuation, all unclaimed superannuation is held by the ATO. Balances in accounts unclaimed after 10 financial years are transferred into consolidated revenue.

Figure 6.8 Rules creating lost and unclaimed accounts are complex
Lost and unclaimed superannuation, 2016



^a Permanently excluded means that the member has done something that indicates a preference to remain a member of the fund, for example, has used an online service. ^b Employer-sponsored means that the member defaulted. ^c Activity refers to contributions or rollovers. ^d A former temporary resident is a non-citizen who has not renewed their visa, or been granted a new visa, in at least six months.

Sources: Superannuation Industry (Supervision) Regulations, r. 1.04a; *Superannuation (Unclaimed Money and Lost Members) Act 1999* (Cwlth); ATO (2015c, 2017h).

⁴⁹ With the exception of accounts belonging to former temporary residents, which can be transferred to the ATO before they are ‘lost’.

Box 6.1 Eligible Rollover Funds

Eligible Rollover Funds (ERFs) were established as a temporary repository for the benefit of members who had lost connection with their superannuation accounts. Institutional fund trustees are required to nominate an ERF to send accounts to should they deem it in a member's best interests to do so. Regulations do not provide strict guidance on when this would be the case. ERFs are only allowed to receive accounts from institutional funds and cannot take contributions from members or the ATO.

Originally, ERFs were envisaged as developing the necessary expertise to reunite accounts with members, while administering balances at very low cost. The relevant Cooper Review issues paper noted that the ERF sector had not been performing this role because:

- not all funds sent small inactive accounts to ERFs
- there was a lack of incentives for ERF trustees to re-connect members with their accounts
- different investment strategies had resulted in a wide range of returns, some of which did not effectively preserve balances.

Consequently, the Review recommended ERF-specific RSE license requirements that established an obligation to promote the financial interests of the beneficiaries of the fund and to undertake a single, diversified investment strategy for all assets in the fund. These changes were adopted and resulted in a rationalisation in the ERF sector from 16 to 8 funds. The Review also recommended that ERF trustees be required to crossmatch accounts with any active fund that seeks access to its database. However, this recommendation was not adopted. At present, ERFs are currently under no obligation to undertake activity to promote consolidation.

More recently, ERFs were empowered to undertake an automatic consolidation of a member's account into a fund if they could confirm that the receiving account had been active in the last 12 months. At least one ERF has sought to use this empowerment to increase reunification rates.

At present, ERFs make up 10.8 per cent of system accounts (3.1 million), and 0.2 per cent of system assets (\$4.7 billion).

Sources: PC analysis of APRA confidential data; Cooper (2010b); Treasury Laws Amendment (2016 Measures No.1) Regulation 2016; Treasury (2011); Superannuation Industry (Supervision) Regulations, r. 6.29; *Superannuation Industry (Supervision) Act 1993* (Cwlth), s. 242k; IFS (2017).

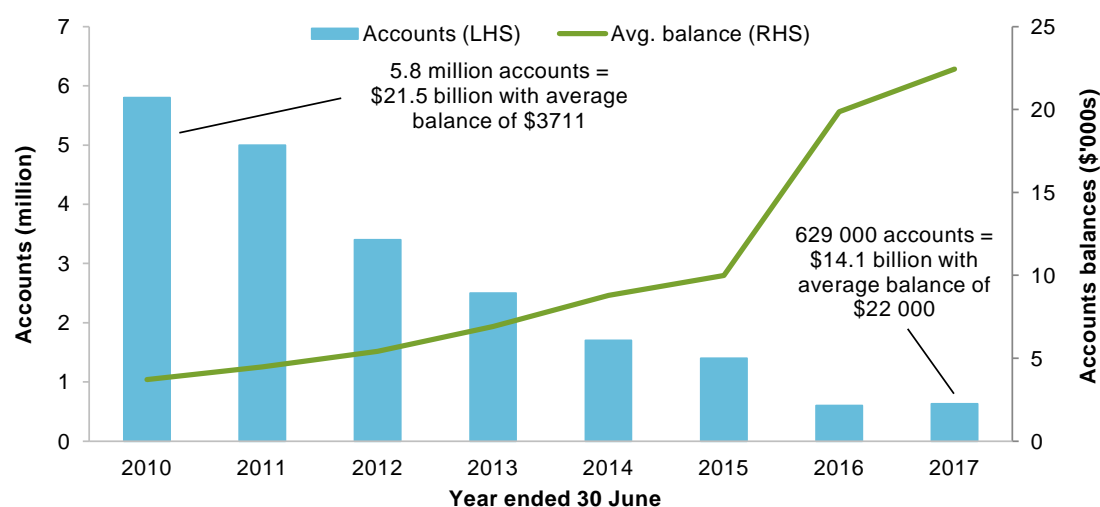
There have been marked reductions in the number of lost and unclaimed accounts

The number of lost accounts has fallen markedly in recent years (figure 6.9). As at June 2010, lost accounts comprised about 18 per cent (or 5.8 million accounts) of all accounts in the system. As at June 2017, they accounted for about 2 per cent (629 000 accounts)⁵⁰ (APRA 2017b; ATO 2017g). Lost accounts now make up around 1 per cent of total assets in the accumulation phase (APRA 2017i; ATO 2016e).

⁵⁰ This figure comes from ATO data. APRA (2014b) also collects data on lost accounts but uses different definitions (that appear out of step with the underlying regulation). Inactive accounts are defined as employer-sponsored accounts with a contactable member, but with no activity for two years (instead of five) — but are not defined as lost. APRA data suggests there is \$104 billion in 7.5 million of these accounts. Lost accounts are defined as accounts that are inactive and uncontactable (although uncontactable is not

The ATO (2017g) has noted that the decline in the number of lost accounts (and the rise in the average balance of a lost account) is in large part attributable to gradual increases in the balance threshold for the transfer of lost accounts to the ATO as unclaimed accounts. These changes lifted the threshold from \$200 to \$6000 starting in 2011. Accordingly, this change has also led to a large rise in the number of unclaimed superannuation accounts (figure 6.10).

Figure 6.9 Lost account numbers have fallen markedly
Number of lost accounts and average balance, 2010–2017^a



^a All dollar figures are in 2017 dollars.

Sources: ABS (Consumer Price Index, Australia, Sep 2017, 6401.0); ATO (2017e, 2017g).

Balances in lost and unclaimed accounts tend to be small. While the average balance for an account in an institutional fund is \$68 000 (APRA 2018c), the average for a lost account is \$22 000 (figure 6.9), and the average for an unclaimed account is just under \$700 (figure 6.10).

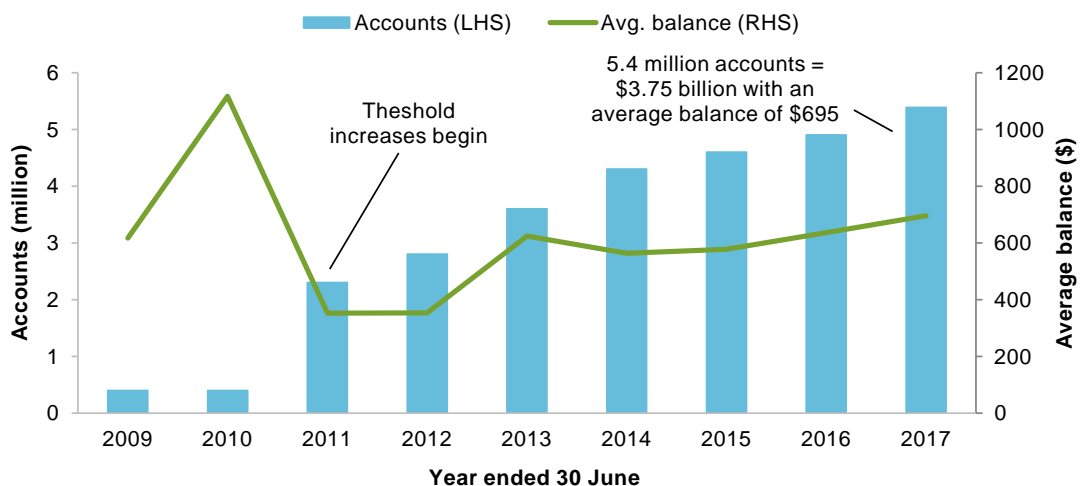
The costs to members of reduced balances from lost accounts are largely captured in the costs of unintended multiple accounts. The Commission estimates that lost accounts comprise at least \$161 million of the \$2.6 billion excess administration fees and insurance premiums charged on multiple accounts. The costs of unclaimed accounts are less direct. They arise in the administrative costs borne by the ATO (and ultimately taxpayers) and the foregone returns to members (given the ATO only pays interest in line with the consumer price index (ATO 2018a)).

clearly defined), and that have seen no activity for 12 months. APRA data suggests there is \$7.8 billion in 471 000 of these accounts (APRA 2017i).

Recent policy initiatives significantly reduced lost account creation

While increases in the balance threshold for unclaimed superannuation have worked to reduce the stock of lost accounts, policy initiatives to stem the flow have also been effective. From 2011, SuperStream allowed a member's TFN to be used as their primary identifier in the superannuation system, and lifted obstacles to member data being provided to funds by employers.⁵¹ The ATO's 'SuperTICK' data-validation service, initiated in 2013, complements this by helping funds ensure that incorrect TFN data are corrected (funds use this service about 6 million times per year, although a large number of funds do not use this service at all) (ATO, pers. comm., 4 October 2017). From 2010 to 2015, the share of accounts with a correct TFN rose from 85 to 95 per cent (ATO 2017g). The ATO also pro-actively updates funds if information attached to a lost account's TFN changes (for example, a member registers a new address as part of their tax return).

Figure 6.10 Unclaimed accounts have grown substantially
Number of unclaimed accounts and average balance, 2009–2017^a



^a Average balance in 2017 dollars.

Sources: ABS (*Consumer Price Index, Australia*, Sep 2017, 6401.0); ATO (2017e, 2017g).

Better information about members has been complemented by initiatives that allow easier consolidation of lost accounts or unintended multiple accounts on track to being lost. Allowing funds to use a member's TFN as an internal account locator was the 'trigger for a wave of intra-fund account consolidation' (ATO 2017g, p. 10). And online services (the MyGov site and SuperMatch) facilitated the consolidation (as mentioned above) of

⁵¹ SuperStream was designed to streamline the 'back office' of superannuation. In addition to making TFNs the primary identifier within the system, SuperStream has led to the design of data and e-commerce standards for the reporting of contributions and straight through processing of superannuation transactions.

1.38 million accounts (with a value of \$6.5 billion) between 2013 and 2016 (ATO 2017g, p. 13).

However, while recent changes have made a significant difference, as long as individuals can create unintended multiple accounts, the potential for those accounts to become lost and unclaimed remains — and for balances to be needlessly eroded in the meantime. As discussed above, the Commission’s proposal for default superannuation accounts to only be created once for people that are new to the workforce, and do not already have a superannuation account, would act as a circuit breaker.

Further initiatives could reduce legacy stock of lost and unclaimed accounts

While a centralised online service has substantial potential to stem the flow of lost accounts, there remains the problem of reuniting already lost and unclaimed accounts with members. At present, this relies heavily on outreach by funds (ERFs in particular) and the ATO, and on engagement by members.

Eligible Rollover Funds (ERFs) are not an effective policy tool

Currently, ERFs are supposed to receive, match and consolidate lost accounts, but *prima facie* evidence suggests only a small part of the ERF sector is meeting this objective. In 2015-16, ERFs transferred out only 12.5 per cent of their accounts. This figure overestimates the proportion of accounts that are reunified as it includes those sent to the ATO as unclaimed accounts. This low reunification rate is despite 76 per cent of the 3.1 million accounts in ERFs having a TFN attached (APRA 2017i).

It has been noted that ERFs may not have the correct incentives to effectively promote unification and may not be adequately preserving balances (Cooper et al. 2010b; box 6.1). While the absence of insurance may make the average ERF a better option for a low balance account (assuming the member does not value the insurance), high investment fees and low returns indicate ERFs could do better at their stated goal of preserving balances (box 6.2).

It is also surprising that three of the eight ERFs charge exit fees, despite transferring accounts out being their remit. While this might be justifiable on cost recovery grounds, data suggest these grounds are not upheld for all fees. For example, one ERF charges \$40.70 for an exit (whether to the ATO or otherwise), while another charges just \$0.25 for an exit to the ATO and \$5 for a non-ATO exit (ERF Product Disclosure Statements).

Incentives aside, an ERF’s fundamental role is account reunification. In this respect they are heavily constrained by the data they have access to. While at least one ERF is actively promoting consolidation through ventures with participating funds, ERFs remain constrained by the fact that funds are not obligated to allow them access to data (IFS 2017).

Making the ATO responsible for reunification efforts would benefit members

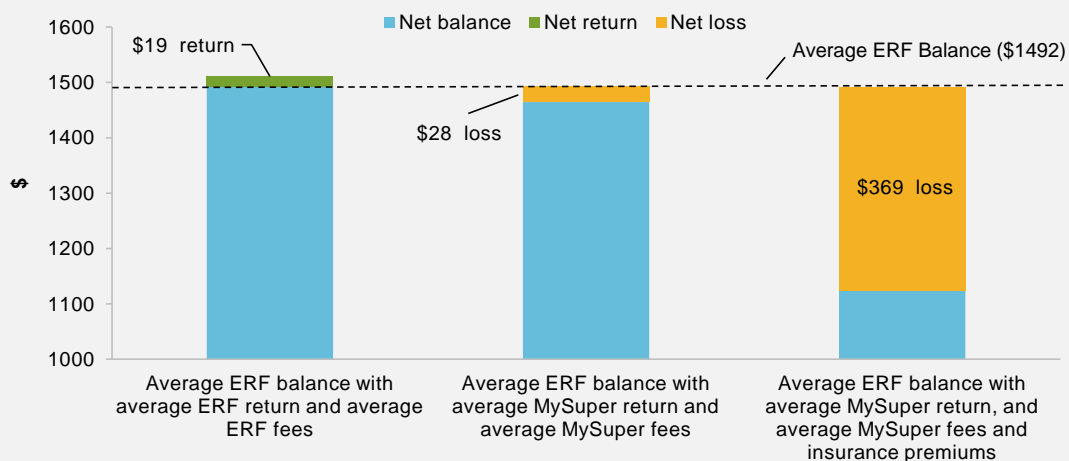
Taking incentives misalignment and data constraints into account, a more efficient way of reuniting members with their lost and unclaimed accounts would be for a properly motivated agent with a system-wide database to undertake reunification efforts. The ATO is well placed to undertake this role — it is able to connect member information and accounts with TFNs, and does not have incentives to hold accounts longer than necessary.

Box 6.2 No insurance means Eligible Rollover Funds should be better for low-balance accounts

In 2016, ERFs produced a weighted-average net return (gross fund-level return minus fees on the relevant average balance) well below the weighted-average MySuper net return — 1.14 per cent compared with 3.17 per cent.^a

This discrepancy is likely due to the relatively high investment fees charged by ERFs and relatively defensive strategies. The weighted average investment fee for ERFs of 1.24 per cent is well above the MySuper sectors' rate of 0.8 per cent. And the weighted average allocation to defensive assets in the ERF sector is 75 per cent compared with 22 per cent for MySuper. The higher fee is despite the fact that defensive assets are generally less expensive to manage.

However, the interaction of low balances and no insurance premiums appears to lead to the average ERF balance doing better in an ERF than a typical MySuper product (using weighted averages and 2016 returns data). Relatively low fixed administration fees in the ERF sector also play a small role.



Overall, despite being subject to relatively high investment fees and relatively poor returns, an inactive account with a low balance may be better off in an ERF. However, ERFs could still better preserve balances by better aligning their investment fees and strategies with members' best interests. And a member would avoid at least some of the fees charged by ERFs if their lost account balance were rolled over into an account outside the ERF.

^a Using a representative \$50 000 balance, as per APRA MySuper data.

Sources: ERF Product Disclosure Statements; PC analysis of APRA confidential data; PC analysis of Rice Warner data.

Therefore, accounts should be sent to the ATO as soon as they are categorised as lost inactive or lost uncontactable (chapter 13). This means that all lost accounts currently with funds should be sent to the ATO. The ATO should then seek to match lost accounts with active accounts in the system and be empowered to consolidate the balances into the active account. If more than one account is found, a simple rule stating that the most recently active account receives the transfer should be used. Before enacting this auto-consolidation, the ATO should attempt to contact the individual and give them an opportunity to opt out or select an alternative account (with a notification that disallowing a consolidation will eventually see their money rolled into consolidated revenue, as is currently the case). This change would also mean that the ATO can undertake the same activities with the existing stock of unclaimed superannuation. If the ATO is unable to confidently match an account, any information that is available should be used for outreach to seek confirmation.

Putting lost accounts in the hands of the ATO for auto-consolidation would greatly increase the efficiency and simplicity of the reunification system. Notwithstanding any potential legal issues that this may give rise to, several participants endorsed various elements of such a policy change. For example, ASFA (sub. 47, p. 25) suggested that the ATO should be empowered to pay unclaimed superannuation into an active account if they are satisfied both belong to the same individual. AustralianSuper supported this suggestion, adding that lost accounts should be sent to the ATO more quickly for auto-consolidation with a matched active account (Australian Super, stage 2, DR60).

Complementary policy changes would enhance the effectiveness of this strategy

Three further elements to this policy change would increase its effectiveness. First, refining the ‘permanent exclusion’ clause. Second, reducing the activity threshold for lost inactive accounts. And third, sending all accounts at ERFs, regardless of their lost categorisation, to the ATO for matching and auto-consolidation.

Currently, an unknown number of accounts are prevented from reaching a lost categorisation as they are subject to the ‘permanent exclusion’ clause (Superannuation Industry (Supervision) Regulations, r 1.03A). In effect, this clause means that an account can be permanently excluded from a lost categorisation on the grounds that the member has signalled they want to remain with the fund, no matter how long ago that action occurred. ATO (2017a) guidelines suggest that any number of actions could fit this definition, including simply calling the fund or using an online service at any point, regardless of whether the contact resulted in any action. This clause should be more directly aligned with an explicit member intent to remain in the fund.

The activity threshold for lost inactive accounts is currently five years. This should be reduced to two years to better protect low-balance accounts from unnecessary erosion when insurance premiums and fixed administration fees outweigh returns. In this vein, the Commission also considered the case for re-instating the ‘Member Protection Rebate’ that was repealed as part of the Stronger Super reforms in 2013. This rebate obligated trustees to ‘top up’ an account if fixed charges outweighed investment returns. However, reducing the

activity threshold to two years would be reasonably effective at minimising erosion on low-balance accounts, without enacting a cross-subsidy from higher-balance accounts and undermining the MySuper rule that all accounts must be charged the same fees.

Not all accounts at ERFs have a lost categorisation, given trustees are permitted to transfer accounts to ERFs before they reach the lost thresholds. However, the fact that the account is at an ERF signals that the trustee at the original fund determined that the account is disconnected from the member. Therefore, all accounts currently with ERFs should be sent to the ATO. Funds should also cease sending accounts to ERFs, but rather should hold accounts until they reach a lost definition and are to be transferred to the ATO.

This policy change is not without downsides. First, it would increase the administration burden on the ATO. Therefore, it may be prudent to extract a cost-recovery administration fee from lost accounts the ATO receives (which would almost certainly be smaller than the benefit a member would receive from reunification). Second, this change increases the risk that a deliberately inactive account (for example, one held for insurance purposes) is transferred to the ATO against a member's wishes. However, lost accounts are already subject to an address verification clause. Few engaged members with a deliberately inactive account would fail to ensure they remained contactable. And third, there is a risk that accelerating the transfer of inactive accounts to the ATO could infringe on the property rights of an adviser receiving commissions from an inactive account, impeding the transfer of these accounts.

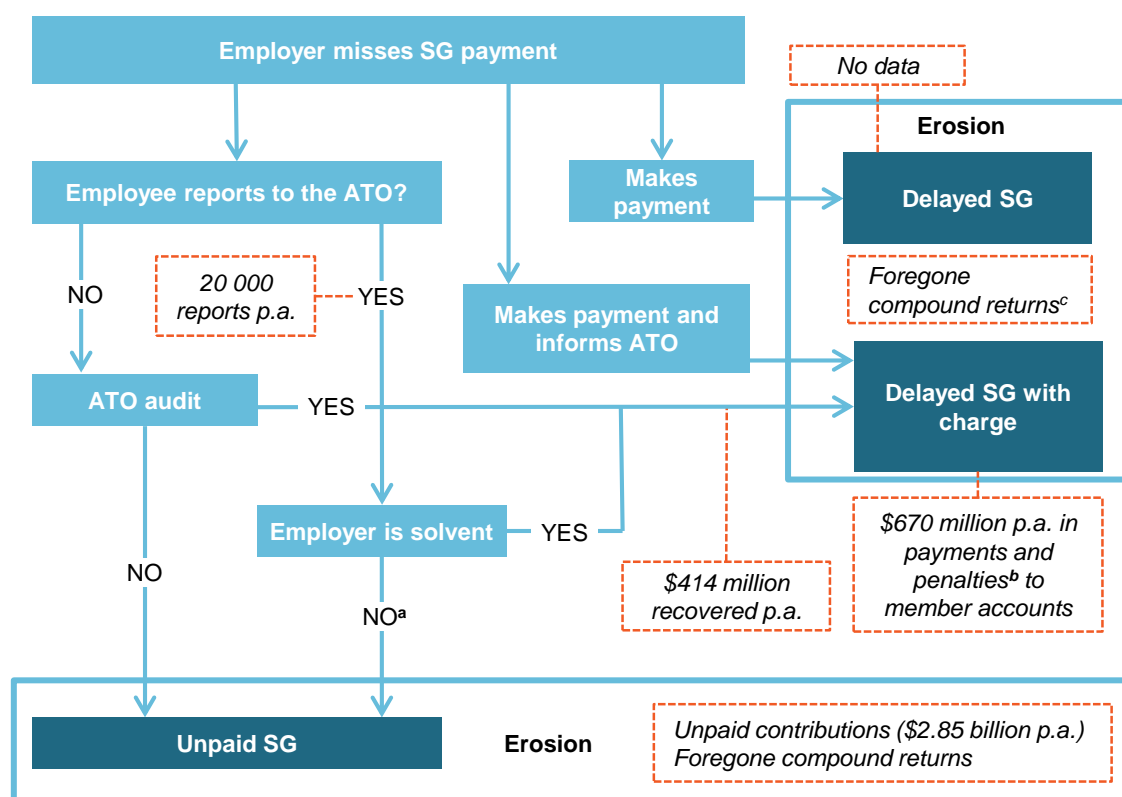
Overall, given these downsides appear to be small, and the current pool of lost and unclaimed superannuation is nearly \$18 billion, there are likely to be net benefits from this proposal.

Last, it is important to note that ATO-held unclaimed superannuation is counted as an asset in the Australian Government's budget balance sheet. This means that measures to reduce the stock of unclaimed superannuation will have implications for the overall budget position of the Government. However, members' best interests should be the policy priority for reunification policy.

6.2 Delayed and unpaid SG contributions

The current SG obligation is 9.5 per cent of an employee's ordinary time earnings (OTE), subject to the employee being at least 18 years of age and earning over \$450 a month. Employers must make these payments at least quarterly. Delayed SG contributions occur when an employer ultimately pays, but after the quarterly deadline. Unpaid SG contributions arise when an employer fails to meet this obligation altogether, and are a significant source of erosion (figure 6.11). Given this leakage effectively occurs before a fund has a member's contributions, there is little funds can do to rectify it. This issue is primarily about policy and the compliance framework.

Figure 6.11 Unpaid SG contributions lead to significant erosion



^a It may be that a trustee/liquidator/administrator advises that there are sufficient funds to meet outstanding SG obligations. ^b The administration fee component of the penalty is paid to the ATO. ^c Foregone compound returns are offset by nominal interest paid as part of the SG charge.

Sources: ATO (2016b, 2017f, 2018d).

Total extent of delayed SG contributions is unclear

There are essentially two types of delayed SG payments — those that are not observed by the ATO, and those that are, and are subject to the SG Charge.⁵²

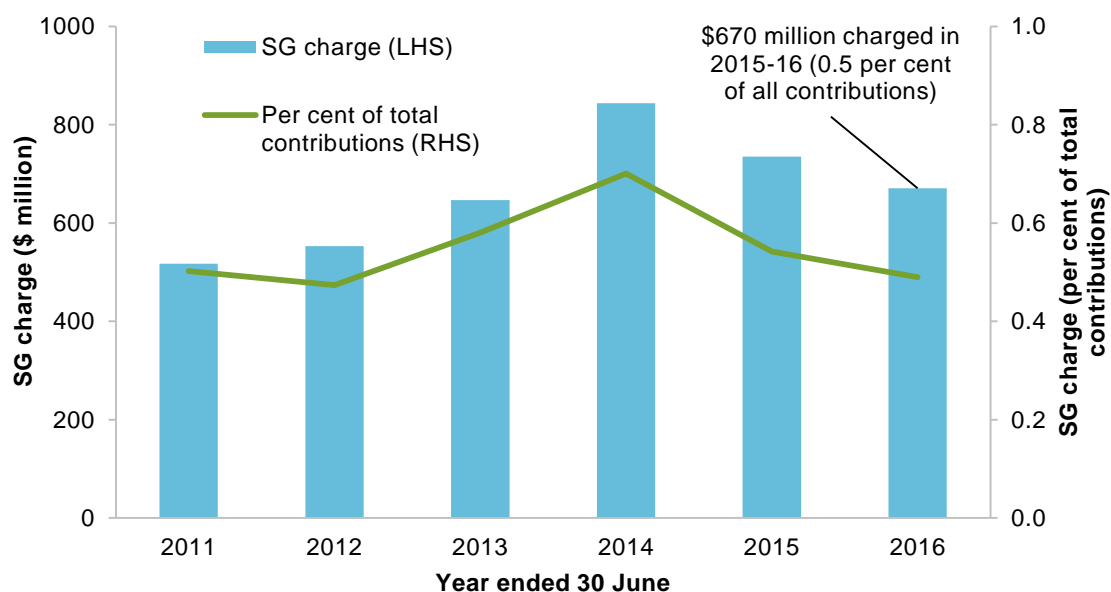
There are no system-level data on the number and value of late payments not reported by employees or employers given they are unobserved by the ATO. Data are available on late payments subject to the SG Charge. They show a fall in recent years, after a peak in absolute terms and relative to total contributions in 2013-14 (figure 6.12).

Compliance activity relating to delayed SG payments can be prompted by employee or employer reports to the ATO of unpaid contributions, or by ATO audit activity.

⁵² The SG Charge includes the amount not contributed, nominal interest of 10 per cent per year and a \$20 per employee per quarter administration fee. There are incentives for employers to self-report late payments that effectively reduce their liability (ATO 2018b).

Figure 6.12 SG charges levied have been falling

Total value and as a percentage of total contributions made, 2011–2016



Sources: ATO (2012, 2014, 2015, 2016); APRA (2017b).

Data on the employees who lodged an SG underpayment notification with the ATO indicate that they are typically younger and lower-income than the working population more broadly. For example, nearly 50 per cent of employees reporting underpayment were aged under 34 years, compared with 38 per cent for all employees. Further, 76 per cent of employees reporting underpayment earned under \$60 000, compared with 66 per cent for all employees.

Moreover, data on the employers subject to ATO action for underpayment show that lower-skilled services industries have the highest incidence of underpayment. In particular, in 2016-17, 7 per cent of all accommodation and food services employers were subject to ATO action for underpayment (compared with an average of 1.8 per cent of employers across all industries). These cases made up 17 per cent of all cases. The data also show that, in absolute terms, construction and retail trade make up a significant proportion of the total complaints (16 and 10 per cent respectively), despite having a relatively lower percentage of employers subject to complaints (1.6 and 2.3 per cent, respectively) (ABS 2018; ATO, pers. comm., 21 December 2017).

Interestingly, the data suggest that larger employers are more likely to be subject to ATO action for underpayment. While employers with 20 or more employees make up 6.5 per cent of all businesses in Australia, they make up 19.5 per cent of employers subject to ATO action for underpayment (ABS 2018; ATO, pers. comm., 21 December 2017).

Unpaid SG contributions remain significant, but difficult to calculate

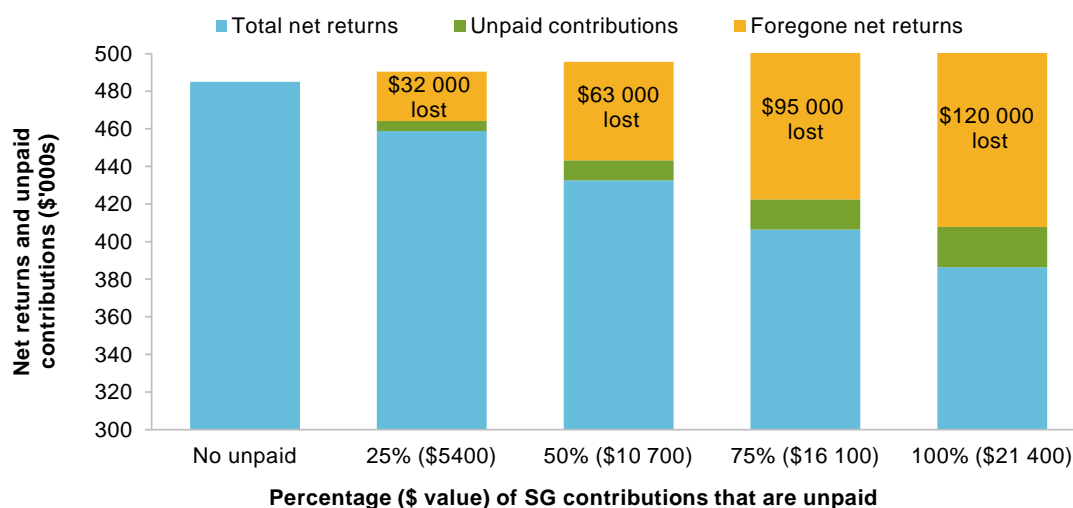
Recent research has estimated the value of unpaid (and unreported) SG contributions in the superannuation system. The most conservative estimate is \$2.85 billion (5 per cent of all SG contributions) in 2014-15 (APRA 2017h; ATO 2017f) — indicating that a material share of contributions goes unpaid. And, although there are no data to draw definitive conclusions, unpaid SG is likely to be highly regressive in its impact on member balances.

The potential impact on retirement balances of unpaid contributions and the associated foregone compounded returns can be marked. For example, estimates from the Commission's cameo model (chapter 1) indicate that a person whose employer does not pay 50 per cent of due contributions during the early years of the person's career (while they are aged 21 to 25) would have a retirement balance 7.6 per cent (\$63 000) lower than a peer who received all their contributions (figure 6.13).

Impacts of unpaid SG contributions extend beyond lower retirement incomes for affected members. For example, unpaid contributions lead to foregone taxation revenue as contributions and earnings are both taxed. They also allow non-compliant employers to benefit (through lower wage costs) at the expense of their workers and compliant employers. And last, they can void some disability and income protection insurance policies that rely on regular contributions to remain valid (SERC 2017).

Figure 6.13 Unpaid SG payments can have a significant impact on retirement balances^a

Cameo model simulation results by per cent unpaid for ages 21 to 25



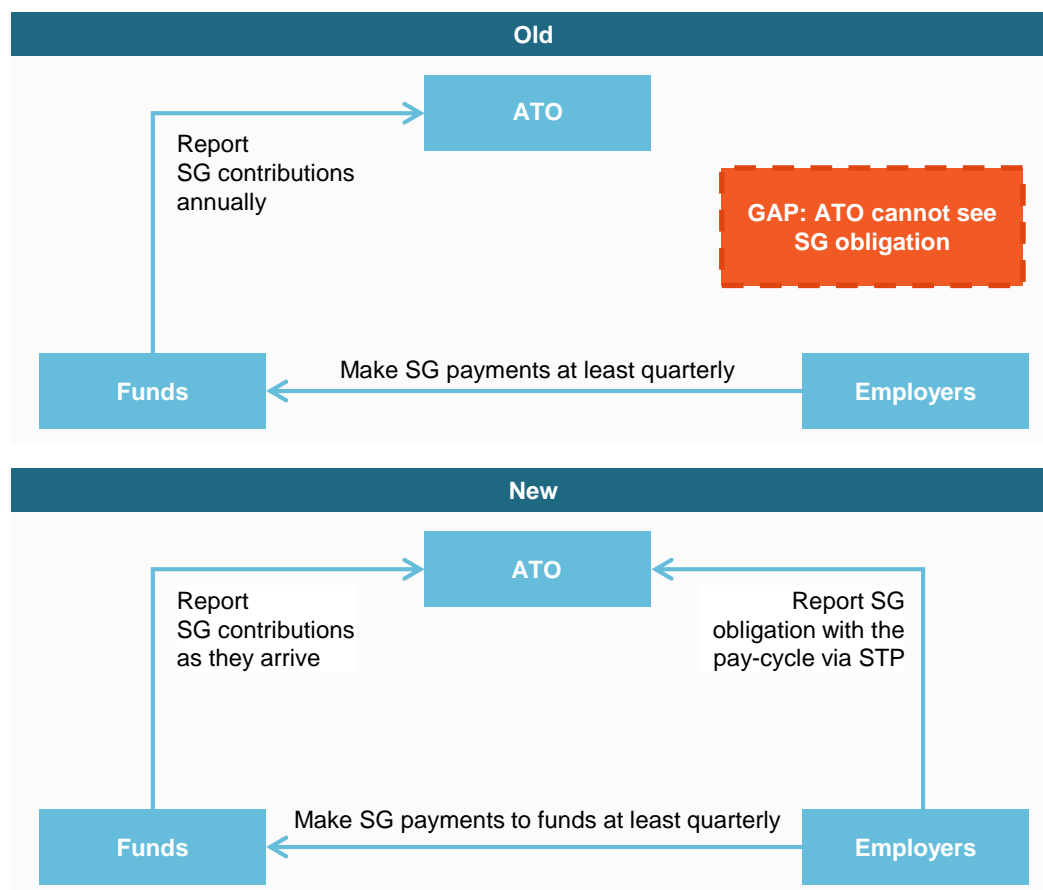
^a The assumptions underpinning this cameo are set out in chapter 1.

Recently proposed policy changes should significantly reduce unpaid contributions

In August 2017, the Australian Government announced its intention to introduce policy changes that would greatly reduce the potential for employers to avoid meeting their SG obligations (O'Dwyer 2017b) (figure 6.14). If implemented, the changes will mean that:

- Single Touch Payroll will be extended to small employers (less than 20 employees), from 1 July 2019 (currently in draft bill form)⁵³
- funds will need to report contributions to the ATO at least monthly (this can be given effect through a legislative instrument by an ATO Commissioner)
- the ATO will have stronger powers to enact penalties on non-compliant employers and recover unpaid SG contributions (currently in draft bill form).

Figure 6.14 **New SG compliance regime fills gaps in the old regime**
Current and new/proposed



⁵³ STP will mean that employers can report ordinary time earnings or SG contributions to the ATO directly from their payroll software.

The extension of STP to all employers would give the ATO regular data on ordinary time earnings (and thus an employer's SG obligation). This is critical, as currently the ATO has no direct visibility of SG obligations. Given universal digital interaction with the ATO, this is not an undue impost on small- and medium-sized businesses. This extension, combined with the requirement for funds to report contributions received to the ATO at least monthly (instead of annually), will give the ATO regular data on SG obligations and SG contributions received for all employees. This will enable the ATO to identify non-compliant employers and take action to recover unpaid SG contributions much more effectively than it is currently able to. Strengthened compliance and enforcement tools (for example, employer fines) will also act as a disincentive for potential non-compliant employers.

As part of another package of policy changes, the Australian Government announced in July 2017 that it would legislate to remove the ability for employers to deduct an employee's voluntary contributions from their SG obligation. While this practice is not technically an illegal non-payment, the legislation will help ensure that unwitting employees do not receive less SG contributions than they are entitled to.

DRAFT FINDING 6.1

Several proposed policy changes will promote Superannuation Guarantee payment compliance:

- Single Touch Payroll being extended to small employers (with less than 20 employees) from 1 July 2019
- funds being required to report contributions to the ATO at least monthly
- the ATO having stronger powers to penalise non-compliant employers and recover unpaid contributions.

In stage 2, the Commission suggested that a centralised clearing house might improve oversight of employer compliance with SG contributions (PC 2017c, pp. 9–10). However, the emerging reporting framework and a centralised clearing house would have similar functionality for compliance monitoring. The practical distinction between the approaches is that the ATO will receive real-time data from employers and funds under the reporting framework, whereas the ATO would facilitate the creation of that data under a clearing house model. The visibility is effectively the same.

Last, it is important to note that the discussions above all rest on the assumption that the employee and employer are visible to the ATO to begin with. There remains the problem of workers in the black economy. However, this issue is broader than the superannuation system. Unpaid SG contributions in the black economy can only be meaningfully addressed by addressing black economy activity more broadly, which is outside the scope of this inquiry.

6.3 Undue erosion

Trailing adviser commissions — a grandfathered and costly problem

Trailing adviser commissions arise when a financial adviser receives an ongoing payment (normally a percentage of the account value) from a member after recommending a particular superannuation product. The Future of Financial Advice laws effectively banned these commissions from 2013. However, some superannuation products, and insurance products inside superannuation, had existing commissions ‘grandfathered’ (or preserved).

The Commission’s funds survey asked whether funds had any members subject to trailing adviser commissions, and if so, the percentage of their members affected. Around 30 per cent of the 114 responding funds (collectively representing 29 per cent of assets and 26 per cent of member accounts in all APRA-regulated funds) indicated that they have members paying these commissions, but disappointingly (and perhaps not unsurprising) less than half of these funds provided the relevant percentage. However, from the information provided, it can be inferred that at least two per cent (636 000) of all accounts in the system (or close to three per cent of accounts for the responding funds) are subject to trailing adviser commissions. Given the data gaps, this is likely to be a significant underestimate.

Applying an estimated average trailing commission fee of 0.5 per cent per year (Dixon Advisory 2018) to the 636 000 identified accounts at the relevant funds’ average balances suggests an annual total cost of at least \$214 million across the system.

It is highly unlikely these commissions represent value for money for members (Kollmorgen 2015). Therefore, existing members subject to trailing commissions should be clearly informed by their fund, on an annual basis, of the commissions they are paying and that this practice has been made illegal for new members. The extent of trailing commissions and number of affected members should also be publicly disclosed by funds in their annual reports and notified to the Australian Securities and Investments Commission (ASIC) (chapter 13).

DRAFT FINDING 6.2

The superannuation system, primarily due to its policy settings, does not minimise the unnecessary and undesirable erosion of member balances. This erosion is substantial in size and regressive in impact.

- Unintended multiple accounts (one in three of all accounts) are the most egregious driver, directly costing members nearly \$2.6 billion a year in excess insurance premiums and administration fees. For an individual member holding just one unintended multiple account throughout their working life, the projected reduction in their balance at retirement is 6 per cent (or \$51 000).
- Superannuation Guarantee non-compliance is hard to estimate, but may be costing members about \$2.8 billion a year.
- At least 2 per cent of all member accounts (about 636 000) are subject to (grandfathered) trailing adviser commissions. These commissions may cost members in excess of \$214 million a year.

Recent policy initiatives have improved the situation, but current policy settings are inevitably making slow progress by treating the symptoms and not the structural cause.

Tax management matters for member returns

At a high-level, super funds are taxed on investment earnings at 15 per cent. But in reality the actual rate paid is quite different as investment earnings in the pension phase are tax free, and the use of franking credits and capital gains discounts can greatly reduce the effective rate paid.

While the environment is complex, how funds manage tax (including exemptions and discounts) is important because it can make considerable differences to the net returns credited to a member's account.

Funds are supposed to be optimising tax management

Section 52(6)(a)(vi) of the *Superannuation Industry (Supervision) Act 1993* (Cwlth) stipulates that trustees must:

... formulate, review regularly and give effect to an investment strategy for the whole of the entity, and for each investment option offered by the trustee in the entity, having regard to ... the expected tax consequences for the entity in relation to the investment covered by the strategy ...

This amendment resulted from recommendations from the Cooper Review (2010b, p. 84), which noted that there was '... wide variation in the extent to which most trustees and investment managers have regard to the optimisation of tax outcomes for members'.

While the cost of this suboptimal management was hard to gauge, the Review (Cooper et al. 2010b, p. 86) suggested that ‘... estimates of the cost of this lost tax efficiency vary, ranging from around 5 basis points per year (considering the impact of turnover alone) up to some 200 basis points per year on a more holistic basis’. Further, Williams (2011, p. 1) has argued that ‘[f]or super funds, the combined effect of capital gains discounts and franking credits is to improve — that is, add to — the pre-tax return by between 0.2% —0.5%’. Estimates from the Commission’s cameo model (chapter 1) suggest that just a 0.2 per cent improvement in returns over a working life can improve a member’s balance at retirement by 5.4 per cent (\$45 000).

However, there have been concerns raised that the amendment to require trustees to have regards to tax efficiency has not had the intended effect of eliciting more ‘Tax Aware Investment Management’ (TAIM). For example, Mackenzie stated that his research (from 2014) found that funds were not paying adequate attention to tax efficiency:⁵⁴

... of the 19 or so tax strategies that could be applied to funds management in a superannuation fund, the Chief Investment Officer [of each fund in the sample] focused on only two. First, in managing CGT payable by the fund, as in holding assets for at least 12 month to gain the benefit of the 1/3rd discount on assessable gains, and, secondly, with respect to the tax rules for imputation credits. Specifically, ensuring that the 45-day rule (Section 177EA *Income Tax Assessment Act 1997*) was not breached, thereby protecting the funds’ entitlement to claim the imputation credits. This limited application or use of the tax rules is notwithstanding an obligation on trustees of non-SMSFs superannuation funds to have regard to tax when making investment decisions. (stage 1, sub. DR73, pp. 5–6)

There are well-documented difficulties in implementing TAIM (Mackenzie and McKerchar 2014; Williams 2011, p. 1), however some large funds, including Mercer, AustralianSuper and UniSuper have made public their use of external consultants to optimise tax management (GBST 2017). This suggests that at least some funds are taking this relatively new obligation seriously, and also that it is not prohibitively difficult to implement. Further to this, there are after-tax benchmarks available for funds to use to assess their tax management. The FTSE ASFA Australia Index Series is one example (ASFA 2017a).

Much fund reporting, including on MySuper dashboards and the way comparison websites showcase performance, requires an after-tax return. This should mean that funds are competing on an after-tax basis, and thus should imply that funds are optimising tax. A lack of interest in TAIM could be indicative of a lack of competition more broadly. (Competition in the system is addressed in chapter 7.)

The available evidence does not allow the Commission to draw firm conclusions on whether funds are optimising tax management. In particular, data on the effective tax rate paid by funds are not readily available. Therefore, the Commission is seeking further evidence relevant to this issue.

⁵⁴ However, it is worth noting that the small sample of 22 funds overrepresented industry funds compared with non-industry funds, and inside of this, it overrepresented both smaller industry funds and larger non-industry funds.

The transition to retirement

Mackenzie noted issues around tax management upon the switch from accumulation mode to pension mode:

Specifically, we were told when doing our research that because some of these funds hold a member's accumulation assets and pension assets in separate pools, when the trustee moves the funds supporting the accumulation account from that pool of assets to a pool of assets supporting the member's pension account, the value of their interest in the accumulation pool that is transferred is net of any accrued deferred tax liability. In other words, the member is, in effect, paying tax at that point. (sub. DR73 to PC 2016a, pp. 5–6)

However, there are ways that funds can target the tax benefit towards those members entering the retirement phase (QSuper nd; Sunsuper nd; QSuper, stage 2, sub. DR96). This has also been noted by the ATO:

Some institutional funds also now offer member directed investment opportunities and some are offering a 'tax bonus' to members moving from accumulation phase to pension phase on the basis that the fund receives a benefit when unrealised gains on assets move into the tax-free retirement phase on the basis that the fund receives a benefit when unrealised gains on assets move into the tax-free retirement phase. (ATO, pers. comm., 21 Feb 2018)

Are tax advantages a motivation for establishing SMSFs?

SMSF members may have an advantage in the transition to retirement as the assets held in accumulation stop accruing capital gains upon the switch to pension mode and, assuming the assets are not sold immediately, the liability is extinguished. This extra level of control that comes from not having a wide membership base is noted by the ATO:

The relevant tax provisions are the same for both SMSFs and institutional funds. Nevertheless, the variance in the operational structure and membership between SMSFs and institutional funds means that these common tax provisions can give rise to different outcomes at a member level in various scenarios. (ATO, pers. comm., 21 Feb 2018)

More broadly, tax advantages are often cited as a motivation behind establishing SMSFs, particularly in the later stages of life.

Dixon Advisory argued that SMSFs were more likely to have better tax outcomes for their members compared with APRA-regulated funds:

APRA funds do not allow their members to achieve tax outcomes that are already utilised by SMSFs (i.e. separation of capital gains income out from investment income would allow unitised funds to apply a 10% tax rate to capital gains, rather than applying an overall tax rate of 15% to all income). (sub. 61, p. 4)

AIST noted that the ability to gear has given rise to a tax advantage for SMSF members:

The use of [limited recourse investment vehicles] to gear property, and the relatively extensive investment into private trusts suggests that SMSFs are quite often tax driven. (sub. 39, p. 81)

Previous surveys have suggested that, while tax flexibility is relatively important as a motivation for establishing an SMSF, it generally ranks lower than choice and control over investments. For example, Bird et al. (2016b) — based on a survey of 500 SMSF members — found that of the 21 possible reasons for having started an SMSF, ‘minimisation of tax’ ranked third in importance behind ‘choosing investment myself’ and ‘manage fund myself’ (p. 22).

The results of an online survey of over 500 SMSF members conducted by the SMSF Association and the Commonwealth Bank (2017), suggested that the desire for higher returns was also a key driver for establishing an SMSF. It found that the top three most important reasons for establishing an SMSF were ‘to achieve better results’ (59 per cent), ‘to take more control over personal finances’ (53 per cent) and ‘lower cost/fee structure (43 per cent). In comparison, 28 per cent of respondents nominated that ‘it’s more tax effective’; ranking it sixth out of eight possible reasons.

The results from the Commission’s members survey are broadly consistent with these observations (chapter 5). While SMSF members commonly consider tax flexibility, it is rarely a driving factor in the decision to establish an SMSF. Around one fifth of SMSF members cite ‘tak[ing] advantage of the tax benefits’ as a factor that motivated them to set up an SMSF but less than 4 per cent said that tax flexibility was their main motivation.

7 Market structure, contestability and behaviour

Key points

- The superannuation system — with healthy competitive conduct and pass-through of scale economies — should deliver good member outcomes over time.
- Being a product of member compulsion and much fund regulation, superannuation is a unique market characterised by an important distinction between competition *in* and *for* the market.
- There is no single or simple metric to assess whether the system is performing competitively and delivering good outcomes for members. Some high-level metrics suggest much of the system is potentially conducive to rivalry and contestability.
 - The retail level of the system is characterised by many diverse funds, low concentration and a contestable choice segment. While structural features of the system create challenges for new entrants, they are not prohibitive or even high barriers to entry.
 - Small high-cost funds have dominated exits (largely corporate and retail funds) over the past decade; though the pace of consolidation has slowed and a large number of small funds (112 with assets under \$1 billion) remain in play for over two million member accounts.
 - The ability of larger funds to shift to insourcing functions such as investment and administration provides a welcome source of competitive pressure in wholesale markets.
- But this masks the absence of healthy competition, at the expense of members.
 - There are high barriers in the default segment for new entrants and a marked absence of competition *for* the market.
 - Product proliferation (excessive choice) and the absence of simple comparable data are symptoms of unhealthy competition. Member inertia creates challenges for new entrants in the choice segment where competition has not always led to better member outcomes.
 - Horizontal and vertical integration, while not of themselves a problem, have not always led to better outcomes for members. The absence of robust, transparent reporting (including to APRA) on related-party outsourcing arrangements precludes any reasonable assessment of this conduct and needs immediate redress. The poor response to the Commission's funds survey (including on these arrangements) is symptomatic of a concerning disregard by many funds for transparency and members' best interests.
- Significant economies of scale have been realised over the past decade, albeit largely driven by the exit of high-cost subscale funds. However, the remaining large tail of small funds suggests unrealised scale economies remain in the system at much cost to members, and point to less than fully effective competition in the system. Preliminary analysis also reveals an absence of scale economies being passed through to members.

The superannuation system exists to serve its members. Healthy competition does matter for members — it is needed to drive funds to deliver better returns, lower fees and products that meet members’ needs. Competition can also be a strong driver of innovation and efficiency improvements.

This chapter examines the market structure, contestability and behaviour of funds and service providers in the system; and how these factors influence member outcomes and efficiency. Section 7.1 assesses the conditions for market structure and rivalry. This is followed by an assessment of retail level contestability (section 7.2), the competition impacts of vertical integration (section 7.3) and scale economies (section 7.4). The approach draws on the following criteria of the assessment framework from the Commission’s stage 1 study.

- Is the market structure conducive to rivalry? (C3)
- Is the market contestable at the retail level? (C4)
- Are there material anticompetitive effects of vertical and horizontal integration? (C5)
- Are economies of scale realised and the benefits passed through to members? (C7)
- Do all types of funds have opportunities to invest efficiently in upstream capital markets? (E3)

7.1 Is the market structure conducive to rivalry?

Because rivalry benefits superannuation members, it is relevant to consider whether the market structure at the wholesale and retail levels is conducive to rivalry.

Retail level (the funds and SMSFs)

The retail level of the system is characterised by a diverse range of funds (chapter 1). APRA-regulated funds (65 per cent of total system assets) and SMSFs (30 per cent of total system assets) are the main focus of this chapter.

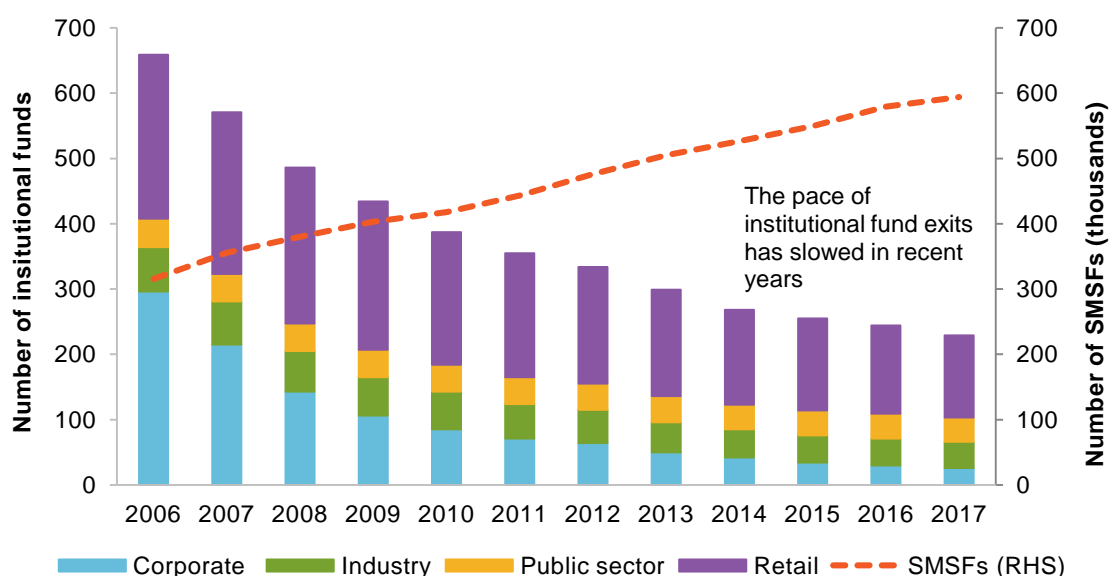
A large number and diverse range of funds

As at 30 June 2017, there were 140 RSE Licensees (trustees) responsible for 212 APRA-regulated funds — which can be classified into for-profit (retail funds) and not-for-profit entities (public-sector, industry and corporate funds). Two-thirds of funds are open to the public, and these account for 80 per cent of total assets (APRA 2017i).

There has been consolidation in the number of APRA-regulated funds over the past decade through ‘exits’ (funds winding up or merging). Much of the consolidation has been in the number of corporate funds and, to a lesser extent, retail funds. The pace of consolidation in the system has slowed in recent years. A counter trend has been significant growth in SMSFs (figure 7.1).

Figure 7.1 Fund consolidation: progress but pace slowed

Trends in the number of funds^{a,b}
2006–2017



^a This figure includes both APRA-regulated funds and exempt public sector schemes that collectively are 'institutional funds'. SMSFs include small APRA-regulated funds. ^b Data are the for the June quarter of each year.

Sources: PC analysis of APRA confidential data and APRA (2017g).

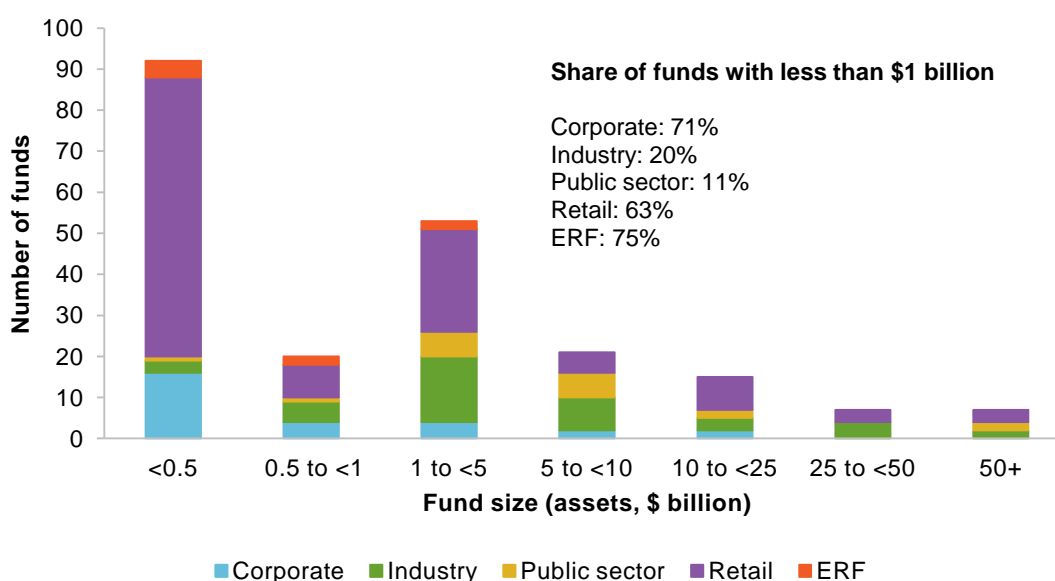
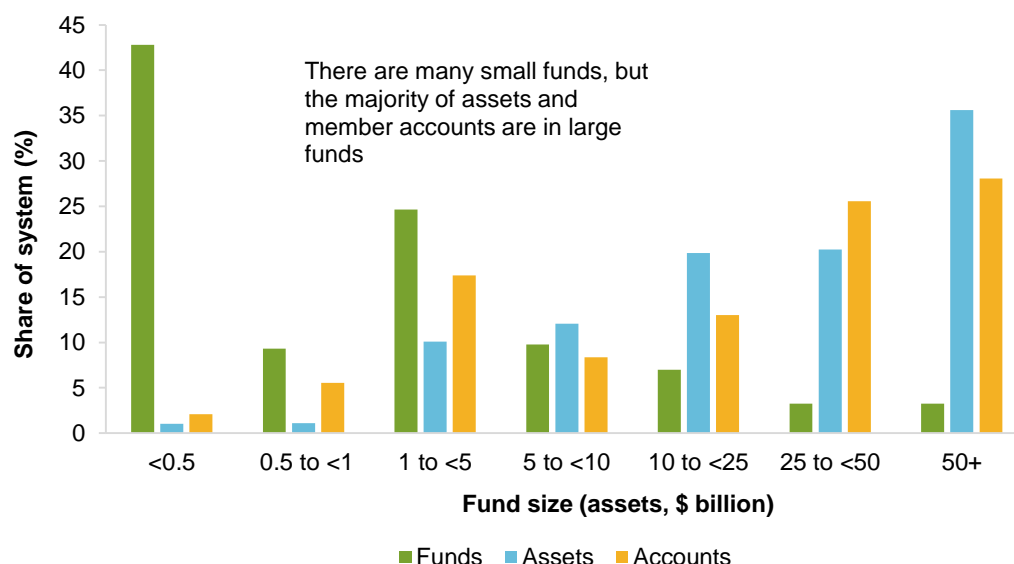
Still a large number of small funds

The APRA-regulated sector is characterised by a small number of very large funds and a large number of smaller funds (APRA, stage 1, sub, 32). As at June 2016, while the largest fund had over \$100 billion in total assets, importantly the median fund size was just \$850 million (based on confidential APRA fund-level data).

While more than half of funds (112 of varying type) had assets of less than \$1 billion, they collectively accounted for 2 per cent of total assets and 8 per cent of member accounts (figure 7.2). 165 funds with assets of under \$5 billion represent 25 per cent of member accounts and 12 per cent of total assets and covers all types of funds (retail, corporate, public sector, industry funds and eligible rollover funds).

At the RSE Licensee level, the median Licensee size was \$2.6 billion. This reflects that some trustees oversight several smaller funds, a phenomenon mainly in the for-profit (retail) sector (APRA 2017i).

Figure 7.2 A large number of small funds remain in play
Distribution of fund size and assets; APRA-regulated sector^a
June 2016



^a This figure does not include funds that reported zero total assets or zero total members in 2016.

Source: PC analysis of APRA confidential data.

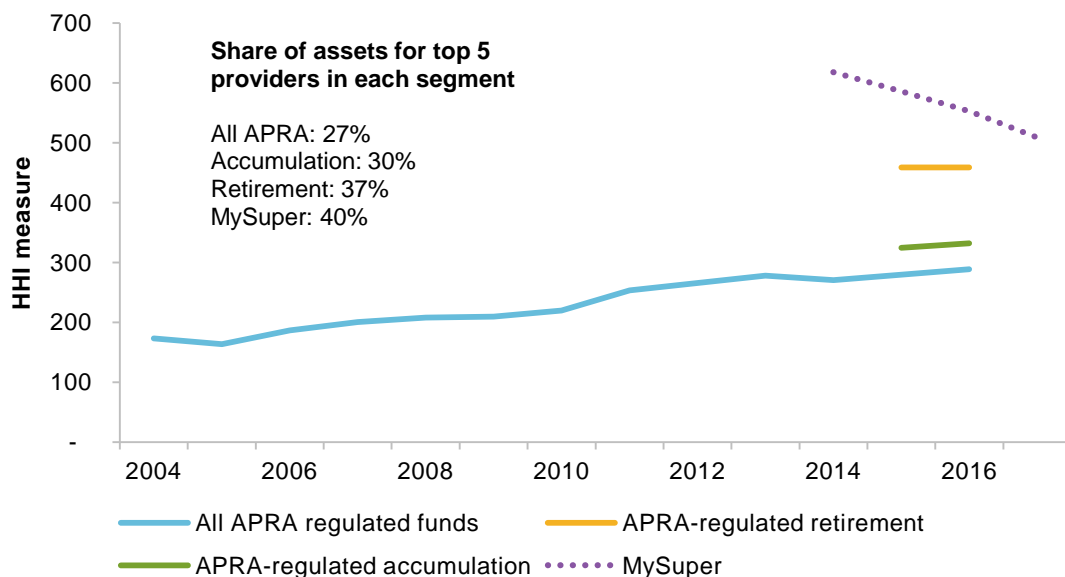
Relatively low levels of market concentration

A larger number of firms in an industry is typically seen as a means of increasing competition and efficiency. However, the weight of opinion across a range of stakeholders and past reviews is that there are still too many funds in the superannuation system, and that further

consolidation will increase competition and efficiency, including due to realisation of scale economies (for example, ACTU, sub. 50; APRA, stage 1, sub. 32, p. 3; ASFA, stage 1, sub. DR98, p. 30; Murray et al. 2014). Economies of scale are assessed in section 7.4.

Market concentration at the fund level in the APRA-regulated sector is low based on generally accepted thresholds, whether looked at in totality, or in the accumulation, retirement and default segments in isolation (figure 7.3). Concentration in the default segment is moderately higher than in other parts of the system, most likely reflecting higher barriers to entry (section 7.2). APRA has noted that the superannuation system is the least concentrated sector within its regulatory ambit (stage 1, sub. 32).

Figure 7.3 Market concentration remains low
Market concentration in the system and key segments^{a,b,c}
2004–2017



^a In this figure, market concentration levels were estimated using the Herfindahl–Hirschman Index (HHI), a commonly accepted measure of market concentration (ACCC 2017; DOJ 2015; PC 2016b). While there is no prescriptive threshold, levels around 2000 are generally considered to be approaching highly concentrated. ^b The HHI for all segments was estimated using data on funds' share of assets. ^c The top 5 market share of asset estimates are for 2016, except for MySuper which is for 2017.

Sources: PC analysis of APRA confidential data and APRA (2017d, table 1a).

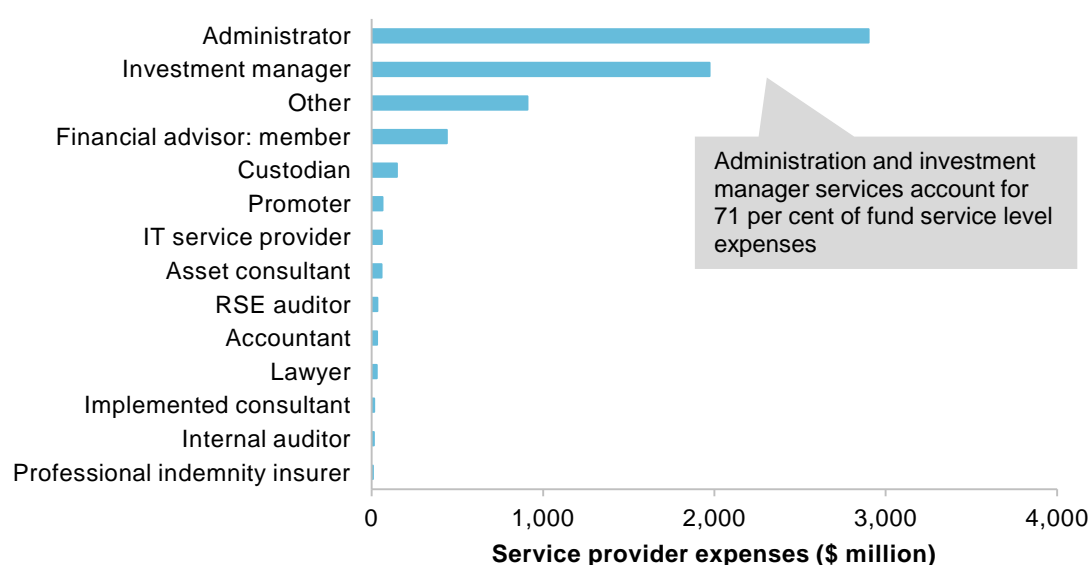
Wholesale level (investment managers and administration providers)

Superannuation funds source various wholesale service inputs in providing end products to members. The most material are administration and investment management services (figure 7.4). As such, the degree of rivalry in these service markets in particular will have an important bearing on the fees ultimately paid by members and on broader system efficiency.

High concentration in wholesale markets could be a sign of large economies of scale or that funds have limited market power to get a competitive deal (ASFA, stage 1, sub. 42, p. 24). A potential counterbalance is the ability of funds to source these inputs ‘in-house’, either within the fund or through use of a related party.

Figure 7.4 Administration and investment the largest expenses

Composition of fund service level expenses^a
2015-16



^a Service categories represented in this figure are defined in APRA (2014), with the exception of ‘Other’ which is not explicitly defined

Source: APRA (2017b, table 7).

Outsourcing is prevalent in the system

Superannuation funds outsource extensively. 80 per cent of funds’ reported service expenses were attributed to external service providers in 2016 (broadly similar to 2014 and 2015). High levels of outsourcing were reported for the key expense items, including investment management and administration (APRA 2017b, table 7c). Heavy reliance on outsourcing arrangements is likely to reflect several factors, such as a means of sourcing expertise, accessing scale, or serving other strategic objectives (ASFA, stage 1, sub. 42, p. 24).

Importantly, outsourcing can take different forms. In particular, the distinction between using an independent external service provider or a related party could have implications for the conditions for market rivalry (on both the demand and supply side). The use of related parties is a form of vertical integration in the system. (The extent to which these arrangements raise competition concerns is explored in section 7.4.)

Defining the wholesale market is challenging

The first step in assessing market concentration is to define the ‘market’. But this is not straightforward in the case of wholesale service markets in the superannuation system.

At a conceptual level, the main question is whether the service ‘market’ should only include supply by independent external service providers, or be broadened to also include in-house supply (as a substitutable option). At a practical level, even if the scope of the market can be settled, there are challenges with assembling the necessary data to pin down concentration levels. While APRA has collected services expenses data from 2013-14, it has expressed (and to date not resolved) concerns about the consistency of these data and reporting gaps (APRA, sub. 89, p. 2).

More fundamentally, APRA service categories may not neatly align with the product dimensions of a market for the purposes of competition analyses. For example, an aggregate view of the investment management market would understate the level of concentration where there is significant specialisation by some managers in particular asset classes or types of products, and also risks abstracting away from a more complex supply chain within the investment management sector (PC 2018, p. 186). Similarly, an aggregate view of the administration market could mask the ability of funds to unbundle their service requirements to purchase or deliver components separately, such as IT systems or call centre functions.

Concentration in some wholesale outsourced markets

The Commission estimated concentration levels in the markets for outsourcing APRA-defined services to external service providers classified by APRA as *non-associate* providers. Based on this analysis, the markets for administration and auditing are the most highly concentrated, and the markets for actuarial services, asset consulting and custody appear more moderately concentrated (figure 7.5).

Due to a lack of data to permit an assessment of market concentration levels at an asset class level — and gaps in the data on investment management expenses (chapter 3) — the Commission does not consider it meaningful or robust to estimate concentration (using HHI measures) for the investment management market. Nevertheless, features and trends in this market (and for outsourcing administration) warrant further discussion.

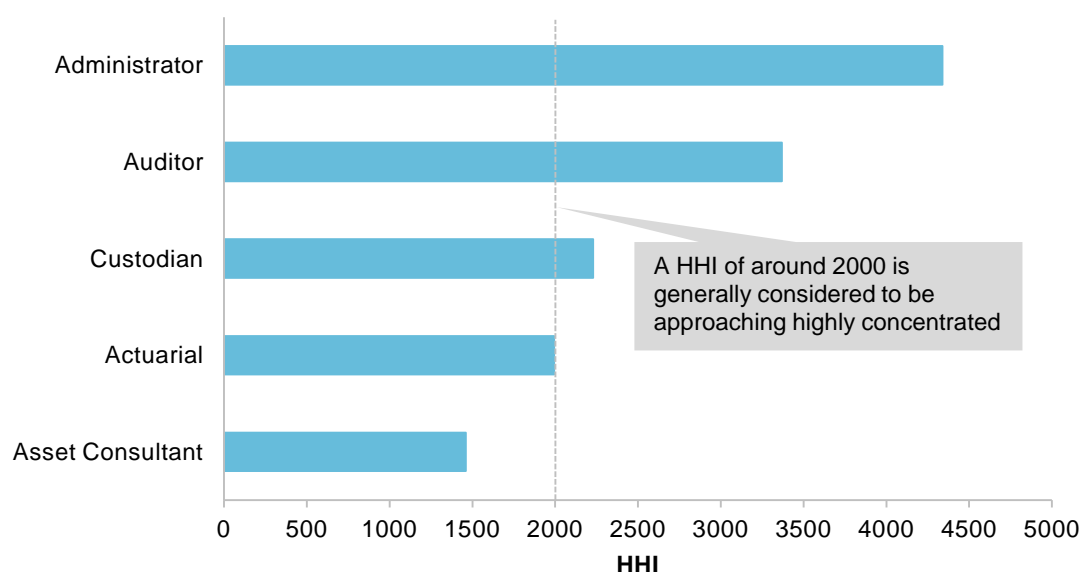
High concentration in administration likely reflects economies of scale

The current wholesale market for outsourcing administration (to non-associate or unrelated providers) is characterised by two large players, and several niche providers (ASFA stage 1, sub. DR98, p. 27). By far the largest player in this market is Australian Administration Services (owned by the Link Group), which administers 10 million (or about 36 per cent) of all superannuation member accounts, followed by Mercer, which administers 2 million

member accounts (Link Group 2016; Mercer 2018). Acquisitions by both in recent years have increased the level of concentration in this market.⁵⁵

Figure 7.5 Some concentration in wholesale markets

Wholesale service market concentration levels^a
2016



^a Refer to figure 7.3 for an explanation of the Herfindahl-Hirschman index (HHI).

Source: PC analysis of APRA confidential data.

Previous estimates indicated that Link accounts for approximately 70-80 per cent of outsourced member accounts itself (ACCC 2016, p. 5; Clare and Craston 2017, pp. 28–29). This is broadly consistent with the Commission’s analysis of confidential APRA expenses data, which indicate that the two largest providers collectively accounted for 85 per cent of the total expenses attributed to non-associate external service providers in 2016. Generally, participants attributed this highly concentrated market to significant scale advantages in providing administrative functions, with outsourcing being a means for funds to access scale benefits and service-provider expertise (for example, ACCC 2016, p. 11; IFAA et al, sub. 53, p. 9).

Funds switching to in-house supply for administration (or threatening to) could add to competitive pressure on the upstream market. However, not all funds could be expected to make this transition, especially for core components such as data management and statement processing that require large upfront investments in IT system and equipment and expertise

⁵⁵ For example, Link Group (2016) completed its acquisition and integration of SuperPartners (an administrator jointly owned by five industry funds) in 2016, which had 2 million member accounts, while Mercer (2016) acquired Pillar Administration in 2016, which had 1.1 million member accounts.

to navigate complex regulatory requirements (ACCC 2016). In practice, there appear to be few examples of funds having made the transition from outsourcing back to insourcing for their ‘full suite’ of administrative service needs. ASFA (stage 1, sub. DR98, p. 29) noted that eight of the ten largest superannuation funds insource some aspect, but not all, of their administration services, such as call centres or handling of insurance claims.

There are indications, however, that larger funds would have the ability to make this transition or negotiate better deals in the outsourcing market (First State Super, sub. 37, p. 8). The Commission found further evidence from its funds survey that stronger competitive pressure could be exerted on the outsourcing market by larger funds — with 56 per cent feeling they had a high influence compared with only 27 per cent of small funds.

Overall, when viewed across the system, the threat of some funds switching to insourcing some or all of their administrative functions is likely to be a source of competitive pressure (and rivalry) in wholesale markets. Some funds, including larger industry and public sector funds, already have in-house provision for some or all of their administrative functions (ASFA, stage 1, sub. DR98, p. 29; Link Group 2015). The continued growth in funds’ size and scale may also put them in a better position over time to credibly make this transition, or negotiate better rates in the outsourcing market.

The investment management market is conducive to rivalry ...

APRA-regulated funds have a range of options when choosing *how* to invest. Broadly, the two main channels are either investing directly themselves (including through use of an in-house team) or using external investment managers as intermediaries. The outsourcing market for investment management is characterised by a complex supply chain of functions including distributors, advisers, asset managers, platforms and products (PC 2018).

The use of both direct and indirect channels by APRA-regulated funds is evident, although use of the outsourcing market is prominent. In 2015-16, about one-third of investments by APRA-regulated funds were in ‘directly held’ investments,⁵⁶ up from 29 per cent in 2010, while other investments were channelled through the external investment management market (APRA 2015c; FSA 2017, p. 17; Williams and Cornelius 2016, p. 6).

APRA-regulated funds outsource investment management by entering the broader investment management market (sometimes termed ‘asset’ or ‘wealth’ management) as wholesale investors. Providers in this market are locally-based and international firms. The major banks and large financial services companies in Australia (which also own superannuation funds) hold a sizable share of assets under management in the Australian market. For example, Macquarie, AMP, Commonwealth Bank and Westpac together control about 43 per cent of the market by assets under management in the Australian market,

⁵⁶ Some care is needed in the interpretation of APRA’s reporting of ‘directly held’ because it includes individually managed mandates. Nonetheless, this increase indicated that funds are taking a more active and controlled approach with the assets they invest in (Williams and Cornelius 2016, p. 6).

although foreign fund managers and specialised fund managers also have a relatively significant presence. Vertical integration is also apparent within much of the supply chain (PC 2018).

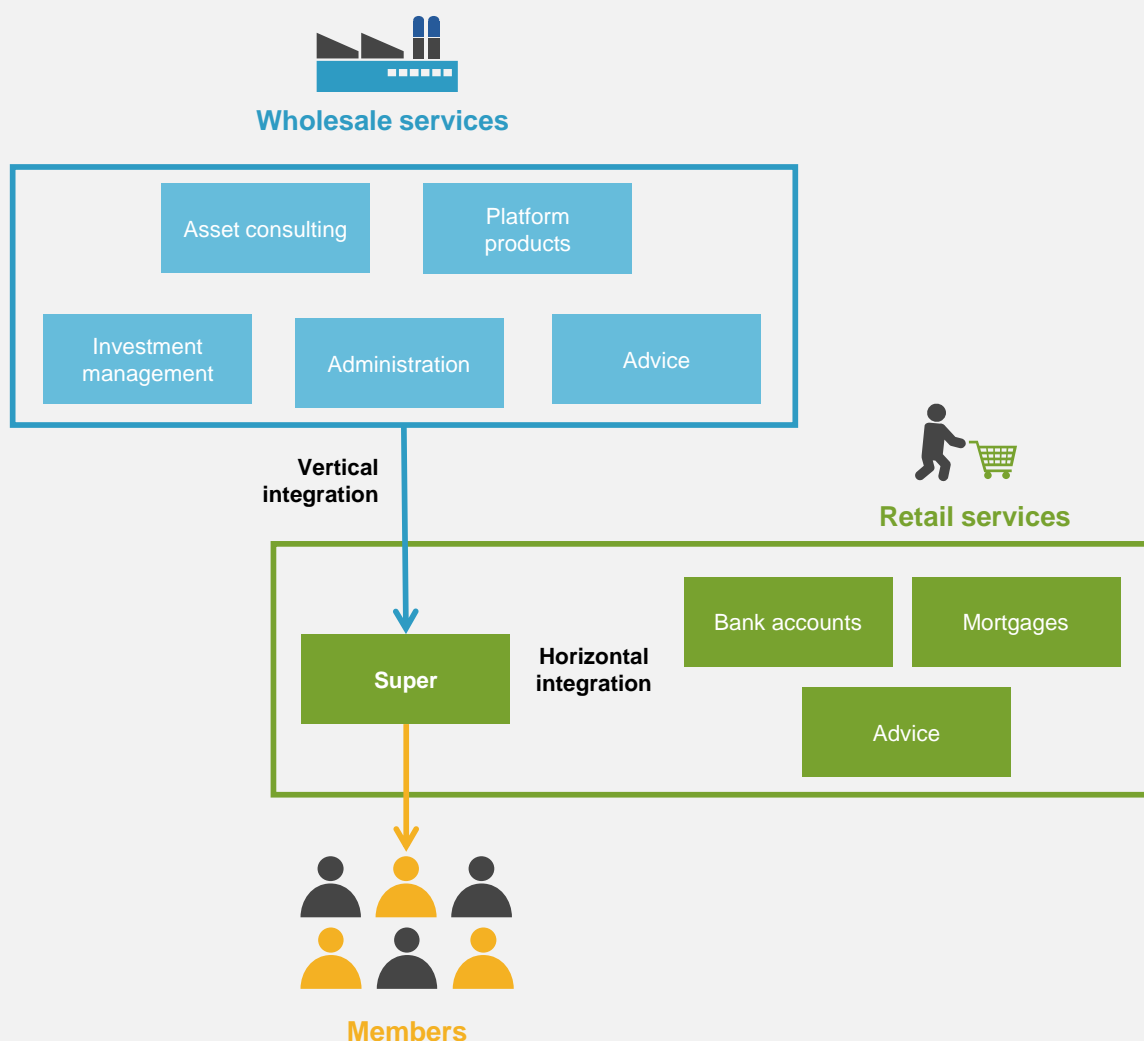
At an aggregate level, the market for outsourcing investment management is not highly concentrated. For example, a 2016 report (FSC 2016, p. 8) found that the top 10 investment managers in Australia accounted for around 58 per cent of the market in 2015, and the top 10 positions had continually changed, both by constituents and market share from 2009.

Participants took different perspectives on the state of competition in investment management markets. Some argued that this is a highly competitive space and that the rates for mandates negotiated by superannuation funds (as institutional investors) are generally competitive by international standards (ASFA, stage 1, sub. 42, p. 24; ASFA 2017, p. 33; FSC, stage 1, sub. 29; Mercer, stage 1, sub. 45; MLC, stage 1, sub. DR115, p. 33). Others expressed concern that the fees being paid by some funds have been very high and have not decreased as expected in line with system growth (for example, ISA, stage 1 sub. DR106, p. 21). There was greater consensus on the view that larger funds are able to exert more purchasing power in upstream markets, at least up to a certain point (Rice Warner 2014b).

To further test these views, the Commission sought further evidence in the funds survey on the investment management fees paid by funds across a range of asset classes. The intention was to benchmark the information against the experience of pension funds in other countries. Despite the poor response from funds on these questions, the data nonetheless imply that costs for the asset classes in which most domestic assets reside (that is, domestic and international fixed income and listed equity products) are likely to be higher than those observed internationally (at least for those funds that responded — refer to chapter 3).

Overall, however, the Commission considers that the structure of the market is broadly conducive to rivalry, with superannuation funds having a multitude of choices in how to invest, and in what. The wholesale market is also subject to ongoing change and disruption — some of these broader trends are discussed in the Commission’s draft report on competition in financial services (PC 2018). For superannuation funds specifically, a notable recent trend has been the recent shift by some (mainly larger) industry funds to insource more of their investment functions (box 7.1). As with administration, in a system where many funds continue to grow in size — both through organic growth and fund consolidation — this adds significantly to competitive pressure at the wholesale level of the market.

Box 7.1 Vertical and horizontal integration in the super system



Recent trends on funds switching to in-house investment management

Several large industry funds have brought more investment management functions back in-house in recent years — including AustralianSuper, UniSuper, QSuper, First State Super, Cbus, MTAA and Christian Super — and have expanded their internal management teams. Even so, most large Australian (industry) funds typically have less than half of total fund assets managed internally (which is well below many international pension funds). Irrespective of size, most funds will maintain some level of external asset management.

The shift towards a greater reliance on in-house supply could be driven by several factors such as the potential to reduce investment management costs, better manage capacity constraints, exploit competitive advantages from owning assets directly, and to have more scope for aligning investment management to the individual objectives of the fund. The trend towards insourcing can be also viewed as a competitive response to activities in upstream wholesale markets. It is also consistent with indications that funds of larger scale have a greater capacity to negotiate lower investment management fees.

Sources: Gallagher, Gapes and Warren (2016); Williams and Cornelius (2016); ASFA (stage 1, sub. 42).

... there are no barriers to investing in upstream capital markets that warrant action

In a competitive market, all funds should have the ability to invest in upstream capital markets in order to maximise long-term net returns and manage risks to their members. Some inquiry participants argued that this is not the case for SMSFs (and some small institutional funds), because these funds are generally unable to directly (or as cost effectively) invest in unlisted infrastructure or corporate bond markets (for example, SISFA, sub. 60, pp. 9–10).

The asset holdings of SMSFs are difficult to observe in ATO datasets due to the way asset classes are defined and viewed (not on a ‘look through’ basis) and ATO’s approach is inconsistent with APRA’s approach (chapter 2). Nonetheless, it is apparent that SMSFs hold, on average, a higher proportion of assets in cash and domestic equities than APRA-regulated funds, and much less in international equities and fixed income products. It also appears that, on average, SMSFs hold significant assets in unlisted property and in various pooled investment vehicles (such as managed funds and listed and unlisted trusts), which may be investing in a range of assets (PC 2016b). Differences in asset allocation between the APRA-regulated and SMSF sectors will be influenced by the fact that a greater proportion of SMSF assets are in the retirement phase (chapter 1). There is no evidence to suggest that it is not possible for SMSFs to access any particular class of financial asset by way of such vehicles.

There may, however, be higher costs associated with entering a pooled arrangement compared with direct investment (though this will not always be the case). These higher costs are not a sign of anticompetitive behaviour (or even inefficiency) where they reflect the true cost of the arrangement. Indeed, it would be expected that a retail investor or a small fund would face higher costs of investing in some asset classes than a much larger institutional fund, given the additional buying power, coordination and lower liquidity costs that come with pooling (ASFA, stage 1, sub. DR98, p. 56; CIFR stage 1, sub. 7).

Similar dynamics may be in play for institutional funds. The Commission has no data on the costs that different funds face in investing in unlisted assets (the disappointing response rate to the Commission’s funds survey on this issue was poor and in itself revealing). However, fund level data from APRA suggest that funds of all sizes hold a significant proportion of unlisted assets. There is no clear relationship in the APRA data between fund size and the share of unlisted assets in a fund’s portfolio. Other factors, such as investment strategy, liquidity needs and fund type appear to offer more likely explanations for systematic differences in the exposure to unlisted assets (BT, sub. 32; PC funds survey).

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The market structure of the superannuation system (as distinct from its policy and regulatory settings) is conducive to rivalry. At the retail level, there are many funds and products. At the wholesale level, while there is concentration in some service provider markets for outsourcing (like administration), a growing ability for larger funds in particular to insource all, or parts, of their service requirements adds to competitive pressure in the system.

7.2 Is the market contestable at the retail level?

Even in a system characterised by many funds and products, barriers to entry and exit could limit the competitive pressure on funds to meet members' needs over time and continue to improve their products and services. As such, evaluating the height of any barriers to entry and exit in the market is integral to understanding the degree of market contestability and actual competitive pressure.

Trends in entry, exits and consolidations

In a competitive and efficient system, viable funds would enter and underperformers would exit the market.

New fund entry has stagnated in recent years

Four new RSE licences were granted in the five years to 2016 (APRA, stage 1, sub. 32). Over the past decade, fund 'exits' (either through wind-ups or mergers) materially exceeded new fund 'entries' (figure 7.6).⁵⁷ However, the pace of exits has slowed in recent years.

New forms of 'entry' and product expansion are evident

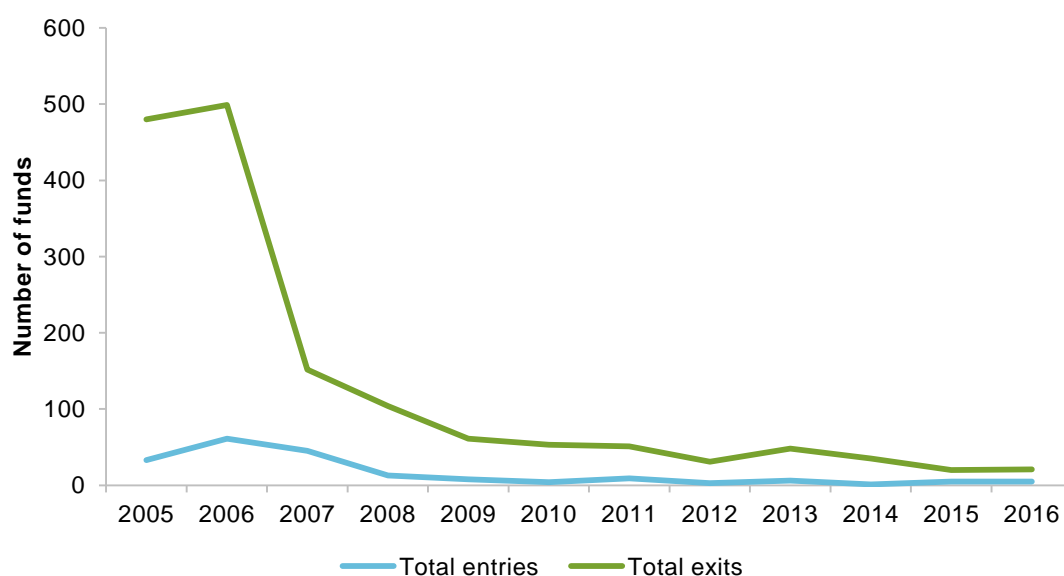
Though the number of funds has been falling, there has been exponential growth in the number of products and investment options offered by existing funds, and new types of products (chapter 4). In the *default segment* the main trend has been the (regulatory induced) introduction of MySuper products — 108 in the market at December 2017 (APRA 2017g).

⁵⁷ As distinct from new product entries perceived as new entrants (discussed below).

Figure 7.6 **Entry versus exits in the superannuation system**

APRA-regulated funds

As at June, 2005–2016



Source: PC analysis of APRA confidential data.

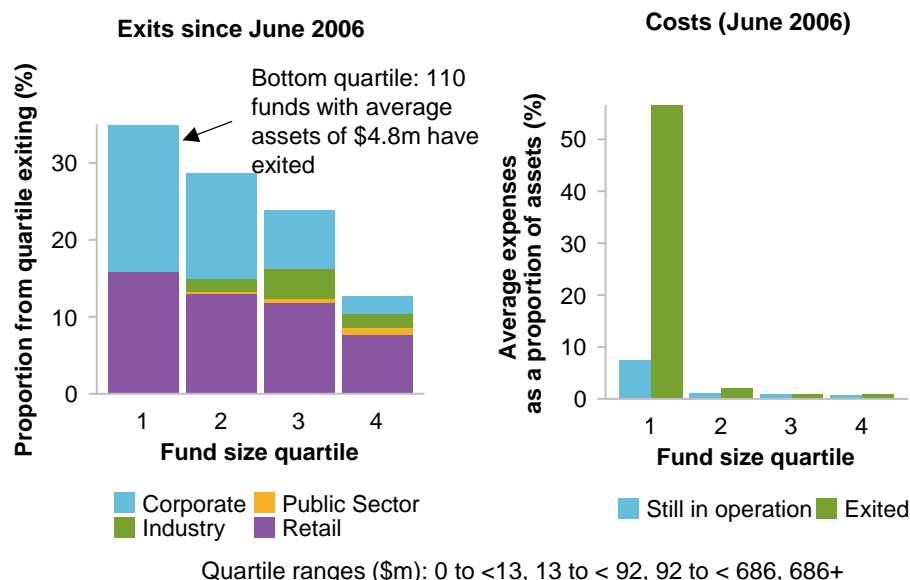
A notable trend in the *choice segment*, setting aside product proliferation generally, has been the entry of several ‘millennial funds’, often targeting a younger member demographic. This form of market entry is, in effect, at the sub-fund or product level, as these new entrants partner with an existing RSE licensee and fund (Carruthers 2017; Uribe 2017). As distinct from pure ‘white labelling’, these new entrants often offer products with some unique characteristics, such as new digital applications, platforms designed to help foster member engagement, and or focusing on particular types of investments — forms of ‘non-price’ competition (Grow Super, sub. 36; St Anne 2017). Some have also reduced their fees since first entering the market (GROW Super 2017; Spaceship 2017). Whether these entrants represent an enduring and competitive force, or are constrained by their upstream relationships, is yet to be seen.

Strong growth in SMSFs over the past decade has been another form of new entry and generated competition in the choice segment. In 2017, 15 per cent of members who switched funds went to an SMSF (Rice Warner 2017a), and a growing number of people are establishing SMSFs at a younger age (APRA 2017i; PC 2016b). Some APRA-regulated funds have responded by developing products with SMSF-like features (chapter 4).

High cost corporate and retail funds have exited over the past decade

A closer analysis of system exits indicates that, among funds that exited over the decade, most were smaller, higher cost corporate and retail funds (figure 7.7).

Figure 7.7 Smaller, higher cost funds have dominated exits
Fund exits over 2006–2015^{a,b,c}



^a Exits capture both funds that wound up or that merged with another fund. ^b Fund size quartile 1 is the smallest size and quartile 4 is the largest. ^c 2016 data are not included because fund exits are identified by the proceeding year's data.

Source: PC analysis of APRA confidential data.

To the extent that there remain unrealised economies of scale in the system (analysed in section 7.4) more exits and consolidation should be seen in the future. Indeed, merger activity continues, with some recent mergers between industry funds (table 7.1). There is a general expectation that consolidation will continue over the medium term, including as funds come under pressure because of scale disadvantages or negative cash flows, which will pose an elevated fiduciary duty for trustees to consider merging (APRA, stage 1, sub. 32; Chant West 2017; Rice Warner 2017i).

However, consolidation trends may not be uniform across the system. For example, a paper published by Frontier Advisors (Carruthers 2017, p. 3) suggested that many small corporate funds will either seek to merge or continue in 'rundown mode', but that merger activity is likely to be slower for industry funds and public sector funds; and that consolidation in the retail sector will be mainly a result of product rationalisation rather than fund consolidation.

Future consolidation trends will be influenced by the intensity of competition between funds in the system and the regulatory settings and regulator oversight activities (chapter 9).

Table 7.1 Some recent merger activity in the industry fund sector

<i>Parties involved (total assets)^a</i>	<i>Sector</i>	<i>Date announced</i>	<i>Estimated combined assets (at June 2016)^a</i>
Transport Industry Super (\$0.11 billion) and MyLifeMySuper (\$9.3 billion)	Industry funds	October 2016	\$9 billion
Rio Tinto Staff (\$5 billion) and Equisuper (\$8 billion)	Corporate & industry fund	June 2017	\$13 billion
Kinetic Super (\$3 billion) and SunSuper (\$39 billion)	Industry funds	July 2017	\$43 billion
Concept One (\$0.47 billion) and WA Super (\$2.6 billion)	Industry funds	September 2017	\$3 billion

^aThe total assets reported for each fund and the estimated combined total assets is based on APRA-fund level data as at June 2016. Combined assets may not add due to rounding.

Sources: APRA (2017i); Carruthers (2017); Equisuper (2017); Kinetic Super and Sunsuper (2017); MyLifeMySuper (2016); WA Super (2017).

Are there high barriers to entry in the system?

Barriers to entry may limit the competitive pressure on incumbent funds to continually improve member outcomes (their performance, products and services) and could arise from several sources (ACCC 2017; PC 2016b).

- **Legal and regulatory barriers**, arising from licensing and market entry conditions and restrictions to new entrants servicing particular segments (such as default members).
- **Market barriers**, arising from structural features of the market (such as substantial economies of scale, customer inertia), or particular characteristics of the system itself (such as the payment processes and interactions).
- **Strategic barriers**, arising from conduct of incumbent firms that has the effect of deterring new entry (such as some funds leveraging their vertically and horizontally integrated business models to limit distribution channels for new entrants).

If high or material barriers are identified, a relevant question is whether this warrants policy intervention, and in what form.

The main legal and regulatory barriers are in the default segment

Limited new fund entry in the APRA-regulated sector could be partly explained by the costs associated with becoming an RSE licensee or establishing an RSE. This includes the costs of obtaining a license from APRA, raising the necessary capital to meet minimum operational reserves, having a MySuper product authorised and (depending on the functions performed and services provided) obtaining an Australian Financial Services License from ASIC (APRA, stage 1, sub. 32; ASFA, stage 1, sub. 42, p. 21).

The ‘regulatory’ costs associated with entry requirements were generally considered a necessary part of the system. Indeed, several considered these provide an appropriate minimum standard for new entrants and work to protect members’ interests and help promote system stability and product quality control (for example, ASFA, stage 1, sub. 42, p. 21). Some participants went further and argued that current entry rules do not set the bar high enough: there was strong participant support for proposed reforms by the Australian Government to lift the requirements for MySuper authorisation under a revised ‘outcomes test’, focusing on performance, products and services (chapter 9).

Others, including respondents to the Commission’s funds survey (111 funds responded on this issue), argued that the impact of rising regulatory and reporting costs in recent years were a drag on fund and system efficiency. Logically, these costs will factor into the entry decision, though some recent ‘entrants’ (as discussed above) have outsourced their trustee function to an existing RSE Licensee.

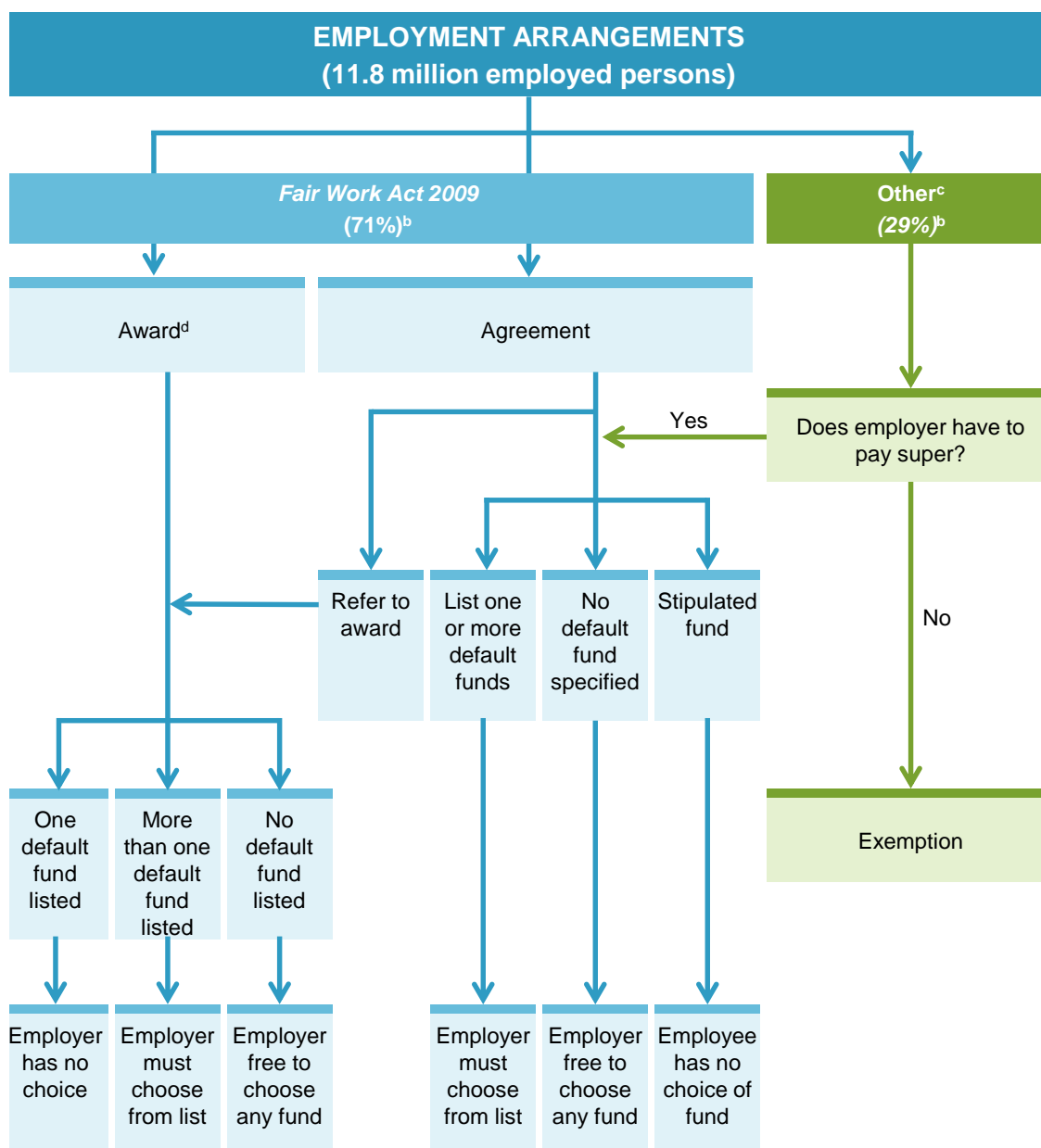
Past default rules have impeded access to the default segment

While default members represent about half of the accounts (and a quarter of the assets) in the system, nearer to two-thirds of people default on starting a new job. Eligibility for default status confers an advantage on funds that have it, and a disadvantage for those that do not. The default market is unique in that there is an absence of competition in the market driven by the member. As such, the relevant consideration is whether the *process of* selecting defaults is contestable and competitive (competition *for* the market) and undertaken by those best placed to make the decision in terms of expertise and incentives.

The rules and processes surrounding how default members are allocated to a default product vary significantly across awards, agreements, contracts and other employment arrangements (figure 7.8). These arrangements have largely evolved through the industrial relations system (chapter 12). While employers are typically the ultimate decision maker in selecting a default fund for their employees, often their choice is constrained by the default fund(s) listed in a relevant award or, for example, by the default fund that is negotiated into an agreement. The overlay of MySuper reforms in 2013 means that, where not prevented by an award or agreement, some proportion of employers can choose from any MySuper product.

There is no data collected, nor any precise measure of the number of employees who derive their default fund in accordance with an award, or the number of employers that have unfettered choice among MySuper products. Nevertheless, it is clear that accessing a large bulk of the default segment has been dependent on being listed in awards, both directly where an employer must choose a fund from a list in the award, or indirectly where being listed in an award has acted as a reference point for the enterprise bargaining process or the employers’ decision (PC 2012). The Commission estimates that award-listed funds account for about 80 per cent of total MySuper assets (APRA 2017g).

Figure 7.8 Default funds in Australia's workplaces^a



^a All default funds must offer a MySuper product or be an Exempt Public Sector Superannuation Scheme.

^b Numbers in brackets are the approximate proportion of total employed persons under the specified work arrangements, sourced from PC (2015b, p. 5). ^c This includes State-based systems and common law employment contracts

^d Where there are grandfathering provisions in a modern award, employers can generally continue to make contributions (on behalf of their employees) to their previously selected default fund, even if it is no longer listed in the award (PC 2012, p. 6).

The process for becoming a default-listed fund in awards is administered by the Fair Work Commission (FWC). The role given to the FWC reflects that superannuation entitlements have largely emerged from the workplace relations system and that choice of fund has been a focus of industrial parties (chapter 1).

The issue of whether the process for becoming an award-listed fund has been contestable was a matter of contention amongst participants. Several argued that it has not been, largely because it restricted default status to only those funds associated with unions or employers (for example, FSC, sub. 69, p. 3; BT, sub. 32). Some others argued that it was not difficult for funds to access the award system, and pointed out that for-profit funds can be (and are) listed under current industrial awards (for example, AIST, sub. 39).

The Commission reviewed the process for listing default funds in modern awards in its 2012 inquiry, and, among other things, concluded that the process was not fully contestable (PC 2012). This included because some funds found it difficult to present their case on an equal basis to the FWC and because of the lack of a systematic process for assessing or removing listed funds even if they are underperforming. A new default process was legislated in 2012 (chapter 12). However, the process stalled in 2014 and has not recommenced since. And in this sense, not much has materially changed from 2012. There is still a high degree of fund concentration in many awards (with 1–4 funds listed), many funds are only in a handful of awards, and there is limited evidence of new entry or exits in recent years (figure 7.9).

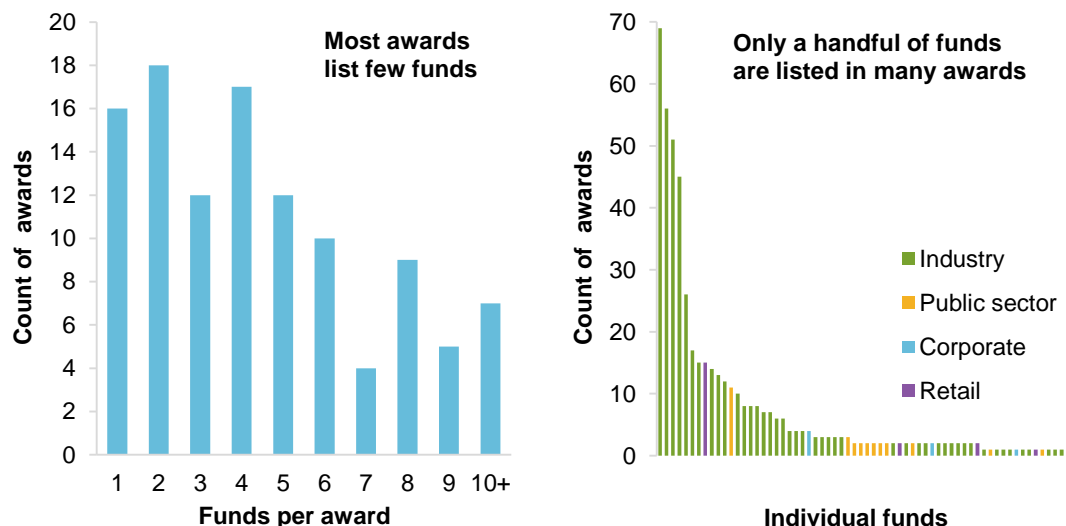
Perspectives on the merits of the new FWC process are mixed. Several participants argued that it would enable contestability in the default segment if allowed to proceed (for example, ISA, sub. 59, p. 2; AIST, sub. 39, p. 8, p. 21; Cbus, sub. 58, p. 4). Others argued that barriers for some funds would still remain in place even if this system was in operation (FSC sub. 69, pp. 5–6). One of the impediments identified was that there is no certainty that funds would have the ability to present their case to the final decision maker, the full bench of the FWC.

In the Commission's view, the legislated, but currently stalled, FWC process would initiate some competition *for* the default segment over the status quo with all funds having access to a process to put their case for inclusion in particular awards (PC 2016b). However, it would only go part way to introducing merit-based competition *for* the default segment, including because the FWC expert panel would be advisory in nature only, and due to questions about whether the FWC is well suited to the role of making merit-based assessments of super products. Moreover, the FWC has never demonstrated any preparedness to remove underperforming funds from awards.

In any case, not all workers are covered by awards and many employers could, in theory, choose any MySuper product. While this may be seen as pro-competitive, there is no requirement for employers to choose a suitable product and therefore no guarantee of a good outcome for employees in terms of their fund's performance, products and services. This highlights a fundamental problem with the current system: the choice of default fund lies with employers and there is no guarantee they will choose products based on merit

(chapter 12). The Commission considers that competition for the default segment must focus on the member (rather than on funds), and therefore be based on merit as distinct from access.

Figure 7.9 Award listing is concentrated^{a,b,c}



^a The Fair Work Commission lists 122 modern awards on its website. ^b Not all superannuation contributions made under awards are made to default funds listed in awards. 'Grandfathering' clauses in all modern awards allow employers to continue to contribute to funds to which they were contributing before 12 September 2008 (FWC website; PC 2012). ^c This figure includes six funds that have now merged or appear to no longer be in operation, but where it is unclear whether a successor fund is able to be selected as a default fund within each award.

Source: PC analysis of the 122 modern awards listed by the Fair Work Commission (2017).

While the default system has generally outperformed the system overall, it has not always guided members into the very best funds available based on long-term net returns, and has enabled some underperformers to remain in play (chapter 2). Over time, a lack of contestability from outside and from within the process may not only lock some good funds out, but could also stifle dynamic efficiency if incumbent funds have more muted incentives to continually improve their products and services than in a fully contestable market. There is scope for improvement and a case to consider the merits of a different default mechanism to drive competition for the market. This is discussed in chapter 12.

Some market structures may constrain contestability

Barriers to entry could arise from inherent structural features of the market or particular aspects of the superannuation system (and its machinery).

The presence of economies of scale in the system (section 7.4) could limit the viability of new fund entry below some level of minimum efficient scale (in terms of assets and members). Against this, however, is evidence of low market concentration levels and

unrealised scale economies and that size does not always necessarily explain the returns delivered to members (chapter 2; section 7.4). New entrants may also have the ability to generate scale in adjacent or upstream markets (such as in upstream investment management, or in other countries), or through outsourcing relationships (section 7.1).

Achieving scale in a timely manner is not the only structural challenge facing new entrants. There is also a need to invest significantly in the infrastructure needed to support the payment and data flows that occur between stakeholders in the system (members, funds, employers and regulators). In its stage 2 draft report, the Commission flagged the possibility of a central clearing house (along the lines of what is in place in New Zealand) as a means of simplifying administration for employers and funds in the system, which in turn could lower the costs faced by new entrants to the system. The weight of feedback on this proposal from participants was that such an architectural shift was unnecessary, on the basis that there is a well-developed market for clearing house services, and the SuperStream reforms have markedly improved the efficiency of transactions.

On the available evidence, the Commission considers that barriers to entry arising from a need to invest in infrastructure are likely to be low, and do not materially bear on the contestability of the market for prospective new funds.

System characteristics and potential barriers on the demand side will also enter the calculus of a new entrant. Previous chapters (chapters 4 and 5) pointed to high information barriers, weak member engagement, and strong reliance on defaults or other intermediaries (such as employers and advisers) as features of the demand side of the system. High levels of customer inertia and low switching rates are also evident. Such behaviour may be perfectly rational given the long-lived nature of superannuation and where members are happy in their current fund. However, it does present a challenge for the ability of a new entrant — even a highly efficient and attractive one — to enter and attract members. New entrants will rely on having or developing distribution channels to attract members — whether through defaults, existing relationships with consumers, or innovative marketing or other means.

Overall, while structural features of the system on the supply and demand side are likely to create challenges for new entrants, on the available evidence it would be an overstatement to characterise them as prohibitive or even high barriers to entry.

Strategic conduct from integration unlikely to create high entry barriers

Some superannuation funds are able to leverage horizontal and vertical relationships (forms of integration) as distributional channels to attract and capture members, such as through bundling, cross selling, or the use of related-party adviser networks (PC 2016b). From a contestability perspective, concerns would arise if these business models locked out otherwise more efficient funds from entering the system (or expanding to other market segments) to compete for members, and hence acted as a barrier to entry.

Integrated business models used to attract members ...

There is no system-wide data on the extent to which some funds rely on connections arising from their integrated business models — such as bundling or cross selling superannuation with other financial products, or use of related-party adviser networks — to attract members. This is not captured in (regular) regulatory reporting. The Commission’s funds survey attempted to address this evidence gap, however, the Commission was unable to derive meaningful results from the responses provided.

However, it is clear that these distribution channels are used, particularly by some retail funds. For example, previous surveys and reports have found that bank-owned superannuation funds have a large proportion of members who utilise banking and other services with the same group. However, these funds appear to have been less successful in capturing a share of their customers’ superannuation due, in part, to competition from industry funds and SMSFs (Investment Trends 2015; Roy Morgan Research 2013, 2014, 2015a).

Retail funds have been successful at capturing members who choose to switch in the system — a reasonably moderate (but still material) cohort of 5–10 per cent of members each year. For example, Rice Warner (2017a) member-level data indicates that the most popular destination for switchers was retail funds, which captured 40 per cent of switchers, compared with 29 per cent for industry funds and 16 per cent for SMSFs.⁵⁸ The success of retail funds in this area can be partially attributed to adviser distribution channels, and the cross selling of super products to banking customers (ISA, sub. 87, p. 25.)

Financial advisers have typically been one of the main distribution channels used by bank-owned superannuation funds in particular for attracting members (ISA, sub. 5). Research by ASIC (2018a, p. 7), based on a survey of five of Australia’s largest banking and financial services institutions, found that while the majority (80 per cent) of superannuation products financial advisers could offer their clients were products not offered by their employer group, a majority (70 per cent of customers) ended up going with the ‘in-house’ superannuation or pension option. Some participants argued that an impact of the FoFA reforms has been bank-owned funds utilising more direct selling of superannuation rather than reliance on advisers (ISA, sub. 5), but this is difficult to verify.

... but integrated business models have not stifled retail-level contestability

While some funds have a market advantage of being able to leverage their vertical and horizontal connections to attract new members, this has not locked out other competitors. This is reflected by market presence in the choice segment being split relatively evenly between retail funds, not-for-profit funds and SMSFs (MLC and NAB, sub. 63, p. 10; chapter 1). As outlined above, analysis of switching rates in 2017 shows a material

⁵⁸ The remainder went to public sector funds (13 per cent) and corporate funds (2 per cent).

proportion of members switching into industry funds and SMSFs. Vertically- and horizontally-integrated business models do not dominate the market.

Essentially, this is because other distribution channels are available. For example, in addition to some funds having access to default members, marketing and advertising is used extensively across the system by all types of funds (or on their behalf) and appears to be growing in importance and profile. The evolution of technology and consumer behaviour may also provide a new avenue for funds to win new members. Funds are already increasingly utilising new ways (such as mobile phone applications and social media platforms) to interact with their members, and introduce greater personalisation of material, and are investing more extensively in these areas (Frost 2016b; Investment Trends 2015; Willis Towers Watson 2016, p. 3; MLC, stage 1, sub. DR115, p. 24).

Are barriers to exit an issue?

As investment risks reside with members not funds, high exit costs do not appear to be a significant issue to the entry of new funds into the superannuation system.

Of greater concern and policy relevance is whether barriers to exit are frustrating the realisation of economies of scale in the system. Several participants argued that some existing regulation is inhibiting fund mergers, such as the temporary nature of capital gains tax rollover relief, taxation issues, and the obligations on successor funds ensuring they deliver ‘equivalent rights’ (on a bundled basis) to new members, a particularly difficult issue when it comes to insurance (ASFA, sub. 47, p. 24).

Some changes are already underway to address barriers. APRA’s (2017f) revised guidance on successor fund transfers is, in part, designed to address concerns about the operation of the ‘equivalent rights’ test. In the Commission’s view, if this does not achieve the desired result, APRA should move quickly to recast the equivalence obligations further (chapter 4). The Commission also sees merit in addressing some of the other identified regulatory impediments to mergers, such as permanent capital gains tax relief and annual reporting by APRA to the Council of Financial Regulators on progress stemming from the application of the scale test (or the outcomes test if that becomes law) in bringing about fund mergers (chapter 9).

APRA’s view is that regulation is unlikely to be the main culprit as a merger blocker.

Whilst there are a range of legislative requirements to be met in relation to fund mergers, APRA does not consider that the current legislative or regulatory settings create any material barriers to fund mergers taking place. In APRA’s experience, there are a range of other factors, such as differing philosophies behind an RSE licensee’s approach to board composition, views of shareholders and differences in strategy and business model, that are more likely to have contributed to some proposed mergers not proceeding (APRA, sub. 89, p. 1).

The Commission largely concurs with this assessment. To the extent that there are impediments to mergers, they are likely to exist outside the realm of regulation, and go to

factors such as limited incentives and competitive pressure on the trustees of some funds to contemplate mergers (BT, sub. 32). That said, the regulatory framework and regulatory activity should be calibrated to encourage mergers that are in the best interests of members. Chapter 9 proposes a package of policy recommendations that include stronger merger transparency requirements and a stronger member outcomes test (which includes a focus on the implications of fund scale) that will help address this.

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At the system level, fund-level regulation is a significant cost of entry and there are structural features of the system on the supply and demand side that are likely to create challenges for new entrants (including gaining scale by attracting members). However, these are not necessarily prohibitive or even high barriers to entry.

In the default segment, there are high regulatory barriers to new fund entry, due to policy and regulatory settings that limit access to the market (including difficulty being listed in a modern award). There is also an absence of competition for the default market. Conversely, the choice segment is largely contestable.

While the costs of exit are unlikely to deter new fund entry, barriers to fund mergers are continuing to frustrate much needed consolidation in the system, at great cost to members.

Is unhealthy competition evident in market segments?

Contestability in the choice segment has not always delivered for members

While the choice segment of the system is largely contestable, a key question is how *effective* (or healthy) competition in this segment has been in delivering long-term outcomes for members in the form of net returns, fees and service quality. Choice members being channelled, via cross selling or upselling techniques,⁵⁹ into higher fee or underperforming products is viewed as a symptom of unhealthy competition in the market by some participants, and stemming from a conflicted business model (AustralianSuper, sub. 43; ISA, subs, 5, 59, 87; AIST, stage 1, sub. DR102). However, much of the evidence about the impact of these tactics and linking them to members' outcomes is anecdotal.

Robust (regularly collected) system-wide data or evidence linking the use of inappropriate cross selling or upselling to poor member outcomes remain elusive, although a recent report by ASIC (2018a) highlighted some conduct that is of concern around the impact of conflicts of interest and the use of related party advisers. Data on *intrafund* and *interfund* switching on their own do not indicate whether a member switched due to marketing practices or for

⁵⁹ *Cross selling* can be defined as the sale of additional products in addition to the primary product, including via bundling; while *upselling* could take place where a member is encouraged to switch from a lower fee to a higher fee superannuation product.

some other reason (such as a member seeking out a product that better meets their individual needs) (MLC and NAB, sub. 63, pp. 3, 6; Rice Warner, sub. 56, p. 14).

Nevertheless, across a range of indicators, the evidence suggests that competition *in* the choice segment has not always delivered better long-term outcomes for members in terms of performance, products and services. Indicators of poor outcomes include greater variation in returns that is sometimes not obviously explained by differences in product design and asset allocation (chapter 2), a long tail of high fee choice products (chapter 3), poor comparability of products (due to poor data and product proliferation) that exacerbate the risk of poor choices by members (chapter 4, 5), and an apparent disconnect between members' needs and the offerings of providers (chapter 4).

Some employer inducements a sign of unhealthy competition in default segment

With few exceptions, the ultimate decision on the choice of a default fund rests with the employer. This creates a principal–agent problem between employers and employees in the selection of a default fund. There is a risk that employers do not have the time, expertise or incentive to act in the best interests of their employees, particularly as the onus to act in members best interest falls to the trustees.

Several participants expressed concern about direct and indirect inducements offered by funds to employers to secure default status for their fund (for example, AIST, sub. 39, p. 21). Legislative protections are in place to mitigate these risks and ASIC has found no evidence of breaches. However, ASIC has noted that contraventions are difficult to enforce. Further, the results of a recent survey by ASIC (sub. 90) suggests this could be an area of ongoing concern — the key results from this analysis are summarised in chapter 9. While there are piecemeal ways to stem this behaviour (the *Superannuation Industry (Supervision) Act 1993* (Cwlth) (SIS Act) obligations, regulator oversight and enforcement), the Commission's proposed default approach directly addresses the problem by removing employers from the default selection process (chapter 10).

DRAFT FINDING 7.3

There are signs of unhealthy competition in both the choice and default segments of the superannuation system.

- While the choice segment is largely contestable, competition has not always translated to better outcomes for members, and product proliferation (some 40 000 investment options is unhealthy choice) and poor comparability is symptomatic of unhealthy competition.
- In the default segment, the risk of employer inducements (of no benefit to members) remain a concern and can work against the interests of members.

7.3 Does vertical integration affect competition in wholesale markets?

Much of the superannuation system is characterised by vertical (and horizontal) integration. Vertical integration can include circumstances where a fund uses in-house supply, or sources services from a related party. Both retail and not-for-profit funds may use related parties, but under different models — for example, retail funds may utilise service providers from within the same corporate group entity, while not-for-profit funds (or trustees) may use service providers in which they are directors or their fund has an ownership interest.

Given the potential for conflicts of interest, it is relevant to consider whether the use of related parties adversely affects competition to the detriment of members (PC 2016b, p. 92).

Vertical integration could enable a fund to capture efficiencies in the supply chain that benefit it and its members, or act as a competitive check on any market power that upstream (unrelated) service providers may otherwise exert (FSC, stage 1, sub, DR110, p. 16; section 7.1). On the other hand, there are longstanding concerns that in the absence of competitive pressure from members, funds might have the incentive and ability to outsource to related parties, ahead of more efficient (but unrelated) service providers, which could in turn lead to higher fees, lower returns or poorer services to members (AIST, stage 1, sub. 30, p. 5).

Disentangling these motivations and outcomes is not straightforward. Data quality is poor. And no single metric is likely to be definitive. Nevertheless, the potential conflicts of interest raised by the use of related parties is recognised within APRA's prudential and reporting framework, and understanding the extent to which potential risks are adequately addressed (or gaps remain) is crucial when assessing competition and efficiency in the system.

How widespread is the use of related-parties?

From 2014, funds have been required to disclose information about their material outsourced service provider arrangements and other information relevant to potential conflicts of interest. However, the information disclosed for some services either requires judgment as to what constitutes a 'related party' or is often not detailed enough for meaningful analysis of related party transactions.

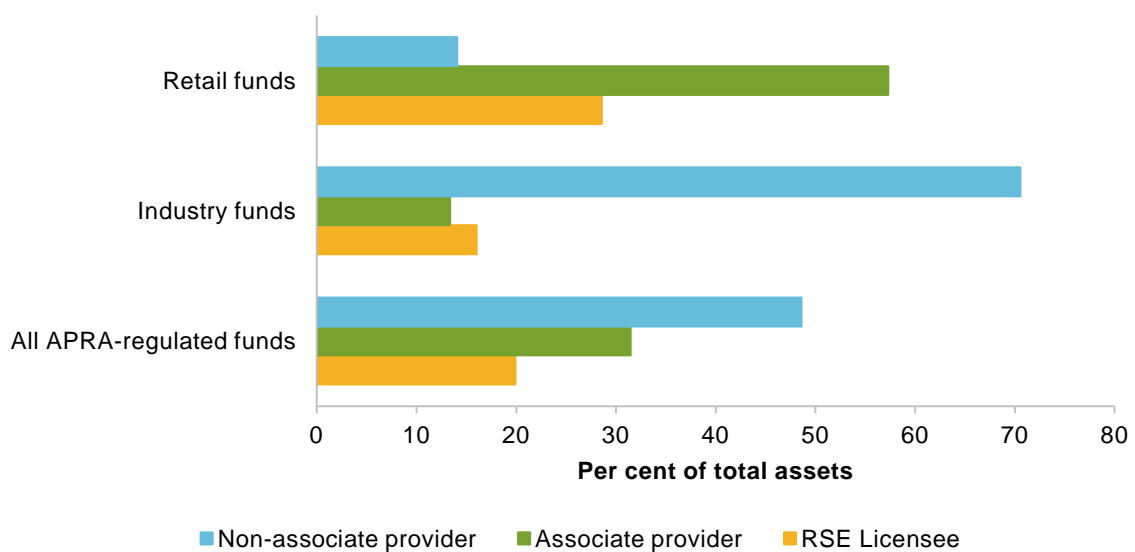
A more complete APRA (confidential) dataset is available on whether funds use 'associate' providers for particular services, but only from 2015. While the concept of an associate provider is similar to a related-party, it is not precisely the same, and the differences in practical terms are sometimes unclear.⁶⁰

⁶⁰ An 'associate' provider represents an entity that is an associate, within the meaning given in s.12 of the SIS Act, or a director of an RSE Licensee and also an associate of the RSE Licensee itself: it excludes an associate or individual director (APRA 2012). A related-party service provider can be defined as a service provider that is a connected entity or a related body corporate within the group (including joint ventures that are collectively owned by multiple industry funds with or without a controlling entity in the structure or related body corporate) (APRA 2012; Liu and Ooi, sub. 92).

Retail funds more likely to report outsourcing to associate parties ...

Based on data reported to APRA, associate providers are more typically, but not exclusively, used by retail funds. Across the suites of wholesale services captured by APRA, retail funds use of associates was almost twice the system average in 2016 and over four times more than industry funds (figure 7.10). Supply by the RSE Licensee was also materially higher for retail funds compared with industry funds.

Figure 7.10 Use of associate and non-associate providers, by fund type
Based on APRA 2016 expenses data^a



^a The proportions allocated to in-house RSE Licensees, associate providers and non-associate providers across retail and industry funds in 2016 were similar to those in 2014 and 2015.

Source: APRA (2017b; table 7b)

This APRA dataset, however, has limitations. APRA (sub. 89) warned of a lack of consistent information reported on expenses paid to associated entities, partly due to the uncertainty about the definition of associate in APRA's reporting standards, and also the collection of expenses only in respect of arrangements between the RSE licensee and the service provider (not between the RSE and the service provider). APRA said (sub. 89, p. 2):

This limits both APRA's and external stakeholders ability to understand, and compare, how fund assets are being used in the management of fund operations.

This leaves open the possibility that the use of associate (or related) parties in the system could be greater or less than reported in APRA data, both overall, and for particular types of funds. APRA (2017a) is currently consulting on improvement to this reporting framework, and is also considering how to collect service provider expense data on a look-through basis.

Even more problematic is that APRA data cannot be used to credibly estimate the proportion of funds that outsource investment management to associate parties (let alone potential differences in costs, or by assets or asset class) due to limitation in the way that the current reporting framework captures investment expenses (discussed further in section 7.4 and chapter 10). This is highly problematic given that investment management expenses form one of the largest components of funds' total expenses and are an area prone to potential conflicts of interest.

A recent study by Liu and Ooi examined the extent of related-party outsourcing by superannuation funds for a range of services and the impact on member outcomes — investment management services were not examined because of a lack of effective disclosure of these arrangements by funds (Liu and Ooi, sub. 92, p. 10). The authors estimated that retail funds made extensive use of related parties for administration (68 per cent of funds) and asset consulting (63 per cent of funds) services, and less for custody (23 per cent), and auditing services (0 per cent); while not-for-profit funds were found to have a very low use of related parties across all services in comparison — although not-for-profit funds can (and do) also use related parties (chapter 9).

... but hard to get a sense of trends over time

A lack of APRA time series data also make it problematic to derive a system-level view as to whether the propensity for funds to use associate providers — or internal supply — has increased or decreased in recent years, both across the system and within the not-for-profit and for-profit segments. Questions to elicit this information from the Commission's funds survey were poorly answered: on average, funds that responded represented less than one-quarter of total assets and member accounts in the system.

Robustness of review processes and switching rates unclear

Robust review processes and evidence of funds switching service providers over time could be indicators that — notwithstanding the use of related or associate parties — these wholesale markets are contestable. Following the Stronger Super reforms, RSE Licensees have been under new obligations, including when outsourcing to associate providers, with the operation of prudential standards covering conflicts of interest and outsourcing (APRA 2012, 2013b), and new reporting obligations to APRA and the public (discussed above).

Some indicate that these measures act as an effective constraint on the inappropriate use of associate providers (for example, MLC stage 1, sub. DR115, p. 33). Others were more dubious. For example, ISA (sub. stage 1, DR106, p. 24) argued that there is no obligation on RSEs to ensure that all related-party transactions are conducted on terms no more favourable to the related party than would be reasonable if the fund were dealing at arms-length. AIST advocated for conflict of interest reporting to be strengthened in line with principles outlined

by ASIC (2016c). Hartley argued that the transparency on fees paid to related parties is deficient and should be rectified (stage 1, sub. DR82, p. 1).

Confidential APRA data indicate that from 2014 the majority of service provider arrangements have been reviewed (at least on an internal basis) — including for funds that reported using an associate provider, though the propensity for review was higher for funds that reported using a non-associate provider. However, the robustness of these ongoing review processes is unclear. And there is no formal requirement for an incumbent service provider to be periodically reviewed to ensure that these arrangements continue to operate in the best interests of members (matters that the Commission considers should be addressed with strengthened regulatory requirements, as outlined in chapter 9).

Nor is there robust evidence on the extent of funds switching from associate to non-associate providers (or vice versa). The Commission attempted to address this evidence gap in its funds survey, but was thwarted by a very low response rate — funds that responded represented less than one-quarter of total assets and member accounts.

Does outsourcing to related parties lead to higher costs and fees?

Concerns may arise if there were systematic evidence that funds using related-party outsourcing arrangements paid higher costs or charged higher fees than those that outsourced to independent (non-related) providers. Several participants pointed to early research on this issue undertaken by Liu and Arnold (2010, 2012), which concluded that for-profit funds that outsourced administration and insurance services to related parties paid higher costs (and charged higher fees) than those that outsourced to independent providers (for example, AIST, stage 1, sub. 30; ISA, stage 1, sub. 38).

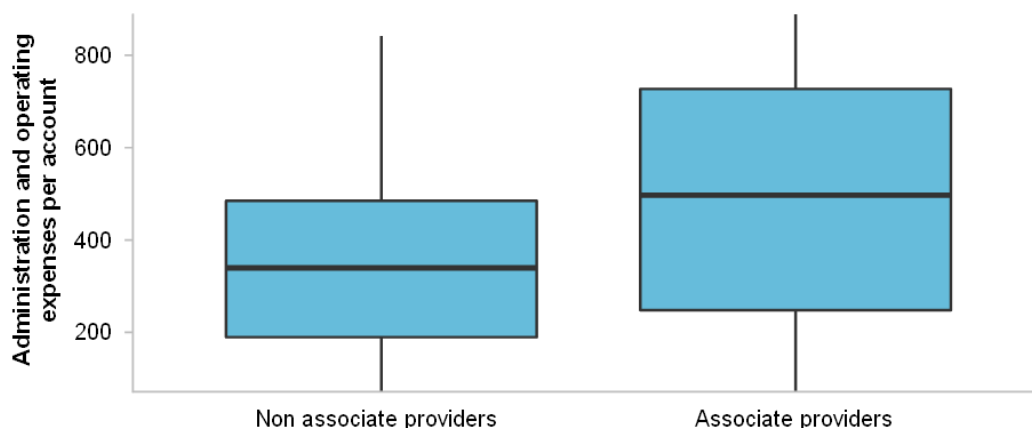
However, the findings of that research were strongly contested by several participants (for example, FSC, sub. DR110; Mercer, sub. DR104). Participants also argued that the analysis has since become obsolete due to a strengthening of the regulatory protections around outsourcing, conflicts of interest, and the use of associate parties (discussed above). In this regard, APRA itself (sub. 89, p. 3) noted that, collectively, these changes ‘limits the relevance of analysis undertaken prior to the implementation of those reforms’.

More recent research noted above (Liu and Ooi, sub. 92) found that, among other things, retail funds that use related-party service providers (for administration, asset consulting, custody, insurance and auditing) and affiliated trustee directors tend to significantly underperform their peers across a range of investment performance metrics over the short term and the long term). This further highlights the egregious poor reporting and disclosure of investment management arrangements and fees for related parties.

Data limitations constrain robust evaluation of related-party transactions

APRA data on service provider expenses and the use of related or non-associate parties (provided in granular form to APRA on a confidential basis) would appear a logical starting point for the Commission's own assessment of this issue. The Commission's analysis of these data for administration services indicates that funds that use associate providers (mostly but not exclusively retail funds) have higher median administration and operating expenses (per member account) than those that use non associates (figure 7.11).

Figure 7.11 Higher costs using associate administration providers ... but data less than robust^{a,b,c}
2015–16



^a The Commission's analysis combined information from a confidential dataset provided by APRA and publicly available APRA fund-level data (on total assets, number of member accounts, total operating and administration expenses) for 2015-16. ^b This analysis controls for fund scale (total assets) and fund classification (not-for-profit or for-profit status). ^c The horizontal line through the middle of each box is the median cost. The box ranges from the 25th to the 75th percentile of the distribution. The vertical lines below and above each box depict the overall range of costs in the data (although values greater than 1.5 times the interquartile range are not shown).

Source: PC analysis of APRA confidential data.

However, these results need to be interpreted with caution. The median measures for each group mask significant variation in the results for individual funds. Further, higher costs could reflect differences in the scope and quality of services procured rather than a sign of inefficiency. Based on the available data, it is not possible to control for this factor.

More fundamentally, these results are subject to the limitations with the underlying data as noted by APRA (outlined above). The inability to examine investment management expenses is problematic given that it represents a significant component of reported funds' expenses (32 per cent), and of member fees (30 per cent). Not only do these data limitations constrain evaluation of related-party transactions, the fact that they exist is a red flag. The

Commission's attempt to address these gaps through its funds survey was ultimately hampered by a low response rate to questions about the use of associate providers, by both retail funds and industry funds (15 per cent of retail funds, or 18 funds, provided fulsome responses for 2016-17, compared with 20 per cent of industry funds, or eight funds).

Several participants called for APRA's research on related-party outsourcing to be updated (for example, AIST, stage 1, sub. 30, p. 7; ISA, stage 1, sub. 39, p. 18) but this has yet to take place. APRA is, however, in the process of conducting a thematic review into related-party arrangements across the system that is close to finalisation (sub. 89, p. 2).

Scope to improve transparency of related-party transactions

There is now a range of regulatory protections in place to mitigate against the risks that trustees' use of related parties is not in the best interests of members. However, the Commission considers that there is a case for strengthening these protections further, to ensure that members are not disadvantaged if their fund chooses to use related-party service providers (chapter 9). Further, deficiencies in the information reported around fees more generally should be addressed (chapters 3 and 10).

DRAFT FINDING 7.4

There is a high propensity for funds in the system (particularly retail funds) to report using associate service providers — a form of vertical integration. While vertical integration is not in itself a problem, it does raise a potential conflict of interest which needs to be addressed by confident regulators and with greater transparency through disclosure and reporting.

7.4 Are there unrealised economies in the system?

Economies of scale arise from a reduction in the average unit costs of supplying a product or service derived from increases in the volume of output. Multiple commentators and reviews have identified scale economies as evident in the superannuation system and an important driver of outcomes for members (Cooper et al. 2010a; Minifie, Cameron and Savage 2014; Murray et al. 2014; Wallis 1997). An assessment of economies of scale can also be used in the context of competition. Evidence of a fragmented market with significant unused economies of scale (or a lack of pass through to members of scale benefits achieved) could be a symptom of barriers to exit or consolidation, or signal an actual lack of competition in the market (van Leuvensteijn et al. 2007).

The Commission has undertaken preliminary econometric analysis of economies of scale in the APRA-regulated system, focusing on their size and scope, and whether the benefits have

been passed through to members. This analysis is a work-in-progress and the Commission will release a technical supplement on this work for feedback post release of this draft report.

In the meantime, the Commission considers it useful to present some preliminary observations based on an assessment of the data, which have motivated the Commission's more detailed econometric analysis.

Likely sources of economies of scale in the system?

Several potential drivers of scale benefits in the super system

The Commission's stage 1 study detailed the sources of economies of scale in superannuation and past research (PC 2016b, pp. 102–105). Broadly, economies could be achieved in two ways: as funds grow in size and are able to spread their fixed costs over larger ranges of output (assets or members), or as increasing scale enables funds to overcome operational barriers or to exert greater purchasing power in securing upstream services (Cummings 2012; PC 2016b). Economies of scale could arise in both administration and investment management.

- Administration economies of scale may arise because of, for example, fixed costs in setting up and continually investing in information technology systems, reporting processes, and general management functions (ASFA stage 1, sub. 42, p. 24; IFAA, QIEC Super and Club Super, sub. 53).⁶¹ There are also indications that size improves the bargaining position in the outsourcing market for administration (section 7.1).
- Investment management economies of scale may arise because of, for example, fixed costs in setting up the baseline capability to undertake investment management (such as investment in platforms, IT systems and specialist in-house investment managers). Size may make it easier for funds to more readily access certain types of investments (such as direct investments with in-house teams), or improve their bargaining position in securing lower investment management fees from third party investment fund managers (MLC, stage 1, sub. DR115, p. 33; Mercer, stage 1, sub. 31, p. 23).

There is an important distinction between the funds realising internal cost efficiencies because of the pressure to innovate or secure greater market share, versus scale benefits arising from organic growth as the system gets bigger due to regulatory fiat. Only the former source is a strong indicator of competition and dynamic efficiency in the system.

More broadly, economies of scale can also be viewed at *system-level*. Through this lens, the system also realises economies of scale when funds exit and members transfer to one of the remaining funds — particularly when those exiting are higher cost funds, which has been the lived experience from 2005 (section 7.2). This has the dual impact of reducing duplicated

⁶¹ It has been estimated that fixed costs account for about one third of the administration costs of an average superannuation fund (Minifie, Cameron and Savage 2014).

fixed costs within the system, and makes (at least some) remaining funds bigger. Scale realised due to system exits is also an indicator of competition.

The distinction between the different drivers and forms of economies of scale will be further detailed in the Commission's econometric analysis.

But the size and cost-efficiency relationship is not straightforward

The benefits of increased scale may have limits. Previous studies have indicated that the benefits may diminish over certain levels of output and, beyond some size, diseconomies of scale may arise: for example, in listed equity markets due to market impact costs, delays in executing trades and loss of investment flexibility (for example, cited in Cummings 2012). Some participants also pointed to constraints on the size of investment mandates that will be accepted by local investment managers (CIFR, stage 1; sub. 10 Rice Warner 2014b).

The picture gets further complicated because growing fund size is not the only way to achieve economies of scale. Funds' outsourcing provides an alternative channel to achieve some of the cost savings that could be achieved through scale, without funds actually achieving scale themselves; a conclusion drawn in some past studies and highlighted by participants (ASFA, stage 1, sub. 42; Higgs and Worthington 2012; Sy 2012). Against this, smaller funds may ultimately still be at a disadvantage in terms of their purchasing power in upstream outsourcing and service provider markets (section 7.1).

Moreover, economies of scale may not always manifest in lower fees for members — for example, following average cost reductions in some business areas, funds might lift service quality or opt to invest in higher cost investment classes with a view to increasing long-term net return. Both these actions could increase average costs, but are not necessarily detrimental to members, a point made by several participants (box 7.2).

Box 7.2 Some participant views on economies of scale

Several participants cautioned against a narrow view of pass through of scale benefits on the basis that it could flow through in the form of enhanced services rather than simply fee reductions. ASFA (stage 1, sub. 42, p. 19) noted that although scale economies may be realised, and reflected in downward pressure in some expense categories, this may be masked by higher expenses in categories not subject to economies of scale. First State Super (sub. 37, p. 8) also indicated that cross subsidisation between funds that outsource to the same administration may make it difficult to measure the benefits realised by size.

Participants noted that while benefits of scale may not necessarily be fully realised in the system, the right balance must be struck between the efficiency of large scale operators, market concentration and competition (for example, BT sub. 32; FSC, sub. 69, p. 4). At a sub-fund level, some participants argued that excessive choice of investment options increases costs for funds overall with a severe lack of scale in the great majority of options. They also suggested that consolidation within funds is an important indicator of the realisation of economies of scale to the benefit of members, including by reducing excessive investment choice (for example, AIST, sub. 39, p. 53).

Data limitations complicate an analysis of economies of scale in the system. Fund-level data are collected quarterly and annually by APRA — including on total assets, member accounts, administration and operating expenses, and investment expenses. Two issues in particular have implications for an analysis of economies of scale.

- There is substantial non reporting of investment expenses by funds. In approximately one quarter of all fund-year observations, reported investment expenses were \$0 (chapter 10). Most of this can be attributed to retail and corporate funds.
- APRA does not collect data on the (unit) fees members pay for products, except for MySuper products from late 2013.

Nevertheless, the Commission considers that analysis of economies of scale using APRA data (supplemented with research firm data on fees) provides useful insights.

Economies of scale are evident in the APRA-regulated system

Smaller funds typically have higher average costs when scale is measured for total expenses (scaled by either the number of members accounts or total assets), or for administration expenses (scaled by total assets) or investment expenses (scaled by total assets) separately, as demonstrated by the downward sloping relationships in figure 7.12. This is consistent with other studies that have found that economies of scale exist in the superannuation system.

It is also consistent with the results of the Commission’s preliminary econometric analysis (mentioned above).

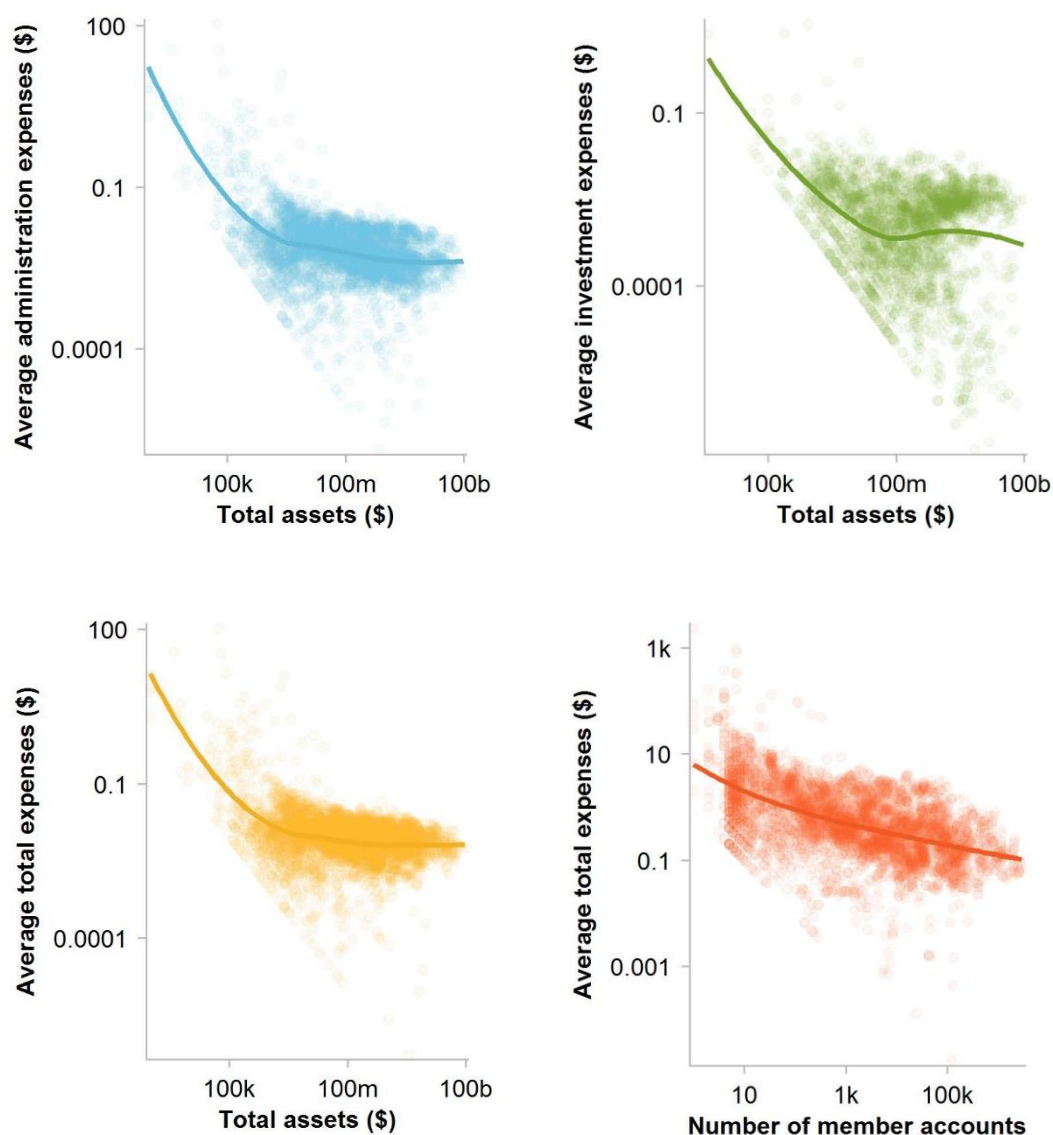
Diseconomies of scale are not apparent in these data although there appear to be diminishing returns to scale as funds get larger — as observed from the flattening of the relationships in figure 7.12 for average total expenses (by assets) and average total administration expenses (by total assets) in particular. However it should be noted that tiny changes (of a few basis points) in average costs for the system as a whole are material, given it is worth \$2.6 trillion (APRA 2018f; cameo 3.1).

That said, it is possible that scale economies could become diseconomies beyond a certain point, an issue that some studies have explored (and summarised in PC (2016c)). However, detecting a precise point at which diseconomies emerge is challenging given limitations with reported investment expenses data, and more fundamentally, because there are only a few really big funds in the system (section 7.2). This will be further explored in the forthcoming econometric analysis along with a survey of international literature.

Many funds have not achieved economies of scale

As noted in section 7.2, a close analysis of system exits over the period 2006–2016 reveals that most exits were of higher cost, subscale corporate and retail funds. This has contributed to economies of scale being realised in the system.

Figure 7.12 **Economies of scale are evident (in higher expenses) for small funds^{a,b,c,d,e}**
2004–2015



^a Logarithmic scales have been used to help clearly represent the downwards sloping relationship of average expenses and size over large ranges. ^b Observations with zero average expenses reported in fund-level APRA data or zero size have been removed. ^c Greater intensity in shading indicates greater overlap of observations. ^d Curves have been fit using local regression. ^e This figure draws on a panel of fund level data over time.

Source: PC analysis of APRA confidential data.

Table 7.2 Mixed results on whether funds have achieved economies of scale^a

Per cent, 2004–2015

	<i>Proportion of funds with higher average expenses at end of period (share of total assets)</i>	<i>Proportion of funds with lower average expense at end of period (share of total assets)</i>
Average Total expenses (per unit of assets)	49 (38)	51 (62)
Average Administration and Operating expenses (per unit of assets)	40 (38)	60 (62)
Average Investment expenses (per unit of assets)	67 (65)	33 (35)

^a This only includes funds that were still around in 2015 (not those that exited during the period) and that grew in total assets from their start date to 2015. In 2015 this constituted \$1.03 trillion in total assets.

Source: APRA confidential data.

There are some important caveats to note with these results. Aside from data quality issues there may be counteracting factors which have affected the ability of funds to achieve economies of scale over this period. For example, larger funds may be disproportionately affected by the impact of rising regulatory costs, disproportionately spending more to deliver higher service quality to members, or disproportionately seeking more exposure in higher cost illiquid assets with the aim of delivering better net returns to members. The Commission's econometric analysis will aim to test for these possibilities.

A large tail of small funds suggests unrealised economies

Despite many small funds exiting or merging over the past decade, the market structure of the system is still characterised by a few large funds and many more relatively small funds (section 7.2). Continued consolidation in the system and a reallocation of assets from the small funds to larger funds is likely to realise further economies of scale. This is not to say however, that the aim should necessarily be to have a system with very few funds. This would need to be balanced against the effects of a lack of competition from too few providers, insufficient product diversity or the costs of mergers that may be quite large.

INFORMATION REQUEST 7.1

What are the main types and quantum of costs involved in fund mergers? How do these vary depending on the size of funds involved?

Is there evidence of pass through?

From a member's perspective, realised economies of scale are of no benefit if they are not passed through by their fund in some form. Clear evidence of pass through of realised economies of scale to members in the form of lower fees, or higher net returns would be a strong indication of effective competition. This is an issue that can only be robustly explored using econometric analysis, although some preliminary observations are worthwhile.

The Commission's econometric results to date have not provided evidence of strong pass through of benefits from scale in the form of lower fees. This is consistent with the observation from the Financial System Inquiry:

The superannuation system is not operationally efficient due to a lack of strong price-based competition and, as a result, the benefits of its scale are not being fully realised. Substantially higher superannuation balances and fund consolidation over the past decade have not delivered the benefits that would have been expected; these benefits have been offset by higher costs elsewhere in the system rather than being reflected in lower fees. (Murray et al. 2014, p. 89)

In further analysis, the Commission will explore the possibility that cost reductions from scale have been realised, but are offset by other cost drivers such as funds choosing to pass-through benefits in the form of better service quality or higher returns through higher cost investment strategies. There are some indications that larger funds have been able to deliver higher net returns, in part due to greater exposure to particular asset classes, although the relationship is not consistent across all larger funds. This issue, and the extent to which increased regulatory costs (such as from the introduction of SuperStream) may have also offset potential cost reductions in the short to medium term, will be covered off in the Commission's technical supplement on economies of scale.

INFORMATION REQUEST 7.2

What evidence is there that funds are passing through economies of scale to members in the form of lower fees, or to members through other channels? Why has the pass-through of scale benefits occurred as it has?

DRAFT FINDING 7.5

Over the past decade, significant economies of scale have been realised in the superannuation system, but this has mainly been driven by the exit of small, high-cost funds. It is not evident that individual funds have been able to realise cost efficiencies as they have grown in size.

8 Insurance

Key points

- Around 12 million Australians hold insurance — for life, total and permanent disability, and income protection — through their superannuation, with about 80 per cent of these policies provided automatically (requiring members to opt out or amend cover if it is unsuitable). Premiums vary widely, but in total increased by 35 per cent over the past three years to \$9 billion in 2016-17 (including an estimated \$1.9 billion on unintended duplicate policies).
- Current settings are more a function of history than considered policy design. The suitability of insurance relies on trustees balancing cover for members against the erosion of account balances for retirement — avoiding unnecessary balance erosion is a formidable task.
- Many members benefit from the lower costs and ready access provided by default group insurance arrangements in superannuation. These arrangements also potentially address an underinsurance problem (although this is not assessed in this inquiry).
- But many entrenched problems remain (and insurance accounts for over a third of member complaints against their fund). These are exacerbated by a lack of awareness by (around a quarter of) members as to whether they have such insurance. Particularly for young workers — either with no dependents (in the case of life insurance) or low incomes (in the case of income protection) — insurance is poor value and does not meet their needs.
- Balance erosion can be excessive and highly regressive — having a disproportionate impact on members with low income, intermittent labour force attachment and/or multiple accounts with insurance (17 per cent of members). The reduction in retirement balances for many of these members could reach 14 per cent (\$85 000), and for some disadvantaged members could be reduced by over a quarter (\$125 000). Trustees should be required to annually determine the 'balance erosion trade-off' for their members and publish it on their website.
- Some members have policies that are of little or no use to them — including 'zombie' policies that cannot be claimed against (income protection being the main and expensive culprit). Funds could better use member data (around 10 per cent of funds use no data, not even low cost imputed data) to inform product design and ensure offerings meet members' needs. The lack of comparability across insurance products makes switching to better superannuation products difficult for members and limits competitive forces.
- The Government-prompted industry code of practice, while a step in the right direction, falls short of what is needed. Its ultimate success depends on it being universally adopted by funds, its provisions being much bolstered and it being effectively enforced. An ASIC-APRA taskforce should monitor code adoption and provide guidance to industry on how to bolster the code. Signing the code should immediately be made compulsory to hold MySuper status. Industry should be given two years to make the bolstered code binding and enforceable.
- Additional actions are required to weed out poor value policies — insurance should only be provided on an opt-in basis to members under 25, and cover should cease for all members on inactive accounts after 13 months, unless the member explicitly chooses otherwise.
- An independent review of insurance in superannuation should be initiated within four years to review progress and determine whether further policy interventions are needed.
- The Commission was asked to estimate the fiscal impact of insurance in superannuation. Existing (public) fiscal estimates underestimate the fiscal impact of insurance in superannuation as they do not consider the impact of balance erosion on Age Pension eligibility. The Commission will prepare an estimate for the final report.

This chapter examines whether insurance in superannuation is delivering value for money to members. The assessment is based on the criteria outlined in the stage 1 study, but expanded in areas to address the terms of reference for stage 3. The assessment does not consider the broader policy question of whether insurance should be opt in or opt out in superannuation. Such an assessment is beyond the scope of the current terms of reference, and is an inquiry in itself (requiring an assessment of underinsurance in Australia and the distributional and wellbeing impacts of that underinsurance). Rather, the focus of this inquiry, if the Commission finds that insurance is not providing value for money for all members, is to consider what changes to the current arrangements are warranted, without undermining the benefits insurance in superannuation provides.

Section 8.1 describes the framework used by the Commission. Section 8.2 provides some context about current arrangements. Section 8.3 examines the impact of insurance on members' account balances. Section 8.4 evaluates the value for money of insurance. Section 8.5 outlines recent initiatives, including the voluntary industry code of practice, while section 8.6 discusses further changes that are required. Section 8.7 canvasses the fiscal effects of insurance in superannuation and outlines further work the Commission intends to undertake on this issue.

8.1 A framework for assessment

The broad objective of superannuation is to provide an income source in retirement. In some circumstances, there is some alignment between this objective and the objectives of insurance — life, total and permanent disability (TPD) and income protection (IP) — in superannuation.

- For TPD cover, insurance contributes to retirement income, as it insures against the risk that a member's accumulation phase is cut short.
- For life cover, the links are less clear, except to the extent that insurance payouts can fund the retirement of a dependent partner.
- For IP cover, there may be a link if Superannuation Guarantee contributions are deducted from the payment, or if the payment assists the worker to re-enter the workforce (for example, through facilitating rehabilitation programs).

There are a number of rationales that support the case for insurance in superannuation.

- Superannuation provides a pooling mechanism to facilitate group insurance policies that can be provided more cheaply than individually underwritten policies. The cost effectiveness of group insurance is primarily attributable to lower distribution costs (there is no need to pay commissions to insurance agents to sell the product given the opt-out arrangements) but group insurance also has lower advice, administration and underwriting costs.⁶²

⁶² It is the opt-out nature of insurance, not the fact that insurance is contained in superannuation that delivers the group insurance benefits — alternative opt-out arrangements for insurance could be developed.

-
- Group policies can charge lower premium costs by pooling risk and reducing adverse selection, particularly under opt-out arrangements. This means that an individual with higher risk factors can access insurance at a substantially cheaper rate than under an individually underwritten policy.
 - The default opt-out arrangements that facilitate group insurance assist in addressing reported problems of underinsurance.⁶³
 - There are potential benefits to individuals from having life insurance through superannuation compared with purchasing it outside of superannuation. It allows members to pay for insurance using funds that cannot otherwise be currently spent and that are taxed concessionaly.⁶⁴

However, as the Commission noted in its previous work (PC 2016b, 2017c), the provision of insurance in superannuation is marked by conflicting objectives on fund trustees. Trustees are obligated to offer insurance on an opt-out basis in MySuper products, but must simultaneously ensure that the cost of this insurance does not inappropriately erode members' retirement incomes.⁶⁵

The Commission's assessment of the efficiency and competitiveness of insurance in superannuation is designed to ensure that it delivers value for money to members. While, there are potential efficiency and member wellbeing benefits from insurance in superannuation, there is also a range of potential 'leakages' that harm members and reduce value for money, including:

- excessive balance erosion — for some members, expensive insurance premiums (relative to contributions) can lead to a significant reduction in balances at retirement
- low value policies — some members pay premiums for policies that provide them with little or no value. While some cross-subsidisation is necessary for group insurance to function, inappropriate cross-subsidisation should be constrained.

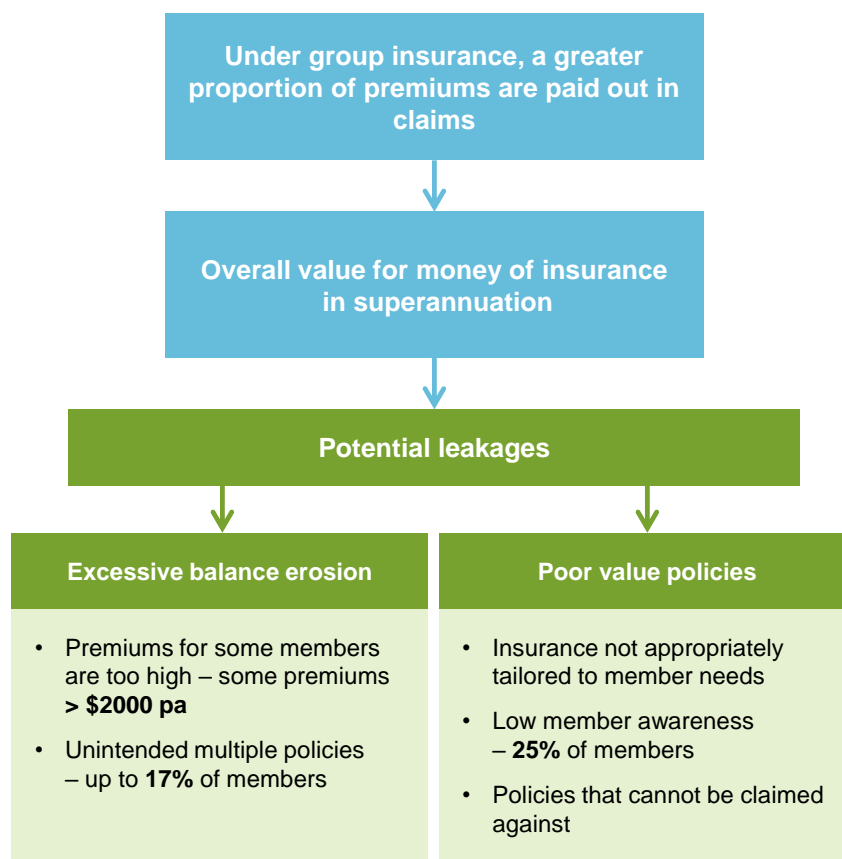
The Commission's approach to assessing the value for money of insurance in superannuation is illustrated in figure 8.1. The suitability of these arrangements relies on trustees balancing provision of insurance cover for members today against the erosion of lower balances at retirement — avoiding unnecessary erosion is a challenging task.

⁶³ Rice Warner (2016a) noted that default group insurance in superannuation goes some way to addressing the underinsurance gap in Australia (that is, Australians are typically insured for less than is required to meet their basic needs in the event of death or permanent disability). The Commission has not made an assessment of the underinsurance gap in Australia in this report, but rather considers whether policies represent value for money.

⁶⁴ This does not apply to income protection insurance premiums as these are typically tax deductible outside superannuation, or for individuals whose average tax rate is below 15 per cent.

⁶⁵ MySuper products are required to include life and TPD insurance on an opt-out basis. Trustees may also include IP insurance on an opt-out basis in MySuper products.

Figure 8.1 Assessing the value for money of insurance for members



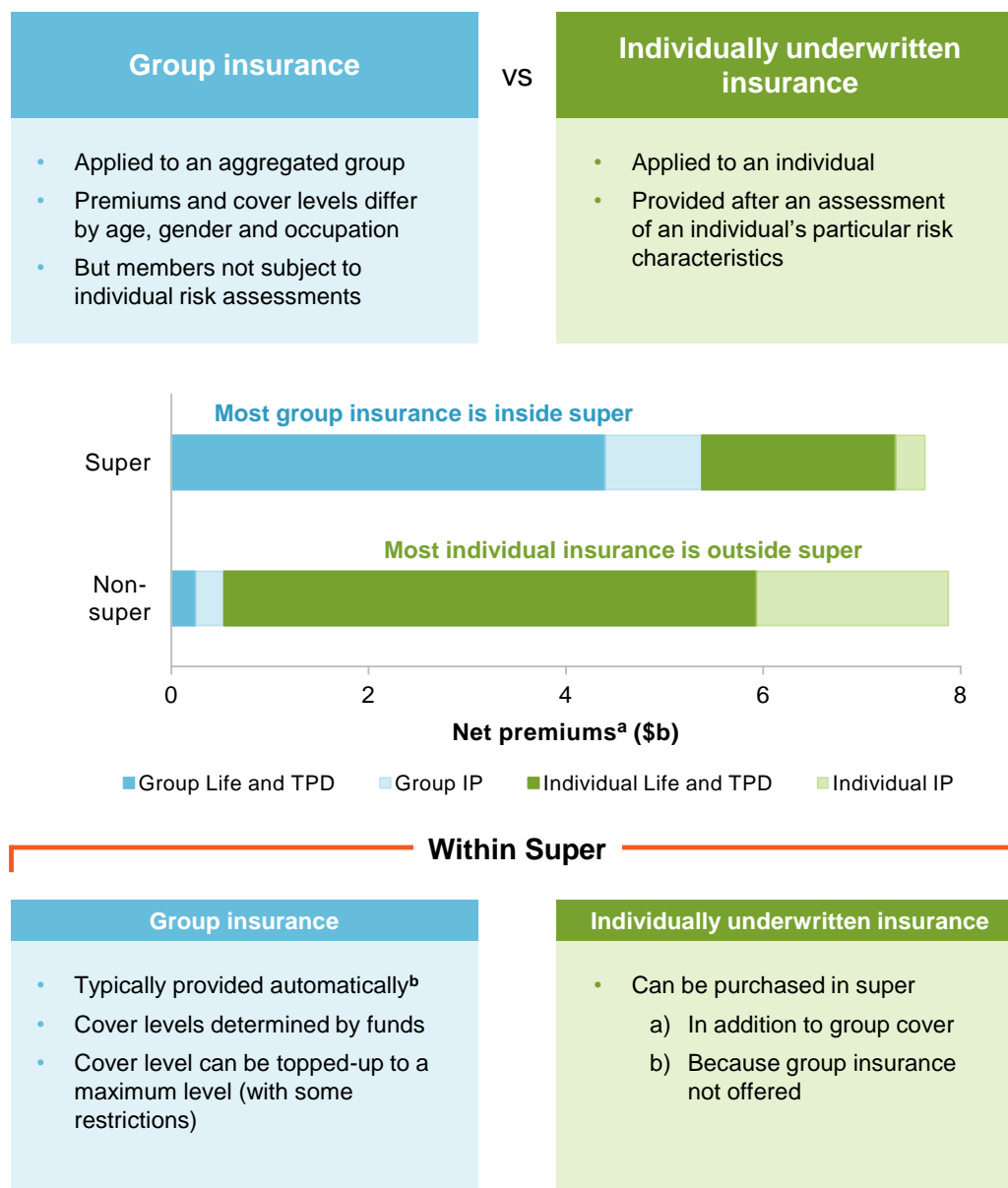
8.2 Some context

Life, TPD and IP insurance is permitted within superannuation, with premiums deducted from members' superannuation account balances. Insurance can be organised on either a group or individually underwritten basis. Most insurance in superannuation is group insurance and is provided on an opt-out basis (figure 8.2).

In determining their insurance settings, fund trustees are bound by their trust obligations to operate in the best interests of beneficiaries (the members); section 52(7) of the *Superannuation Industry (Supervision) Act 1993* (Cwlth) (SIS Act), which among other requirements, requires trustees to only offer insurance if it 'does not inappropriately erode the retirement income of beneficiaries'; and Prudential Standard SPS 250, which requires registrable superannuation entity (RSE) licensees to have an insurance management framework, which includes how it will address the requirements set out in the SIS Act, processes for monitoring and reviewing insurance benefits, its approach to claims management and dealing with conflicts of interest.

Figure 8.2 **Superannuation facilitates group insurance**

Characteristics of group and individual insurance



^a Net premiums for the year to June 2016. ^b MySuper products are required to provide life and TPD insurance on an opt-out basis.

Source: APRA (2018d).

There appear to be few international parallels to default opt-out insurance in superannuation. A high-level assessment of seven other countries by KPMG (2017) noted that only Chile and Canada had insurance within their pension schemes,⁶⁶ but these differed from the default arrangements in Australia because members were often unable to opt out.

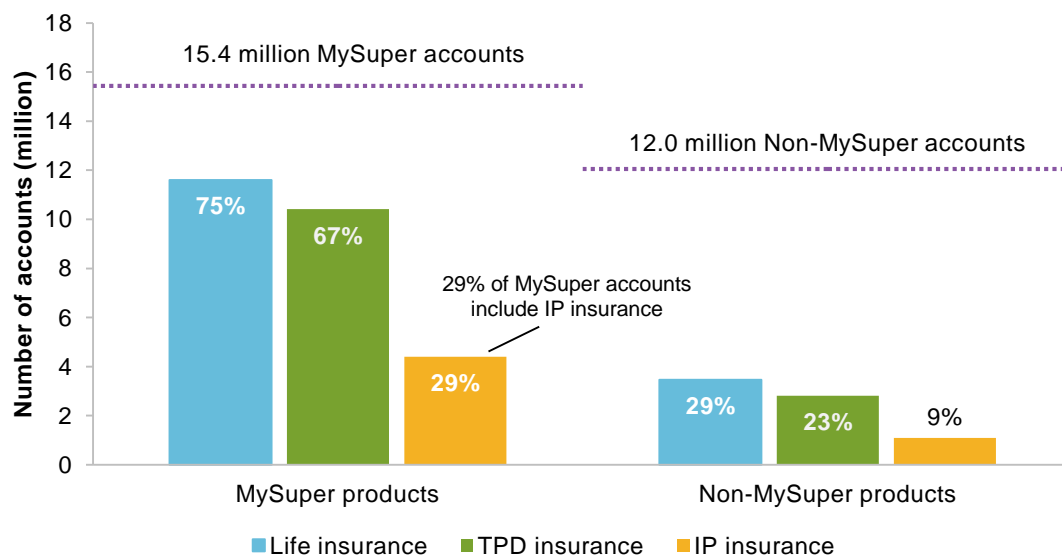
⁶⁶ Of the seven countries examined, which also included the United States, New Zealand, Sweden, the United Kingdom and France.

How big is the footprint of insurance in superannuation?

Insurance within superannuation accounts for just under half of the total market (in terms of net premiums) for life, TPD and IP insurance in Australia (figure 8.2). While difficult to pinpoint accurately, overall, there are around 12 million individuals with some type of insurance through their superannuation.⁶⁷

- Around half of all superannuation accounts (and three quarters of MySuper accounts) have premiums deducted for one or more insurance products (figure 8.3).
- Life insurance is the most commonly held insurance in superannuation, closely followed by TPD, with IP insurance held by a much smaller number of accounts.
- Most accounts with insurance (across both MySuper accounts and accounts in the choice sector) have automatic group cover rather than individually underwritten cover (figure 8.4). Overall about 80 per cent of policies within the superannuation system are provided through default group cover.

Figure 8.3 Most accounts in MySuper have insurance^a
Superannuation accounts with insurance, June 2017



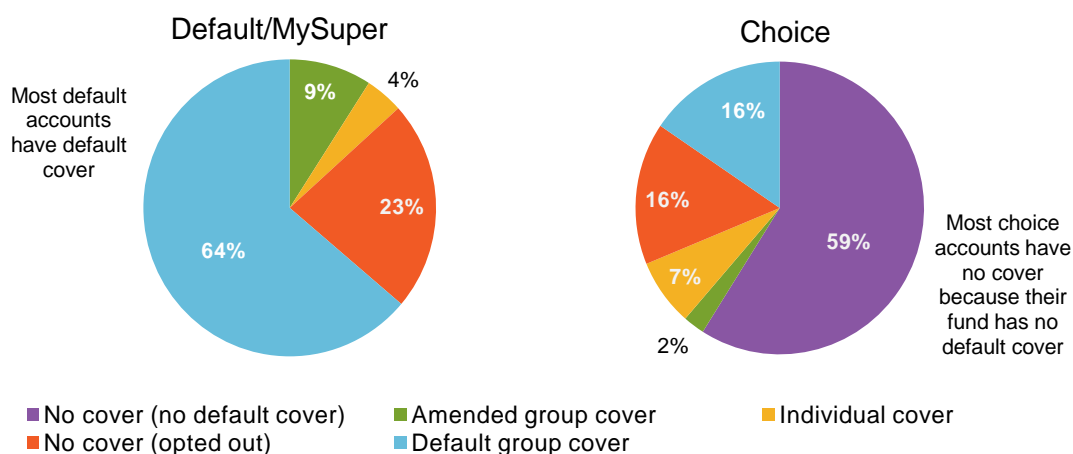
^a Total accounts is for entities with more than four members.

Sources: APRA (2018b, 2018c).

⁶⁷ This is an estimate using ATO data on accounts with insurance, although it is likely an underestimate, as it is based on member accounts with a tax file number attached. The number of unique individuals is not discernible from published APRA data as this counts total accounts with each insurance type.

Figure 8.4 Disparate insurance cover across MySuper and choice accounts^a

Per cent of accounts, 2016-17



^a 75 funds responded to at least one of choice and default sections for 2016-17 of this question in the funds survey, representing 59 per cent of balances and 51 per cent of accounts. Data represents 2016-17 responses.

Source: Funds survey.

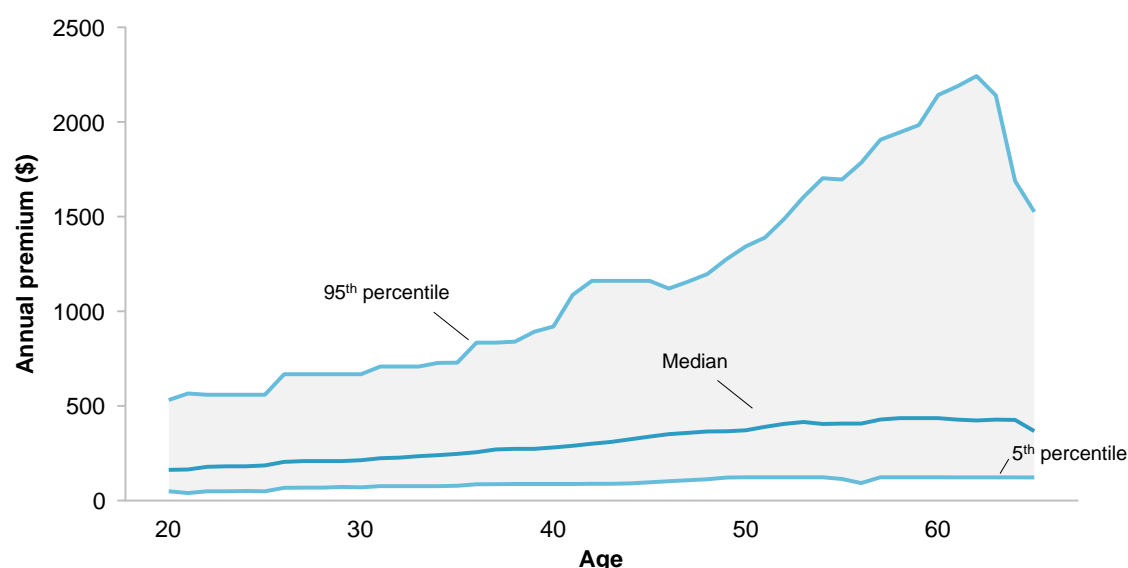
Default insurance premiums

The default premiums that members pay vary widely — while average premiums hover around \$300 per year, they can be as high as \$2000 per year (figure 8.5). The most obvious discriminating factor is age — premiums tend to increase by age (reflecting increasing risk), but then decrease again at older ages as funds reduce the default levels of cover. But there are a number of other reasons why default premiums differ. For example:

- some members are subject to risk loadings to account for the risks associated with more manual and/or hazardous work — ‘light’ blue collar products are around 20 to 40 per cent more expensive than comparable white collar products, while ‘heavy’ blue products can be more than twice as expensive than comparable white collar products
- some funds include IP insurance in their default cover, while others do not. For example, a worker with a white collar loading will on average pay around \$250 per year more if their default cover includes IP insurance
- funds choose different levels of default cover and charge different prices per unit of cover.

Figure 8.5 Default premiums vary significantly between funds^a

Annual default premiums (\$), 2017



^a Default premiums for a male who is a non smoker.

Source: PC analysis of Rice Warner data.

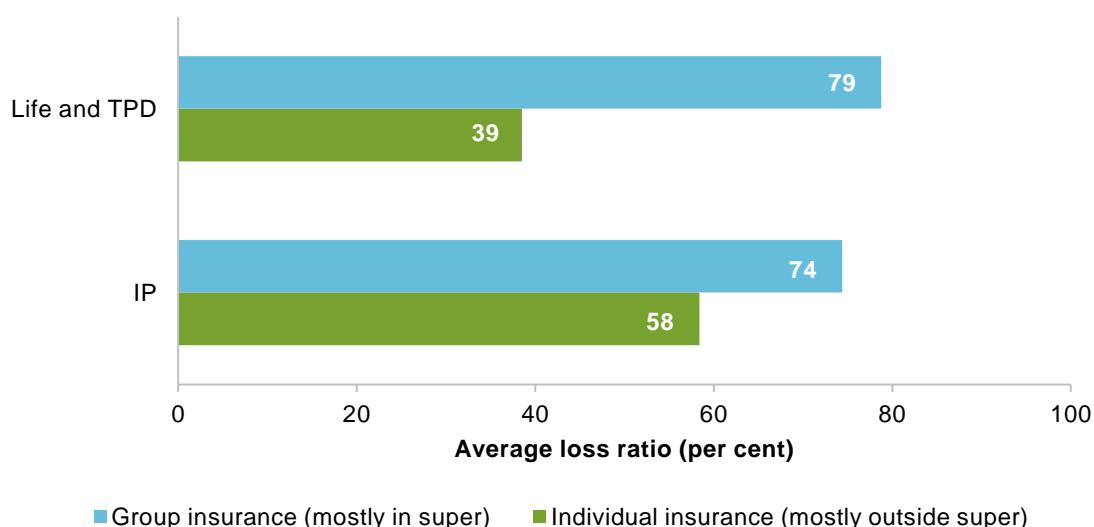
Insurance in superannuation pays out a relatively high proportion of premiums

Australian Prudential Regulation Authority (APRA) data indicate that insurance in superannuation has relatively high loss ratios (the proportion of premiums paid out as claims), although there are data limitations that impact their accuracy. While it is difficult to directly calculate loss ratios for insurance inside superannuation, this calculation can be performed for group insurance (which is mostly inside super) and individually underwritten insurance (which is mostly outside super).⁶⁸ Group insurance provides loss ratios of around 75 to 80 per cent, reflecting the much lower cost base of group insurance, compared with individually underwritten policies (40 to 60 per cent) (figure 8.6).

⁶⁸ Premiums and claims do not always occur in the same year, which means that to calculate loss ratios, data on the changes in the Outstanding Claims Reserves (reserves set aside for claims that are expected to still emerge in respect of that period) and the Unearned Premium Reserve (a reserve set aside for premiums paid in advance) need to be considered. Data on the changes in these reserves are not available for insurance inside superannuation.

Figure 8.6 Insurance in super pays out a higher proportion of premiums as claims^a

Average loss ratio, 2009-10 to 2016-17



^a Loss ratios are approximations because of data limitations. They are calculated as the total amount of claims plus any change in Outstanding Claims Reserves (reserves set aside for claims that are expected to still emerge in respect of that period) divided by the total amount of premiums less changes in the Unearned Premium Reserve (a reserve set aside for premiums paid in advance). Loss ratios are net of outward reinsurance. Average loss ratios are calculated as a simple average of annual loss ratios between 2009-10 to 2016-17.

Source: PC analysis of unpublished APRA data.

That said, there is some indication that loss ratios have been decreasing in recent years.⁶⁹ Premiums in the past three years have increased significantly, such that at the system level, premiums are accounting for an increasing share of the contributions into superannuation (table 8.1). This is likely to be an unavoidable but costly ‘pendulum swing’ following the significant losses experienced by insurers attributable to the under-pricing of the risk of the pool by insurers (Rice Warner 2016a). AIA Australia submitted that:

Pricing competition between group insurers was so significant that it contributed to reduced insurer and reinsurer margins and significant losses across the market for the years ending June 2013 to June 2014. Over the past three years premiums have risen to reflect the deteriorating claims experience and increased capital requirements. (sub. 76, p. 11)

The value of claims has also increased over this period (figure 8.7).

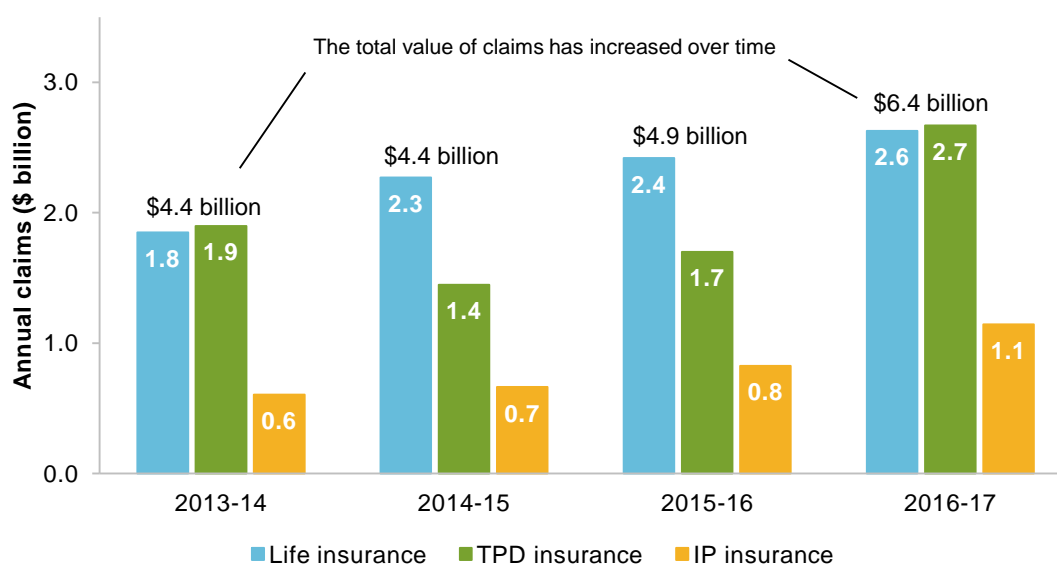
⁶⁹ The year-to-year variation in insurance claims means that multiple years of data are required before observing long-term changes in loss ratios.

Table 8.1 Aggregate premiums increasing relative to contributions^a
2013-14 to 2016-17

	Units	2013-14	2014-15	2015-16	2016-17
Total insurance premiums collected	\$m	6 661	7 866	8 445	9 010
Total contributions ^b	\$m	95 246	104 080	104 181	116 972
— insurance premium share	%	7.0	7.6	8.1	7.7
Superannuation Guarantee contributions ^b	\$m	NA	53 521	55 701	59 041
— insurance premium share	%		14.7	15.2	15.3

^a For entities with more than four members. ^b Contributions are for all members not just those with insurance.
Sources: APRA (2018c, 2018f).

Figure 8.7 Insurance claim payments have increased over time^a
\$ billion, 2013-14 to 2016-17



^a Data are for entities with more than four members. IP payments are commonly made for two years and thus a single claim is likely to have payments spanning two or three financial years.

Source: APRA (2018c).

Current arrangements (and problems) have evolved over time

The nexus between insurance and superannuation goes back a long way (box 8.1). Current settings are arguably more a function of history than considered policy decision and design. Accordingly, there is no specific policy architecture governing how insurance should be

delivered to members. Rather, the suitability of arrangements relies on the broad obligations of trustees acting in members' best interests and some degree of regulatory oversight.

Box 8.1 A brief history of insurance in superannuation

The connection between insurance and superannuation began in the 1950s with life insurance companies beginning to offer superannuation products (primarily to the public sector and to male professionals in large companies). Following the introduction of compulsory superannuation in 1992, insurance continued to be provided in most default products.

Legislative requirements to offer insurance were introduced in the 2005 Choice of Fund reforms. It specified that default funds must provide a minimal level of life insurance cover (but not TPD or IP insurance). Funds did not necessarily have to give members the choice to opt out.

The 2010 Cooper Review made the following findings on insurance in superannuation:

The Panel considers that life and TPD insurance strongly supports the principles of the superannuation system. The Panel believes that in the MySuper sector, where members are least likely to give consideration to their insurance needs, the trustee should be required to offer life and TPD insurance on an opt-out basis.

Requiring MySuper products to offer life and TPD insurance on an opt-out basis provides a safety net to members who might otherwise not consider their insurance needs; a view supported by many submissions. This will lower the cost of insurance for most members in MySuper, because there is pooling of risk between members who face different risks and financial circumstances. (Cooper et al. 2010b, p. 144)

In response, the Australian Government — under the 2013 Stronger Super reforms — made it mandatory for funds to provide life and TPD insurance, on an opt-out basis, in all MySuper products.

Since then, in response to concerns from government and regulators, the Insurance in Superannuation Working Group (ISWG) developed a voluntary code of practice, which contains provisions aimed at improving member outcomes with respect to insurance cover. The code is yet to come into effect, so final adoption levels are still unclear. Further iterations of the code with additional provisions are planned, but timing remains uncertain. This is because of the current focus on adoption (and development of transition plans) of the initial code, and that the priorities, (including administrative processes and accountabilities) for future developments are yet to be determined, and thus remain unknown to the Commission at this time.

These arrangements have led to a litany of problems, which is in part evidenced by insurance matters accounting for over a third of member complaints against superannuation funds.⁷⁰ Issues include:

- a lack of awareness by members that insurance is included in their superannuation

⁷⁰ In 2016-17, the Superannuation Complaints Tribunal received 1376 complaints within its jurisdiction. Just over 50 per cent of complaints (694) were related to administrative matters, of which 195 complaints (28 per cent) were related to insurance matters, including the deduction of insurance premiums. Twenty per cent of complaints (273) were classified as disability-related, which covers complaints related to TPD and IP claims. A further 30 per cent of complaints were categorised (409) as death, which would also include complaints about insurance claims, but the bulk of these complaints (366) were about the distribution of death benefits (SCT 2017a).

- the complexity and lack of comparability of insurance products
- excessive balance erosion
- account proliferation resulting in many members holding multiple insurance policies, some of which they would be ineligible to claim against (so called ‘zombie’ policies).

Increases in premium costs in recent years have magnified the magnitude of these concerns.

Notwithstanding some acknowledgment of the scope for improvement, there is broad industry support for the presence of insurance in superannuation, including on a default, opt-out basis (box 8.2).

Box 8.2 The benefits of insurance in super — industry views

AustralianSuper stated that:

Insurance is an important part of the superannuation system. The purpose of insurance is to protect members’ incomes and the future of those who matter to them. AustralianSuper believes that there is an opportunity to improve insurance within the superannuation system but strongly believes it is an important safety net for working Australians and helps alleviate pressure on social security. (sub. 43, p. 11)

Rest Industry Super submitted:

REST is of the view that flexible and affordable insurance should be a core part of any default superannuation model. It should not be separated. (sub. 49, p. 12)

Mercer noted that:

... insurance cover represents an important part of the Australian superannuation industry. In fact, it has been considered critical by previous Governments and hence is a compulsory part of MySuper products. (sub. 57, p. 6)

ANZ submitted that:

It provides a safety net to those who would have otherwise not chosen, or not been able, to take out life insurance individually. It therefore plays a pivotal role in reducing costs to the Australian Government and providing economic and social benefits to Australians who may not engage or understand the importance of insurance. (sub. 73, p. 17)

Rice Warner submitted that:

... insurance in superannuation provides a valuable benefit for working age Australians and their families. If life insurance were not built into the design of a MySuper product, most members would not be covered. The growth of insurance within superannuation over the last 30 years has closed the gap significantly between the insurance needs for a member (and their family) and the amount of cover provided.

Further, life insurance is provided in a way that is efficient, competitive and offers benefits to the Government and economy by way of reduced social security payments and increased spending capacity for members and their families. (sub. 46, p. 2)

Other participants, including those representing member interests, were generally supportive of the role that insurance in superannuation plays in providing a safety net for members, but many raised concerns about the deficiencies inherent in the current settings (box 8.3).

Box 8.3 Insurance in super — views from outside the industry

Some participants submitted that insurance benefits could be of great assistance to recipients. For example, MS Australia said:

... it is crucial that TPD and to a lesser extent income protection insurance benefits remain accessible under the current opt out regime. Any reduction in the availability of insurance benefits and in particular automatic acceptance eligibility would have significant consequences for people with chronic illnesses whose working lives may be cut short because of disability, such as MS. (sub. 44, p. 4)

Consumer Action Law Centre, Berrill and Watson Lawyers and the Chronic Illness Alliance submitted that:

Superannuation has delivered life insurance to millions of Australians in an efficient and affordable pathway. It has had its problems over the last five years, problems that are in need of rectification to protect the integrity of the retirement incomes system. ...

It is our strong submission that it would be throwing the baby out with the bathwater to move default superannuation to an opt in insurance model. It would put the retirement incomes of thousands of Australians at risk and add to the burden on the Australian taxpayer. (sub. 55, p. 9)

Individual participants raised differing views about insurance in superannuation. For instance:

... this is the most tax effective way to get this cover. (Munro, sub. 31, p. 2)

... many would opt to take out disability insurance if that was available as a separate product. However, typically death cover is bundled with disability insurance in many main stream superannuation funds with no ability to take only one. (Rogers, sub. 2, p. 1)

... life insurance offered should be on a strictly opt in process and it should be very clear what the payment is before signing up. I do not understand why Life Insurance is a deduction from Super Funds, it should be totally separate. (Clapham, sub. 14, p. 1)

We strongly believe that insurance should be opt-in rather than opt-out. In the case of our daughter, she has intermittent work while completing a doctorate having amassed the sum of about \$600 over 3 years. She was unaware that she could opt-out of the insurance component that, together with fees, have eroded her contributions. (Hemming and Delliou, sub. 38, pp. 1–2)

Similarly, Choice raised concerns about complex and diverse policy terms and conditions:

Consumers need greater protection in the bundled life insurance market and this can only be achieved through standardisation of cover. In recent years some funds have attempted to control premium increases by making cover more restrictive. For consumers this is a zero sum game. More restrictive definitions may lead to a reduction in premiums for the membership as a whole, but will make it harder for those needing to make a claim. Meanwhile, the ever growing diversity of policies makes comparison between offers close to impossible for consumers. (sub. 71, p. 11)

Another perspective is that of other financial sector interests, such as financial advisors:

ClearView believes that a system which requires members to consciously opt-in for group insurance in super will result in a substantial improvement in understanding what they are, and aren't, covered for and how much cover they have. This will significantly reduce the number of workers who think they, and their loved ones, are adequately protected when they're not. Importantly it will lead to more workers seeking advice, either via their super fund or a third party, about the type, and level, of cover they need. (ClearView, sub. 48, pp. 5–6)

8.3 How significant is balance erosion?

The deduction of insurance premiums over a member's lifetime reduces their superannuation balance, resulting in less disposable income in retirement. This section assesses whether this trade-off is beneficial for all members, focussing primarily on the impact of default cover on account balances (because most members are disengaged and have not made a deliberate choice to expend their superannuation savings in such a manner). Earlier chapters analysed the effects of balance erosion as they relate to administration and investment fees (chapter 3) and unintended multiple accounts (chapter 6). The latter estimated the total system-wide premiums collected from unintended duplicate insurance policies to be about \$1.9 billion per year. It found that multiple insurance premiums are a key reason that a representative member with two superannuation accounts (from ages 25–45 years) would be over \$55 000 worse off at retirement compared with a member that has one superannuation account.

Balance erosion is a key input into the broader question of whether insurance represents value for money for members — that is, are premiums too high given the level of cover that members receive? An evaluation of the value for money of insurance in superannuation is provided in section 8.4.

There is a range of factors that can lead to significant balance erosion for many members.⁷¹ These can be categorised as factors that either lead to higher premiums or that reduce member contributions (and thus increase the relative impact of insurance premiums on balances at retirement).

On the premium side of the equation:

- some funds have higher than average default premiums (due to higher levels of automatic cover or higher costs per unit of cover)
- some members have multiple accounts with insurance cover, which means that they pay additional premiums
- many funds (about a third) include IP insurance — which can be quite expensive — in their default cover
- members in relatively hazardous occupations may have risk rating factors applied to their premiums to account for higher levels of risk
- members who choose individually underwritten insurance policies may have substantially higher levels of cover, and therefore premiums, than those who are covered by group insurance. Individually underwritten policies also tend to have a higher cost per unit of cover.

⁷¹ There is no widely-accepted definition of inappropriate balance erosion, but the recently released industry code of conduct has set out a benchmark premiums not exceeding 1 per cent of average salary for the membership generally and/or segments of the membership. The Commission considers this to be a reasonable benchmark.

On the contributions side:

- members with low incomes are more susceptible to balance erosion (default premiums typically do not vary with income — although a fund may take into account income levels across its membership in setting cover levels)
- balance erosion can be particularly high for members who have periods out of the workforce because during those times there are no contributions to offset insurance premiums.

Balance erosion effects are not insignificant

The Commission has used its cameo model (chapter 1) to analyse the balance erosion implications of insurance under a range of scenarios (table 8.2). The base case scenario shows that an individual who earns roughly the average annual total earnings over their lifetime could expect insurance premiums to reduce their balance at retirement by 4 per cent, given the cameo model assumptions. These cameos only consider the impact of insurance premium deductions on account balances at retirement and do not take into account any offsetting benefits to members, such as a successful claim on their insurance, or the peace of mind from insurance, even when no claim is made.

The results of the first three cameo scenarios (summarised below) suggest that insurance-related balance erosion can readily rise to 5 to 7 per cent of balances at retirement.

- *Higher than average premiums* — increasing the average lifetime premium from \$282 to \$541 (representing the inclusion of IP insurance) increases balance erosion from 4 per cent to 6.9 per cent at retirement.
 - There is significant variation in the default insurance premiums included in superannuation products (figure 8.8). (The inclusion of IP insurance is used as an example of a member paying higher-than-average insurance premiums.)
- *Low incomes* — an individual who enters the workforce on a full-time minimum wage (\$36 000) incurs balance erosion of 5.6 per cent at retirement.
 - The higher balance erosion occurs because a low income member will make fewer contributions over their lifetime, leading to insurance premiums having a proportionally higher impact on retirement savings.
- *Interrupted work history* — a worker with an interrupted work history will experience balance erosion of 5.6 per cent at retirement.
 - This scenario assumes that an individual exits the workforce for five years at age 28 years (for example, on parental leave) and then works part time for five years from age 33 years before returning to full-time work. The worker does not receive any experience-based wage increases while they are out of the workforce.

Table 8.2 Balance erosion cameo scenarios^{a,b}

Scenarios	Contributions			Premiums			Balance erosion at retirement		
	Starting wage	Average wage ^c	Work history	Insurance cover	Risk loading	Multiple policies	Average premium	Real value	Share
	\$	\$					\$	\$	%
Average worker	50 000	63 000	Full-time	Life and TPD	White collar	No	282	35 000	4.0
IP insurance	50 000	63 000	Full-time	Life, TPD and IP	White collar	No	541	60 000	6.9
Low income	36 000	45 000	Full-time	Life and TPD	White collar	No	282	35 000	5.6
Interrupted work history	50 000	51 000	Intermittent	Life and TPD	White collar	No	282	35 000	5.6
Multiple accounts	50 000	63 000	Full-time	Life and TPD	White collar	Yes	409	55 000	6.4
Low income worker	36 000	45 000	Full-time	Life, TPD and IP	Light blue collar	No	771	85 000	13.6
Cumulative impact	36 000	37 000	Intermittent	Life, TPD and IP	Light blue collar	Yes	995	125 000	28.2

^a The assumptions underpinning these cameos are set out in chapter 1. ^b Assumptions that are different from the 'Average worker' scenario are in bold. ^c This excludes the effect of real wage increases (all cameo scenarios assume economy-wide real wage growth of 1.5 per cent annually).

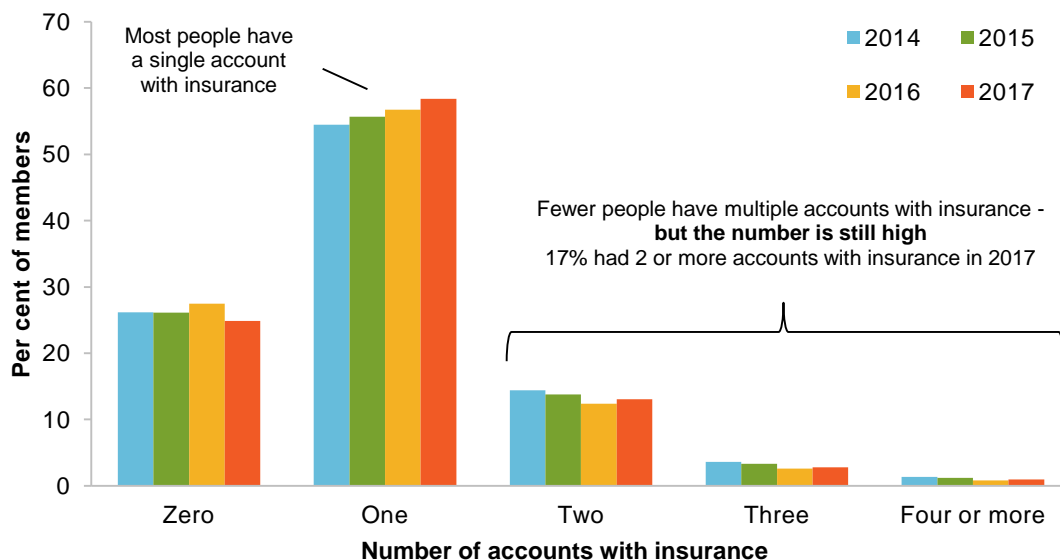
Multiple accounts exacerbate balance erosion effects

The effects of balance erosion in superannuation accounts are exacerbated when members have multiple accounts with insurance. This erosion is particularly egregious because members may be over-insured, or unable to claim on multiple insurance policies (though this is predominately a problem with multiple IP policies — the least common type of cover).

Holding multiple superannuation accounts with insurance is relatively common. While there has been some improvement since 2014, in 2017 an estimated 17 per cent of members still had two or more accounts with insurance (figure 8.8).

Most of the additional accounts that members hold are likely to be inactive (where there have been no contributions in the past 12 months). Rice Warner estimated that 25 per cent of accounts with insurance are inactive, while data from the Commission's funds survey suggest that there are at least 3 million inactive accounts that include insurance cover.

Figure 8.8 Many members have multiple accounts with insurance^a
Number of accounts with insurance, 2014–2017



^a ATO data only include accounts with tax file numbers only, and do not distinguish between the type of insurance in different accounts.

Source: PC analysis of ATO confidential data.

The Commission’s analysis suggests that a member holding two accounts deducting insurance premiums between the ages of 22 and 41 (and one account deducting insurance thereafter), would have a balance at retirement that is 6.4 per cent lower than if they had no insurance cover (but still had multiple accounts). These results are consistent with Rice Warner’s analysis of inactive accounts:⁷²

Our analysis indicated that a large portion of the membership has insurance premiums deducted without any contributions being made. ...

We found a large impact on the retirement balance when insurance premiums continue after contributions cease. This is particularly evident for those at younger ages. For members with a Heavy Manual occupation, at younger ages the account balance is completely eroded; further, there is a significant impact at all ages, though cover reduces near retirement. (sub. 46, p. 15)

⁷² KPMG (2017) estimated that removing insurance from multiple accounts would only have a modest effect on the average level of balance erosion because it assumed that a large share of duplicate accounts were likely to be very small balances (less than \$1000) resulting in multiple insurance policies being limited by exhaustion (or triggering of a fund cessation rule). However, this assumption is implausible. First, ATO data indicates that in 2016-17, around 50 per cent of members with duplicate accounts had less than 90 per cent of their total balance in their main fund. This, coupled with data that shows that members with multiple accounts on average have similar total balances to members with a single account (chapter 6), suggests that many multiple accounts have non-trivial balances. Second, the persistence of multiple accounts across all ages (figure 6.5) suggests that duplicate accounts are not being exhausted.

Balance erosion can be large and is highly regressive

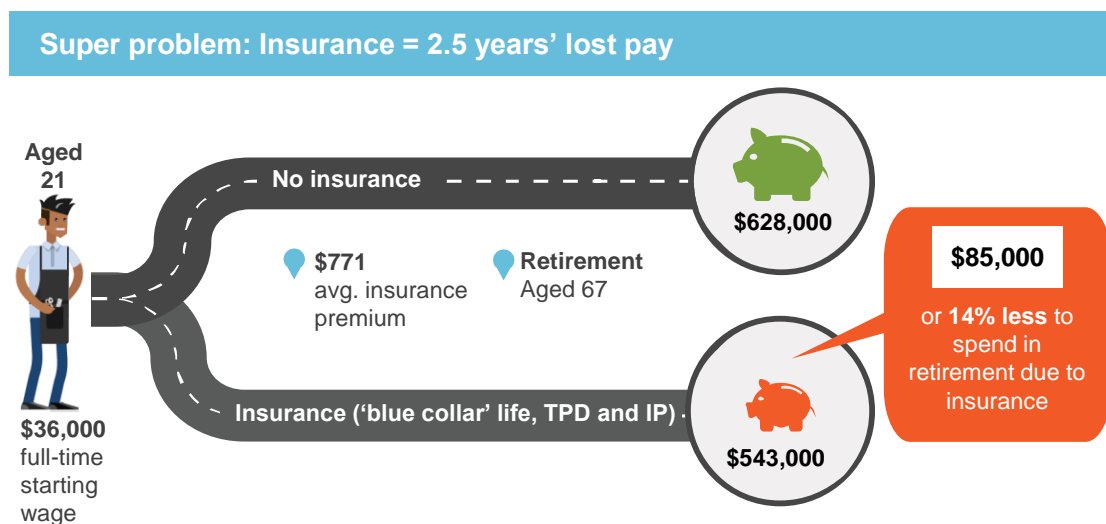
The cameo scenarios presented here have each varied a single assumption. In reality, there is likely to be some correlation between factors that increase balance erosion (for example, low income workers who are less engaged with their superannuation may be more likely to have multiple accounts deducting insurance premiums).

The Commission's final two scenarios are designed to highlight the impact of facing multiple factors that led to increased balance erosion.

- A 'typical' low income worker who attracts a light blue collar loading and is paying for IP insurance. This member's balance at retirement would be 14 per cent (\$85 000) lower at retirement than if they had no insurance (cameo 8.1).
- An 'extreme' low income worker who has an extended period out of the workforce, has multiple accounts deducting premiums, is paying for IP insurance, and faces a light blue collar worker loading. This member's balance at retirement would be 28 per cent (\$125 000) lower at retirement than if they had no insurance (cameo 8.2).

These scenarios demonstrate that the effect of insurance premium payments on members' account balances at retirement is regressive. This result is in line with other research on balance erosion (box 8.4).

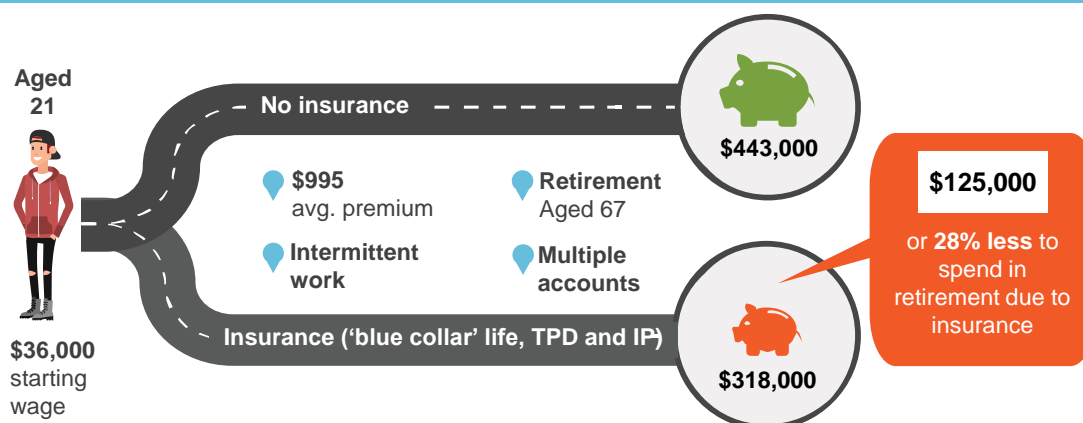
Cameo 8.1 Insurance premiums can materially lower the retirement savings of low income workers^a



^a The assumptions underpinning this cameo are set out in chapter 1.

Cameo 8.2 For disadvantaged members, insurance's cumulative impact can be extremely high balance erosion^a

Super problem: Insurance = 3.5 years' lost pay



^a The assumptions underpinning this cameo are set out in chapter 1.

Box 8.4 Other work in this area

KPMG

The ISWG recently commissioned KPMG to examine the effect of insurance on account balance erosion (KPMG 2017). Overall, KPMG estimated that default insurance premiums would reduce retirement balances by 6.2 per cent. This was based on the projection from a current snapshot of the population (in terms of age, account balances and member contributions), rather than an estimation of the lifetime effect (the report notes the impact on younger members should be considered as more reflective of the likely lifetime effects). The analysis found that the impacts were higher for those with lower incomes (including women, because of their lower average earnings).

Rice Warner

Much industry commentary has focused on a benchmark of premiums being affordable (or in other words, having an acceptable level of balance erosion) if they are equal to around 1 per cent of salary (or approximately 10 per cent of Superannuation Guarantee contributions). Rice Warner analysis found that, insurance premiums were below 1 per cent of salary for the average member when only life and TPD cover were considered. When IP cover was added, premiums remained under the 1 per cent threshold at younger ages but substantially exceed the threshold at older ages (sub. 46, pp. 13–15).

DRAFT FINDING 8.1

The deduction of insurance premiums can have a material impact on member balances at retirement. This balance erosion is highly regressive in its impact — it is more costly to members with low incomes. It also has a larger impact on members with intermittent attachment to the labour force, and those with multiple superannuation accounts with insurance (the latter comprise about 17 per cent of members).

Balance erosion for low-income members due to insurance could reach a projected 14 per cent of retirement balances in many cases, and in extreme cases (for low-income members with intermittent work patterns and with multiple income protection policies) could be well over a quarter of a member's retirement balance.

8.4 Do members get value for money?

Ultimately, what matters from a member's perspective is whether the insurance cover that they receive is sufficiently valuable to offset the premiums that they pay (and the inevitable superannuation balance erosion they will experience). This section assesses whether insurance in superannuation is providing value for money to members, including identifying any leakages or impediments that, if addressed, could improve the value of the current arrangements. There are a number of aspects to answering this question, but the analysis draws broadly on the following criteria (and associated indicators)⁷³ as set out in stage 1.

- Do funds offer value for money insurance products to members? (E11)
- Are the costs of insurance being minimised for the level and quality of cover? (E12)

In most markets, demand for a product implies that consumers consider it to be value for money. However, this does not apply to insurance in superannuation because members are generally disengaged and are automatically signed up to insurance. Therefore, the Commission's assessment relies on examining a range of indicators:

- through the members lens — their level of awareness of, and engagement in, insurance in superannuation, and their preferences
- through the provider lens — the degree to which funds minimise costs and tailor default insurance products to meet members' needs.

⁷³ Some of these indicators are common to other criteria discussed elsewhere in the report. Other indicators related to leakages from unintended multiple default accounts (discussed in chapter 6) are also relevant here.

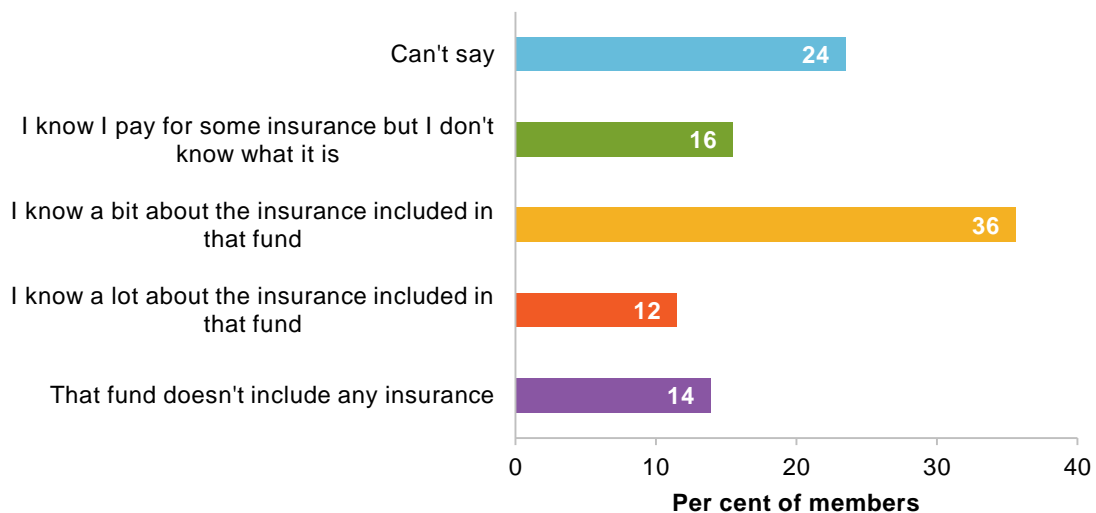
Through the member lens — most do nothing

As mentioned above, members are relatively disengaged making it difficult to draw conclusions about their perceptions of the value for money of insurance in superannuation. This was confirmed by results from the Commission's members survey.

- While most members have some awareness of the insurance included in their superannuation, 24 per cent of members did not know if there was insurance in their fund and 16 per cent know they pay for insurance but do not know what it is. Few members (12 per cent) said they knew 'a lot' about their insurance (figure 8.9).
- Very few members amend or opt out of their default insurance cover. Around 78 per cent of members have never made changes to their default level of insurance and only 6 per cent opted out in the previous 12 months.
 - The most common reasons given for not opting out of default insurance were satisfaction with the default product (31 per cent), lacking requisite knowledge (35 per cent) and assuming it is appropriate (35 per cent). Relatively few cited time (11 per cent) or difficulty (10 per cent), suggesting that ignorance or apathy are more significant barriers to people amending or cancelling their cover than the processes themselves (though these barriers are considered burdensome to members who do alter their cover — discussed below).

Figure 8.9 **Many members have little understanding of insurance in superannuation^a**

What do you know about the insurance that is included in your fund?



^a Weighted using Commission weights.

Source: Members survey.

There are several imperfect methods for assessing whether members consider insurance in superannuation to represent value for money. The evidence derived from these methods is mixed.

- The choice experiment included in the members survey (which estimated accumulation members' willingness to pay for different features of superannuation) (appendix C), found that most members did not value insurance particularly highly and were willing to pay more for other features, such as member communications (for example, smart phone apps, online websites) and control over the choice of investments than for insurance in their superannuation. However, the roughly 30 per cent of members with low levels of financial literacy did value insurance relatively highly (this could be because they have relatively low savings, and thus cannot easily self-insure) (tech. supp. 1).
- MySuper accounts make up close to 80 per cent of accounts with insurance, but just over half of superannuation accounts in total, implying that when members are left to choose whether to purchase insurance in the non-default segment, the vast majority choose not to (though this could be partially explained by a lack of understanding of insurance).

Through the provider lens — mixed efforts

Under the SIS Act and Prudential Standard SPS 250, trustees must meet minimum requirements in setting and administering their insurance arrangements, including the obligation to ensure that insurance does not inappropriately erode members' retirement incomes. Accordingly, they are required to obtain cover on a cost-competitive basis and ensure that it is appropriately tailored to meet the insurance needs of members. This should be reflected in trustees' decisions about the magnitude of cover and its broad design.

Group insurance the basis for lower costs and premiums through superannuation

As previously discussed, group insurance offers substantial cost advantages over individually underwritten cover, resulting in more favourable loss ratios and cover that is better value for money (figure 8.6). Participants provided evidence that this is still likely the case despite recent premium increases.

- Rice Warner gave examples where the price of group insurance cover relative to retail cover ranged between 20 and 60 per cent less (stage 1, sub. DR112, p. 25).
- MetLife submitted that '[i]nsurance in superannuation is generally regarded as being cheaper than insurance obtained outside of superannuation' (sub. 68, p. 4). Similarly, AIA Australia said that 'trustees are well placed to obtain cover for members on good terms and at a relatively low cost' (sub. 76, p. 11).

Selecting insurers

Participants have also submitted that the process of selecting insurers — usually conducted via a tender process — is competitive and minimises the costs of insurance to members. For example, MetLife said:

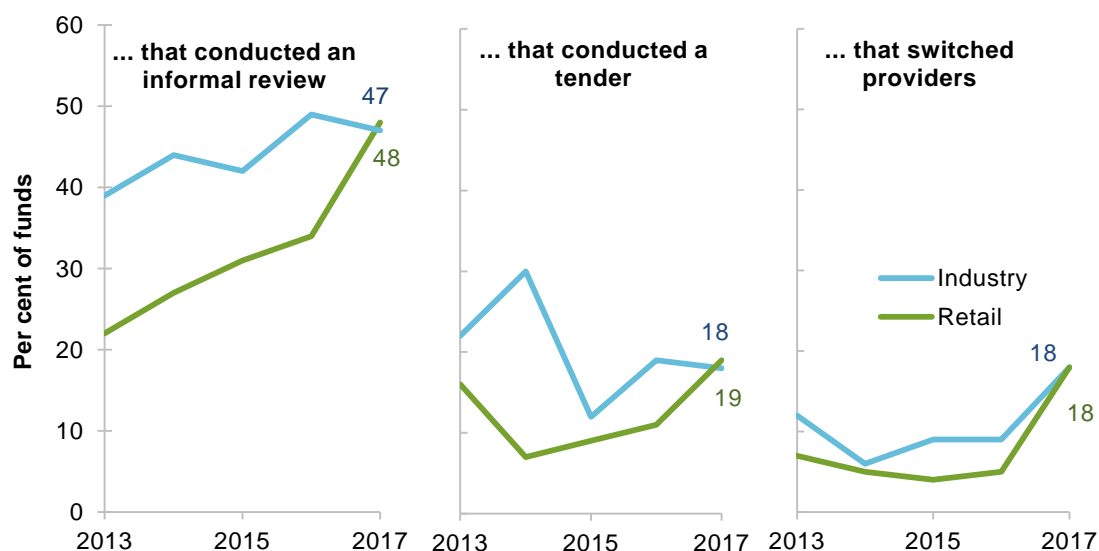
Insurance tenders are rigorous and highly competitive processes that help to minimise the costs of insurance for superannuation trustees. (sub. 68, p. 4)

Similarly, AIA Australia submitted that:

... tendering of insurance has fostered competition for superannuation business for group insurers. (sub. 76, p. 11)

Data from the funds survey broadly support this view. It shows that for each year between 2012-13 and 2016-17, around 15 per cent of funds who responded to the question, put out a tender for the provision of the fund's insurance, with this number increasing in recent years (figure 8.10). The survey also indicates that the number of funds switching providers and informally reviewing the selection of an insurance provider each year has been increasing.

Figure 8.10 Many funds appear to review their insurance arrangements^a
Data on funds switching insurance providers, 2012-13 to 2016-17



^a 110 funds (including 33 industry and 57 retail) responded to this question in the funds survey, representing 88 per cent of balances and 84 per cent of accounts.

Source: Funds survey.

What are the main value-reducing drivers?

Under current arrangements, there are some key drivers that reduce the value of insurance to members.

Inappropriate cross-subsidisation still exists

Cross-subsidisation is an essential feature of group insurance. A key reason that group insurance is relatively cheap is because risk factors that are costly to collect information on can be averaged across the population without the risk of adverse selection occurring.

The question then is one of appropriate versus inappropriate cross subsidisation. Age is an example where premiums should differ to reflect clearly observable differences in risk between members of the pool. Adjusting premiums by other risk rating factors, such as occupation (for instance, white or blue collar) or smoking status may also be appropriate provided they can be identified consistently and reliably. However, this does not always occur, as the Australian Securities and Investments Commission (ASIC) recently noted:

In some cases, trustees have transferred members to a different division of the fund and classified them by default as a ‘smoker’ or ‘blue collar worker’ for insurance purposes, resulting in higher premiums that may not reflect the risk characteristics of the member. (ASIC 2017e, p. 19)

There is also likely to be cross-subsidisation from inappropriate cover that members cannot use — so-called ‘zombie’ policies. Anecdotally, claim rates are lower on inactive policies for reasons such as being unable to claim on duplicate IP policies, not meeting work eligibility requirements, or having a lower risk of injury while not working.

An appropriate level of tailoring by cohorts is still needed

The nature of group insurance places some inherent restrictions on product design — it is not possible to tailor products to each individual’s needs. For instance, the risk of excessive erosion for lower-income members means that automatic levels of cover are unlikely to meet the preferences of higher-income members.

That said, poor tailoring of insurance can result in insurance that is of low value and/or causes excessive balance erosion for some cohorts of members. Funds need to use the information that they collect from members to develop insurance cover that limits these undesirable outcomes and best meets member needs.

Most funds do use some member information when setting their insurance cover. For example, AustralianSuper submitted that it:

... analyses its membership by age, gender, occupation and salary level.

Default insurance cover levels are set based on analysis, across these dimensions, of insurance needs, member preferences and affordability. ...

We conduct member research and broader community research into preferences for insurance, particularly relative to retirement savings. These vary by age, gender, income and occupation. (sub. 43, pp. 12–13)

Similarly, REST submitted that:

Our insurance design and policy definitions are developed to maximise the number of REST members receiving insurance cover that is appropriate to their life stage. Benefits are relatively low for young members with default cover increasing with age when financial commitments are usually higher and there is a greater dependency on income (and a greater capacity to afford). REST has attempted to minimise cross subsidies between different age groups and this should be a focus for the system. (sub. 49, pp. 12–13)

Indeed, there are some recent examples of funds significantly altering their cover to better meet needs of members (box 8.5).

Box 8.5 Examples of funds tailoring their insurance

Dealing with younger members

AustralianSuper announced that from November 2018, it will change its default life and TPD insurance to opt in for members aged under 25, noting that only around 10 per cent of its claims for these members have been paid to financially dependent partners and children. This change will align its default life and TPD cover with its existing settings for default IP cover. Members aged under 25 years will be able to opt in to insurance if they wish.

The relatively low prices of premiums for younger members mean that the projected reduction in premiums paid (at current prices) for a member joining at age 15 years are \$637, although AustralianSuper estimated this could increase balances at retirement by nearly \$9000.

HESTA also announced that from March 2018, its default insurance premiums (for life and IP cover) will vary by age. Prior to this, default members were charged a flat premium for insurance regardless of age, and life cover levels were constant until the age of 39 years, before decreasing as members got older.

Benefit design and affordability

Good benefit design can make insurance cheaper by helping claimants to return to work. For example, Sunsuper's TPD product 'TPD Assist' typically provides claim payments in up to six annual payments (rather than a lump sum) depending on whether claimants are assessed as being able to return to work. The product also limits waiting periods and provides support for rehabilitation to assist members to re-enter the workforce.

The product was changed from a one-off payment structure because many TPD claimants do not permanently leave the workforce. Sunsuper's survey found that 36 per cent of claimants had returned to work or were actively seeking employment. The product changes also reduced TPD premiums by about 30 per cent.

Sources: AustralianSuper (2017); HESTA (2017); Sunsuper (2016).

However, not all funds use the member data that they collect. The Commission's funds survey found that around 9 per cent of responding funds that offer MySuper products

indicated that they do not use information collected on the age or profession of members when determining their insurance arrangements.⁷⁴

Furthermore, there is scope for the majority of funds to make further improvements to benefit design without the need for more (costly) data collection. It is apparent that some funds have successfully used broader research and data (such as census data) to cost effectively impute the characteristics and preferences of the fund's membership.

Duplicate insurance policies and policies on inactive accounts are often poor value

As discussed in section 8.3, paying for multiple insurance policies, or continuing to pay for cover while not working, exacerbates balance erosion. Further, these policies are more likely to be poor value for members, either because there is a lower likelihood that they will claim on the policies (as they often do not know they exist), or because they are unable to claim on them.

IP insurance is a particular problem in this context, as it is relatively expensive and appears to be the main culprit for members being unable to claim against a policy. This can occur because the member either:

- has multiple policies, but payments from one policy reduces their eligibility to claim against another, as total payments cannot exceed a given proportion of their pre-existing income
- is not working and thus does not have an income to offset.

It can be difficult for funds to determine if insurance in an inactive account is unwanted, or if a member has other accounts with insurance. In the members survey, around 18 per cent of members with multiple superannuation accounts said that they kept multiple accounts because they either liked additional insurance, or one fund had a preferable insurance offering, but was lacking on other features.

Nevertheless, while it is difficult to determine the impact of 'zombie' policies on the erosion of members' balances, it is clear that for some members, the effects are material (section 8.3). Accordingly, such erosion cannot be considered to meet trustees' obligations to ensure that insurance does not inappropriately erode member balances.

Complex and incomparable policies impede member decision making

Complexity and lack of standardisation in insurance product offerings also impedes member engagement and reduces the value of insurance to members. Issues include differences in the way products are bundled and priced, and differences in the terms and conditions to qualify for payment of a claim. Variable definitions is a particular problem — for instance,

⁷⁴ There were 68 funds (33 industry and 19 retail) which offer MySuper products and responded to this question in the funds survey, representing 76 per cent of balances and 74 per cent of accounts.

eligibility for TPD claims can vary between policies depending on a range of factors, such as the member's age and work status.

Bundling can reduce the value of policies to some purchasers. For example, as one participant (Rogers, sub. 2, p. 1) submitted, the bundling of life and TPD insurance can disadvantage people without dependents who would value TPD cover, but not life cover. The Commission is seeking further information on the nature and extent of this problem.

INFORMATION REQUEST 8.1

What is the case for bundling life and total and permanent disability insurance together, as is done by some superannuation funds? Are there funds that offer these separately, and if so, do many members of these funds elect to have one type of cover but not the other?

More broadly, as noted by CHOICE (sub. 71, pp. 8–9), the bundling of insurance into superannuation compounds the difficulty in comparing superannuation products more generally, as it adds another dimension to the task of comparing superannuation products. To this end, CHOICE submitted that:

A solution would be to create a single standard policy definition which applies across all default products. This would allow funds to compete on premium, benefit and customer service levels, while giving consumers certainty on policy cover. (sub. 71, p. 11)

This complexity and lack of product comparability could act as a constraint to product switching by members. Switching may also be constrained where a preferred insurance product in an existing fund dissuades a member from rolling over their balance to another fund that offers other advantages, such as better returns.

The problem of complex and variable terms and conditions of policies is compounded in cases where fund disclosure of insurance policies is incorrect. ASIC (2017e, p. 15) recently found instances of incomplete or incorrect disclosure about insurance products, such as product disclosure statements containing the wrong premiums, failing to disclose limitations and exclusions (such as self-harm and suicide), or failure to clearly define what is considered a 'hazardous' occupation.

Some members find it difficult to interact with funds on insurance matters

The members survey indicated that some members making changes to their insurance experience difficulty, mostly in relation to opting out. While most of these members (almost 80 per cent) find amending insurance cover or taking out new insurance cover to be at least somewhat easy (figure 8.11), nearly half do not find it easy to opt out of insurance cover. (While claiming insurance is also challenging for members, the Commission did not receive sufficient responses to assess the level of difficulty.) In (concerning) contrast, of those

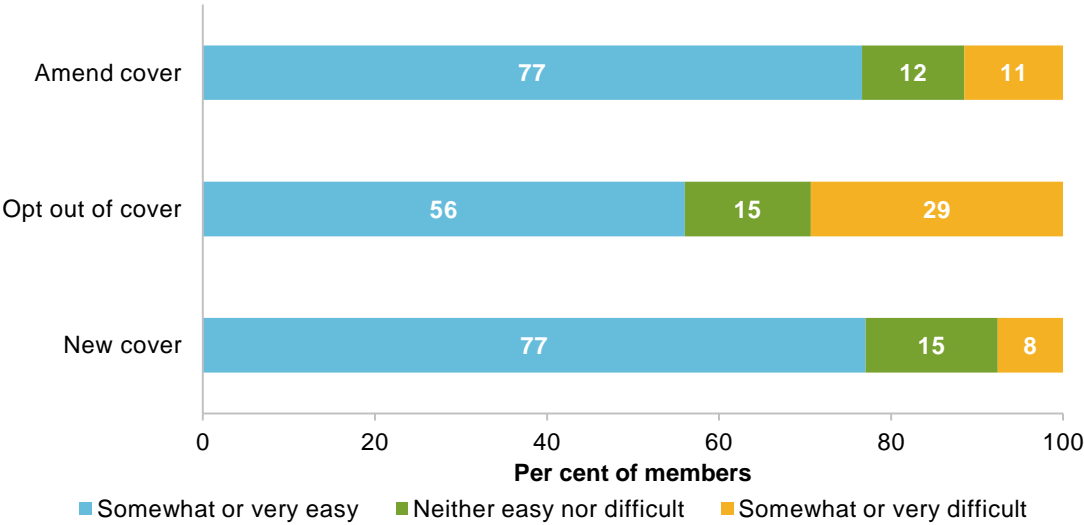
categories, funds responding to the fund survey indicated that their members were *most* satisfied with the process for opting out of insurance.

Recent findings by ASIC show that claims and complaint handling can be a particular area of vulnerability for members:

Claims and complaints handling processes can be difficult for members to navigate. Lodging a claim involves an awareness of the insurance cover available in superannuation, and the process itself can be time consuming and complex, particularly if someone is suffering from a medical condition. (ASIC 2017e, p. 20)

It is also reflected in the substantial proportion of disputes about superannuation that are related to insurance, including the process of making claims.

Figure 8.11 A substantial share of members do not find it easy to opt out of insurance
How easy is it to make changes to insurance?



^a Weighted using Commission weights ^b Responses are from members who have attempted to take one of these actions in the 12 months prior to the survey, where 'can't say' responses are excluded. ^c Responses on the difficulty of claiming insurance have been omitted due to a sample size below 30.
Source: Members survey.

So, is insurance value for money for members?

For some members, default insurance cover is undeniably good value. Further it can provide access to insurance for some people who might not be able to get individually underwritten insurance.

However, for other members — such as (typically young) workers with no dependents (in the case of life insurance) and low-income earners (in the case of income protection) — insurance is poor value and does not meet their needs, but because they are uninformed and disengaged they do not elect to opt out. Better tailoring of insurance to different member cohorts would improve the value for money to some members.

There are other systemic factors that further erode the overall value for money of the current insurance in superannuation arrangements, namely the problems associated with policies on multiple and/or inactive accounts, excessive complexity and lack of comparability and some deficiencies around interaction with members, particularly in relation to claims handling.

DRAFT FINDING 8.2

In terms of premiums paid, default insurance in superannuation offers good value for many, but not for all, members. For some members, insurance in superannuation is of little or no value — either because it is ill-suited to their needs or because they are not able to claim against the policy. Income protection insurance and unintended multiple insurance policies are the main culprits for policies of low or no value to members.

Younger members and those with intermittent labour force attachment — groups which commonly have lower incomes — are more likely to have policies of low or no value to them.

INFORMATION REQUEST 8.2

What is the value for money case for income protection insurance being provided on an opt-out basis in MySuper products?

8.5 Recent initiatives fall short of what is needed

More work needed on the ISWG code of practice

The recently developed voluntary industry code of practice is an initial step, but falls short of what is needed to effectively address deficiencies in the current arrangements for insurance in superannuation.

What are the features of the code?

The Insurance in Superannuation Working Group (ISWG) was an industry group formed to develop an industry code of practice in response to the concerns — from government, regulators, consumer groups and members — about the operation of insurance within superannuation. Following the introduction of the Financial Services Council Life Insurance

Code of Practice, the Minister for Revenue and Financial Services called for further work on insurance in superannuation:

... the Government expects that the FSC and industry will continue to work towards expanding the coverage and scope of the Code to more fully cover group insurance arrangements within superannuation, and will take the necessary steps to ensure that the Code is enforceable across the whole industry, by gaining ASIC approval of the Code. (O'Dwyer 2016)

The first iteration of the code was released on 18 December 2017. The code is voluntary and is intended to operate on an 'if not, why not' basis. It will commence from 1 July 2018. Signatories to the code were to notify their intention to adopt the code on their website by 31 March 2018. The total number of funds that have signalled their intent to adopt the code is not fully clear at this stage, although there are some encouraging early signs. The Australian Institute of Superannuation Trustees (AIST, sub. 99, p. 2) has indicated that more than 40 of its member funds, 'covering the overwhelming majority of the estimated 6 million plus profit-to-member super fund members' have stated their intent to adopt the code (it has subsequently published this list of members on its website). The Association of Superannuation Funds of Australia (ASFA 2018) has published a similar (partially overlapping) list of its members, with the combined lists containing over 50 funds.

Funds can undertake a staged adoption of the code. A transition plan (to allow for the adjustment of existing contractual arrangements) must be published by 31 December 2018, with full adoption of the code by 30 June 2021.

The code is owned by AIST, ASFA and the Financial Services Council. The code owners have undertaken to consult with stakeholders on an ongoing basis and commission formal independent reviews of the code no later than every three years. The code owners have established a transition committee to facilitate implementation of the code through the provision of guidance on matters such as compliance and interpretation of code provisions.

The key elements of the code cover setting premiums in relation to income and approaches to cessation of insurance cover on inactive accounts. The code also contains provisions on areas such as information provision, claims handling and complaints (box 8.6). Signatories are to publish an annual code compliance report that documents where the fund has failed to comply with the code, and where the fund has determined complying is not in the best interests of members.⁷⁵ The code also states that funds should remedy any instances where failure to comply with the code results in direct detriment to members.

What effects might the code provisions have?

While the development of clearer and more consistent member communications and the codification of processes (such as claims handling and complaints) should be beneficial, premium caps and cessation rules are likely to have the most impact for members.

⁷⁵ The code transition committee is developing a standard report template for fund trustees to use (sub. 99).

Box 8.6 **Key features of the code**

Premium limits

To address balance erosion, premiums are to be capped at an estimated 1 per cent of average salary for the membership generally and/or segments of the membership. Membership segments including younger members, members with low or infrequent contributions, and members nearing retirement are to be given particular attention. The code states that premiums and levels of cover are expected to be lower for younger members. If premiums exceed 1 per cent of salary, either for particular segments or the membership generally, funds are to publish the rationales for this.

Cessation of cover on accounts where contributions have ceased

To address balance erosion on inactive accounts and reduce the prevalence of ‘zombie’ policies, the code calls for the IP cover of ‘automatic insurance members’ to be cancelled 13 months from receipt of the last contribution. In the case of life and TPD cover, these will only be cancelled after 13 months if the member’s account balance is below \$6000. Members with accounts that are not receiving contributions will be sent a number of communications prior to the 13 month mark inviting them to consent to cancellation of cover, or to elect to maintain it.

Other elements of the code

Other provisions in the code address various issues that reduce the value for money of insurance, such as low member awareness and the complexity and incomparability of insurance products.

- *Codification of the information provided to members.* Funds will provide a standardised ‘key facts sheet’ and a range of insurance specific information in a welcome pack to new members, along with an annual statement that provides information on the insurance cover (including the current premium). The code also includes standardised headings for TPD cover — funds to describe in plain language if their definitions have more requirements than the code, and if TPD definitions differ from the standard definition in the SIS Act for the release of superannuation benefits.
- *Codification of claims handling.* The code sets out the processes and timelines for: handling claims and how the fund will communicate with claimants; reviewing insurers’ decisions; and lodging a complaint where claimants are dissatisfied with a decision.
- *Refund obligations.* Funds are to provide premium refunds (up to a maximum of six years) in cases where a member is unable to claim on a policy because the benefit is offset by a claim on another similar policy, or in cases where the member was never eligible to make a claim.
- *Premium adjustments.* The code requires all premium adjustments to be paid into the fund’s reserve and used only for future premium adjustments or insurance administration.
- *Complaints.* The code sets out the processes and timelines the fund will follow in its internal complaints handling process and the options available for members to take their complaint to external dispute resolution.

Premium caps could reduce balance erosion, but have limitations

The premium cap could materially reduce the cost of insurance for many members and reduce the erosion of member account balances at retirement. The risk that balance erosion effects could still be highly variable between members based on their individual incomes

(because the caps are applied as an average across the fund or segment) is mitigated by the fact that the code contains an expectation that various cohorts will be catered for differentially. As shown in box 8.5, funds that have acted in anticipation of the code have made design changes that accommodate specific cohorts, including younger members.

Implementing premium caps will likely result in reduced levels of cover for members and change the mix of insurance provided to members. For example, cutting relatively expensive IP insurance seems like an obvious way to meet the salary thresholds. Another potential approach by trustees to meeting cap rules could be to select cover with more restrictive conditions and exclusions. To prevent ‘junk’ insurance emerging, it is essential that the foreshadowed work on standard definitions be initiated immediately. Regulators — primarily ASIC — should provide guidance to industry in consultation with consumer representatives and insurance experts.

The premium cap proposals faced considerable opposition from some funds, either because more expensive cover is considered to be in the best interests of their members or the requirements are too burdensome to implement. In some cases, such as where members have particularly hazardous occupations, higher insurance expenditure may be appropriate, but a key risk is that caps will routinely be breached without sufficiently rigorous justifications.

Cessation rules are too narrowly targeted

Overall, cessation of insurance on accounts where members are no longer making contributions could be an effective approach to addressing two of the key problems with insurance in superannuation — excessive balance erosion and inappropriate ‘zombie’ insurance policies.

However, the code is very narrowly targeted. While it is likely to have an impact on IP insurance, it will have more limited effects on life and TPD insurance — the forms of insurance that are much more common because they are mandated in MySuper offerings — because deductions will still be permitted until account balances fall below \$6000.

A further shortcoming of the code’s cessation rules is that they do not apply to members who have purchased individual cover, or to members who have made any sort of amendment to their automatically allocated insurance. Low levels of member engagement (which exist even for choice products) suggest that many of these members do not remain sufficiently engaged to monitor and adjust their insurance cover over time, and so should be covered by the cessation arrangements. Accordingly, there is a case for cessation rules on inactive accounts to be a legislative requirement across the superannuation system.

Overall, the likely effectiveness of the code is uncertain

The code is a step in the right direction. It contains initiatives that go beyond current regulatory requirements, which, if done well, would improve member outcomes. But it falls

well short of what is considered best practice for an industry code of conduct. Under the ASIC requirements for code approval set out in Regulatory Guide 183,⁷⁶ to be considered for approval by ASIC, a code needs to satisfy a range of criteria, including some key threshold criteria:

1. the rules contained in the code must be binding on (and enforceable against) subscribers through contractual arrangements;
2. the code must be developed and reviewed in a transparent manner, which involves consulting with relevant stakeholders including consumer representatives; and
3. the code must have effective administration and compliance mechanisms. (ASIC 2013c, p. 8)

While the current code clearly does not meet these standards, it was substantially diluted from the draft publicly released in September 2017 (which *was* intended to be binding and enforceable on participants). The draft also had more restrictive provisions and less scope for funds to justify non compliance.

The deficiencies of the code resulted in widespread criticism, including from consumer advocates such as Choice, and calls for the code to go further. For example, the APRA Deputy Chair said:

... there is more to do, both to strengthen the enforceability and oversight of the Code and also to tackle some of the areas that the current Code has not fully addressed. These include looking at opportunities to clarify and standardise definitions for disability insurance, and dealing more fully with multiple accounts and unnecessary multiple insurance cover. (Rowell 2018, p. 6)

Many are now sceptical of its prospects for delivering material improvements to member outcomes. As such, further work is needed to bolster code provisions and implement appropriate administration and compliance mechanisms to make the code binding on participants. ASIC should be involved in these processes and issue guidance to industry on the steps required to bolster provisions and develop an enforceable code.

Other measures could also partially address problems with insurance

There are other initiatives in train that could improve insurance outcomes for superannuation members.

Making opting out of insurance easier

In July 2017, the Minister for Revenue and Financial Services announced, as part of a broader suite of proposed reforms, that APRA would undertake actions to make it easier for members

⁷⁶ ASIC can approve codes of conduct in the financial sector under s1101A of the *Corporations Act 2001* (Cwlth). It is not mandatory for a code to be approved, but approval can provide a signal to give consumers confidence in the code.

to opt out of superannuation-based insurance. APRA has subsequently indicated that it ‘proposes to amend *Prudential Standard SPS 250 Insurance in Superannuation* (SPS 250) to require an RSE licensee to provide simple and straightforward opt-out processes for all insurance products’ (APRA 2017j, p. 24). APRA has indicated that it expects the final requirements to be released in mid-2018 and take effect from 1 January 2019.

Design and distribution obligations and product intervention powers

The Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 proposes additional disclosure obligations on financial products and powers for ASIC to proactively intervene in relation to financial products by making orders prohibiting specified forms of conduct. These arrangements are yet to be implemented, so their impact on conduct in the superannuation industry it is not clear, particularly given that conduct is already regulated under the SIS Act. It is likely that the intervention powers would only be used in extreme cases where a product was of unequivocally no value to all consumers, not just where it was unsuitable given a particular individual’s own circumstances.

Outcomes test

As discussed in chapter 10, recent proposed reforms by the Australian Government include an outcomes test designed to improve the quality of MySuper products. It would include the requirement for trustees to make an annual written determination, including on the appropriateness of the insurance offering and whether it inappropriately erodes the retirement income of beneficiaries.

APRA is also proposing changes to improve member outcomes, including the introduction of *Prudential Standard SPS 225 Outcomes Assessment*, which would require all RSE licensees to annually assess the outcomes to members, including the impact of insurance benefits. However, the additional assessment requirements are intended for the internal use of RSEs to assist in continual improvement of their processes and there is not a public release requirement.

The Commission considers that the publication of annual explicit written statements about the trade-off between the provision of insurance cover and the erosion of members’ account balances that trustees make in determining their default insurance settings *is* an important discipline on funds. It will help to ensure that trade-off assessments are rigorous and give appropriate consideration to different cohorts of the fund’s membership.

Australian Financial Complaints Authority

Effective dispute resolution arrangements are important given that insurance is a major source of superannuation-related disputes. As discussed in chapter 10, following the Ramsay review of financial system external dispute resolution (Ramsay, Abramson and

Kirkland 2017), the Australian Government is introducing a new dispute resolution framework, with a single body, the Australian Financial Complaints Authority (AFCA), which will replace the overtake the functions of existing bodies, including the Superannuation Complaints Tribunal (SCT).

The Ramsay review noted that complaint resolution by the SCT took a long time, but this could be attributed to chronic underfunding. The new AFCA model could improve outcomes, if appropriately funded.

Importantly, the bill — Treasury Laws Amendment (Putting Consumers First – Establishment of the Australian Financial Complaints Authority) Bill 2017 — also contains amendments to allow ASIC to publish aggregate and firm-level data on internal dispute resolution, which may encourage improvements in complaint handling. This will provide for much needed transparency and accountability for insurance in superannuation.

A potential co-regulatory model?

As part of the ASIC Enforcement Review, the panel has raised the idea of a co-regulatory model in appropriate parts of the financial sector, such as those covered by the AFCA regime, which would include the provision of insurance in superannuation (ASIC Enforcement Review 2017).⁷⁷

Under the model, it would be mandatory for industry participants to subscribe to an ASIC approved code, and in the event of non compliance, individual customers would be able to seek redress through internal and external dispute resolution. Code compliance would be overseen by a code monitoring body and report to ASIC on code adequacy and compliance periodically. Content of the code would largely remain a matter for industry, but with broad criteria set by ASIC.

More information provided by the ATO to members with duplicate policies?

A recent inquiry into the life insurance industry by the Parliamentary Joint Committee on Corporations and Financial Services (2018) made a number of recommendations aimed largely at improving the provision of information to members of group insurance policies. One recommendation that could warrant further consideration is for the Australian Taxation Office (ATO) to provide an annual statement to individuals with multiple superannuation accounts and insurance policies along with their annual tax assessment notices.

⁷⁷ The final report from the review (and any Government response) is yet to be released.

8.6 Further actions are required — by industry and government

The prospects of recent insurance-specific initiatives, as they stand, to address the deficiencies of insurance arrangements in superannuation, while welcome, are limited. Accordingly, further concerted action is required — by both industry and government. This includes efforts by industry to adopt and improve on the code of practice, complementary action by government and regulators to drive code adoption, and other actions by government to mitigate adverse outcomes from current insurance in superannuation arrangements. Table 8.3 summarises the Commission’s perspective on some of the key issues, improvements in train and what further actions are required.

What should industry do?

Proactive and pre-emptive actions to self-regulate can address concerns in a more efficient and less burdensome manner than through government regulation. There are two broad areas where funds need to focus attention to increase the value of insurance to members.

- There is scope for funds to improve benefit design, including better tailoring of insurance products to meet the needs of different cohorts, while ensuring that full consideration is given to the effect of insurance premiums on account balance erosion. It is apparent that there is scope to use available data to do this better, with funds able to impute the likely characteristics of their own membership from generic data sources.
 - Complexity and lack of comparability across product offerings is an obstacle that makes switching to better superannuation products difficult for members and limits competitive forces. Development of standard definitions is a crucial step in reducing this problem, although it should be done in a way that does not inhibit better tailoring of products to members’ needs — such as the redesign of TPD products to have staged payments, rather than a single lump sum.
- Engagement with members is another key area for improvement by funds, including ensuring members are aware of their insurance cover and making it easier to opt out, amend cover or make claims.
 - An important aspect of this is having as up-to-date contact details for members as possible, and all funds should work with the ATO to ensure that they have the latest available contact information for their members.

In both of these areas, it is apparent that there is currently a diverse range of approaches by funds, so there is scope for many funds to adopt approaches in line with industry best practice. The code of practice is a potentially good vehicle to enact these changes.

Table 8.3 Issues and responses

<i>Causes</i>	<i>Improvements in train</i>	<i>Further action needed</i>
Problem: Account balance erosion		
Premiums for some members are too high	<ul style="list-style-type: none"> The code of practice includes a premium cap of 1 per cent of the salary of members (as a whole and by segment). Outcomes test annual written determination requirements for MySuper products 	<ul style="list-style-type: none"> Funds should adopt the industry code. ASIC/APRA taskforce to monitor code adoptions, compliance and development (including providing guidance). Industry should be allowed two years to make the 'bolstered' code binding and enforceable (dr. rec. 18) Require funds to publicly document rationales on the appropriateness of cover and the balance erosion trade-off (dr. rec. 16)
Multiple accounts	<ul style="list-style-type: none"> See below 	<ul style="list-style-type: none"> See below
Problem: Unintended multiple policies		
Low member awareness and engagement	<ul style="list-style-type: none"> Industry code of practice includes measures to improve communication with funds 	<ul style="list-style-type: none"> Funds should adopt the industry code. Adoption of the code should be made a condition of offering MySuper (dr. rec. 17). Industry code of practice should be strengthened, including refining annual member statements
Multiple accounts	<ul style="list-style-type: none"> ATO account consolidation initiatives (chapter 6) 	<ul style="list-style-type: none"> Modernise default arrangements to create a single fund for life (chapter 12, dr. rec. 1) Further account consolidation initiatives (chapter 6, dr. rec. 8)
Inactive accounts	<ul style="list-style-type: none"> Code of practice provisions for cessation of cover on inactive accounts 	<ul style="list-style-type: none"> Cessation of insurance on accounts without contributions for 13 months should be made mandatory, unless members expressly choose otherwise (dr. rec. 15)
Problem: Policies not value for money		
Poor data	<ul style="list-style-type: none"> Some funds imputing member characteristics from broader datasets 	<ul style="list-style-type: none"> The code should be amended to facilitate adoption of industry best practice Funds should ensure they use latest contact details from ATO — include in code On-going work to improve data collection and dissemination
Principal-agent problems	<ul style="list-style-type: none"> Product intervention powers will allow ASIC to address grossly inappropriate policies APRA making changes to help members to opt out of insurance Changes to dispute resolution processes under AFCA 	<ul style="list-style-type: none"> Improvements to superannuation fund governance (chapters 9, 10) Make insurance for young members (aged under 25) opt in only, as young members rarely need life insurance (dr. rec. 14)
Complexity and incomparability	<ul style="list-style-type: none"> Code of practice provisions to enhance communication and information provision 	<ul style="list-style-type: none"> Standardisation of definitions and short form annual statements in next iteration of code need to happen promptly
Reassessing extent of problems with insurance in superannuation		
Concerns about prospects for changes		<ul style="list-style-type: none"> An independent review should be commissioned within four years to evaluate initiatives to that date and consider further necessary policy intervention (dr. rec. 19)

Funds should adopt the code

It is the Commission's view that funds should adopt and implement the provisions of the industry code of practice, as this is a transparent and consistent way for funds to make improvements to insurance arrangements that increase the value of insurance to members.

If funds do not adopt the code, they should be prepared to face additional scrutiny from regulators on their insurance arrangements, and be able to explain why adopting the code is not in the best interests of their members. Even where funds do not adopt the code, they should consider adoption of elements of the code that would benefit their members.

The code should be strengthened through its subsequent iterations

While future iterations of the code have been flagged, it is important that the unwarranted flexibility and carve-outs of the current version are unwound. In particular, the code provisions should be enhanced in the following areas.

- *Standard definitions.* While comparability for members will always be difficult due to different mixes of insurance types and levels of cover, common eligibility and exemption definitions for insurance types (particularly in the case of TPD insurance) should be introduced to increase transparency and address the potential use of unreasonable exemptions to address cost pressures.
- *Tailoring benefit design.* While the code requires participants to consider member characteristics in designing benefits, further prescription in the code could increase the adoption of industry-leading benefit design practices (such as imputing member needs using Australian Bureau of Statistics data).
- *Communications.* The code contains extensive provisions on communications, including an annual member statement. However, the risk is that without further direction, the statement will end up long, excessively detailed and unread. Similar to the key fact sheet, the annual statement needs to be a short form document that contains only key details on the level and type of cover, annual premiums, the likely projected balance erosion for the member, and links to additional information on the fund's website (including the fund's balance erosion trade-off determination and a calculator for assessing balance erosion for individual members).
 - Ensuring communications even reach members is a necessary precondition to be effective, but this is not always the case — the code should also require all signatories to regularly access updated contact details from the ATO.

A key objective should be to strengthen the code to the standard necessary for ASIC approval. Beyond bolstering provisions of the code, a critical task for the code owners — with appropriate regulator guidance — is to make the code binding and enforceable on participants.

What should government do?

In broad terms, government should focus on measures to bolster and leverage the work of industry and to intervene in areas where industry efforts are unlikely to be effective.

Policy responses to address broader systemic issues affecting superannuation will also be important in addressing problems related to insurance. For example, addressing superannuation account duplication will also reduce unintended multiple insurance policies — thereby reducing the incidence of one of the most egregious sources of balance erosion (chapter 6).

The Commission is proposing initiatives to modernise the default system by having a single default fund for life, amongst other recommendations (chapter 13). The Commission is also recommending changes to assist in consolidating the legacy stock of unintended multiple accounts.

Ongoing efforts to improve data collection and dissemination will also be important. The need for better data is indeed a common theme across this inquiry and the Commission is recommending the creation of a cross-regulator working group to identify avenues for improved data collection and access.

In addition, there are also some specific insurance-related measures that the Government should adopt. These are detailed below, although the subsequent draft recommendations are contained in chapter 13.

Joint regulator taskforce to bolster code, monitor code adoption and compliance

While the code currently falls well short of where it might ideally be, it would be a missed opportunity if it fell by the wayside. Regulators should leverage the code by undertaking activities that require funds to adopt and comply with code provisions, and provide guidance to assist the code owners in bolstering the provisions and administrative arrangements of the code to an appropriate standard.

To coordinate efforts across regulators, the Australian Government should establish a joint taskforce (draft recommendation 18). It should include both ASIC and APRA to ensure that there is coordination between the regulators, given that some instances of inappropriate activity may require a response by both regulators. Further, there is a close link between many elements of the code and other requirements (or proposed requirements) imposed on funds, such as requirements around opt-out procedures. The taskforce should also consult with consumer organisations and insurance experts.

To ensure that the necessary enhancements to the code occur promptly, the taskforce should provide guidance on priorities for bolstering the code and what is needed to meet ASIC's requirements for an enforceable 'approved' code of conduct. Industry should be given two years to make the bolstered code meet this standard.

As an additional check to ensure code development remains on track, the taskforce should monitor and publicly report on the adoption and implementation of the code by funds, and progress in implementing the necessary enhancements to the code — including implementation of standard definitions and moving to a short form annual insurance statement. The taskforce should make findings on where industry is failing to make sufficient progress and further government action is warranted. These findings should be considered as part of the Commission’s proposed future independent review (discussed below).

Also, where the taskforce finds that funds have not adopted the code or adequately complied with key provisions, this should be used as a catalyst for additional scrutiny from the regulators.

Make the code a MySuper condition

To further drive fund adoption of the code, participation should immediately be made an approval condition of offering a MySuper product (draft recommendation 17).

The code requirements are sufficiently flexible such that there is no apparent reason for funds not to adopt it straight away. Although, as noted above, it is intended that the code will be strengthened in content and be binding and enforceable on funds within two years.

Require funds to publish their balance erosion trade-off assessments

More broadly, fund trustees need to more clearly articulate the trade-offs they are making when entering and designing group insurance arrangements. While the proposed annual written determinations in the outcomes test for MySuper products and the requirements under the new SPS 225 are steps in this direction, publication requirements should apply to all funds providing automatic insurance cover.

APRA should immediately require trustees of all APRA-regulated funds to articulate and quantify the balance erosion trade-off they have made for their members and make it available on their website annually (draft recommendation 16). Funds seeking inclusion on the ‘best in show’ shortlist should also articulate this trade-off for prospective members. This is because while more expensive insurance arrangements in some funds may be appropriate to the existing membership, they could be unsuitable for prospective new default members. These new members might be better served (on average) by a more basic default insurance offering.

In addition, funds should have a simple calculator on their website that automatically inputs a member’s balance, contribution and insurance premium information, so that those members who wish to do so, can estimate how various insurance choices would impact on their retirement balances.

Opt-in insurance for members aged under 25 years

Insurance for members under the age of 25 years should only be provided on an opt-in basis (but can revert to an opt-out basis once members turn 25 years). Overall, young workers are likely to receive less value from having insurance through their superannuation, given their typically lower incomes and financial commitments. This means that they are more likely to be overinsured and hold policies that are of low value to them. For example, automatic life insurance cover for young members without dependents is difficult to justify.

Accordingly, legislation should be changed to require fund trustees to obtain the consent of members under 25 years prior to the deduction of insurance premiums from their account (draft recommendation 14). This would not apply in situations where premiums were financed by a third party (such as an employer) or in defined benefit fund where there is no explicit insurance premium deduction.

This initiative could also assist in reducing the number of unintended insurance policies across multiple accounts given that much account duplication occurs in the age range of 18 to 25 years (chapter 6), although changes to modernise default arrangements should do most of the work in addressing this issue.

Cessation of insurance on inactive accounts

There is a case for making cessation of insurance on inactive accounts a universal legislative requirement. This is further strengthened by the limited approach of the provisions in the code of practice. This would address a number of the problems with current arrangements, including: reducing the stock of unintended multiple insurance policies (beyond that they may be addressed through initiatives to reduce the proliferation of new accounts); reduce the extent of policies that are of no value to members because they are ineligible to claim on them; and potentially remove barriers to the consolidation of inactive duplicate accounts.

Accordingly, all insurance in superannuation (including both default group and individual cover) should be ceased on inactive accounts, unless the member explicitly informs the fund that they wish to retain the cover (draft recommendation 15). The 13 month contribution inactivity period in the code seems reasonable, given the time delays in receipt of contributions and to allow time to establish contact with members prior to cessation.

Future review of insurance in superannuation arrangements

While initiatives taken by industry to date are a step in the right direction and the industry code of practice offers some limited prospects for improving member outcomes, more work is needed. As such, the likely effectiveness of these initiatives is difficult to gauge today. Similarly, the recommendations put forward in this report, if implemented, would take some time to translate into measurable outcomes for members.

As such, an independent review of insurance in superannuation arrangements should be initiated within four years from the completion of this inquiry report (draft recommendation 19). This timing should be determined by the progress made in making the code enforceable, and occur sooner if the code is not made enforceable within two years.

This would provide an opportunity to review progress and the need for further policy interventions in the absence of meaningful remediation of unnecessary balance erosion and inappropriate insurance products for members.

Potential policy changes that should be examined by the review include:

- the appropriateness of opt-out insurance provision in superannuation products generally, including the significance of having group insurance arrangements and consideration of the extent and consequences of levels of underinsurance
- whether there is a case to expand opt-in only settings to other specific cohorts (beyond young members), in particular, members who have very low account balances and/or low or infrequent contributions.

8.7 Fiscal effects

The terms of reference ask the Commission to consider the effects of insurance on social security outlays. These effects, while important to government and ultimately taxpayers, is not the primary rationale for improving the arrangements for insurance in super.

Mixed effects on social security outlays

One of the arguments made by some to support the case for having insurance in superannuation is that it leads to a net fiscal gain to government by reducing social security outlays (KPMG 2017; Rice Warner, sub. 46).

However, there are two broad aspects to the fiscal effects with respect to social security outlays that have opposing effects:

- claim payouts may reduce eligibility for other social security payments (primarily Disability Support Pension payments)
- balance erosion through the deduction of premiums will lead to earlier eligibility for the Age Pension for some members.

There are also some taxation considerations (as noted by the KPMG report) regarding the tax paid on claim payouts and the benefits from being able to buy insurance with concessional-tax superannuation contributions.

Estimates by others

KPMG (2017) estimated that removing insurance from superannuation would lead to a net increase to government outlays of between \$0.65 billion and \$1.85 billion over 10 years. They considered the effects of: savings in Disability Support Pension payments (\$3–\$4.3 billion); additional tax revenue from tax on insurance benefits (\$2.9 billion); and offsetting tax concessions of \$5.25–\$6.4 billion.

Rice Warner (sub. 46) also found that removing insurance from superannuation would result in a net cost to government — they estimated increased social security payments from removing default insurance at around \$1.66 billion per year (it also estimated lost tax and spending capacity due to reduced insurance claim payments of \$4 billion per year).

The two approaches illustrate the difficulty with calculating such estimates. It is also important to note that neither analysis considered the effects of account balance erosion from the deduction of premiums on Age Pension eligibility.

The Commission's approach

The Commission intends to undertake further assessment of the effect of insurance in superannuation on government outlays for the final report. It will release a technical paper after the draft report is released and will hold a workshop with experts before finalising its analysis.

DRAFT FINDING 8.3

The fiscal effects of insurance in superannuation are complex, and the net effects are uncertain. Existing (public) fiscal estimates overestimate the net fiscal benefits as they do not consider the impact of balance erosion on Age Pension eligibility.

9 Fund governance

Key points

- Superannuation fund members are heavily reliant on the conduct and actions of others — funds, financial advisers, government and regulators. This is more so than in many other markets given the superannuation system is the product of Australian Government policy and member compulsion.
- A well-functioning superannuation system requires high quality governance arrangements involving:
 - robust fund governance — quality management of each fund by a board of member-focused trustees
 - diligent system governance — holding the system to account through quality supervision (and enforcement at times) by the key system regulators, ASIC and APRA, of; system and fund performance; trustee and financial adviser conduct; product appropriateness (including for insurance in superannuation); and licensing arrangements.
- Fund governance has improved materially in recent years (albeit off a low base). The Stronger Super reforms have raised governance standards but they have also, by improving disclosure, highlighted some ongoing problems.
- There remain a number of governance practices that raise not inconsiderable doubts about whether funds always have the best interests of members at heart. For example:
 - not all funds employ satisfactory practices for appointing adequately skilled and qualified board members, and it appears some sponsoring entities do not take this process seriously
 - there is often inadequate independent assessment of board capability
 - not all funds have adequate practices in place to deal with related-party transactions (and questions focused on related party transactions in the Commission's survey of funds received disconcertingly low response rates)
 - many CEOs claim that their boards regularly assess and fully understand the attribution of investment performance outcomes, but relatively few funds were able to provide the data that they would hold if they had undertaken this activity
 - many funds acknowledge that they are at least somewhat focused on peer risk (their short-run performance relative to their peers).
- Arguably the most costly manifestation of poor fund governance is the failure of funds to merge where this would benefit members.
 - Measures now being undertaken by APRA will go some way towards addressing these concerns, and would be further advanced if a proposed member-focused outcomes test was legislated.
- Introducing competition for the default market (as proposed by the Commission) will also prompt much needed fund consolidation.

High quality governance is integral to a well-functioning, efficient and competitive superannuation system. It is an essential prerequisite for ensuring that members' interests are protected in a system where members are: compelled to save; often reliant on the actions of others; and often disengaged, meaning demand-side competitive (and conduct-disciplining) pressures are not felt as strongly as in many other areas of the economy.

High quality governance rests on:

- robust fund governance — quality management of each fund by a board of member-focused trustees
- diligent system governance (chapter 10) — holding the system to account through quality supervision (and, at times, enforcement) by the key system regulators, ASIC and APRA, of system and fund performance; trustee and financial adviser conduct; product appropriateness (including for insurance in superannuation); and licensing arrangements.

This chapter focuses on governance within funds (from a system-wide perspective). Governance of the system and, in particular, the role of regulators is the focus of chapter 10.

In essence, good fund governance boils down to the characteristics of the trustee board members and how well they do their job — and the assessment of the performance of Australian trustee boards in this chapter reflects this.

Among other evidence sources, this assessment draws on the results of a survey of Australian fund CEOs and their equivalents undertaken by the Commission. Most CEOs (80 of a potential 94, representing around 95 per cent of member accounts and 94 per cent of assets in the system) participated in the survey. The Commission is well aware of the potential for bias to be generated from self-reported performance, and has observed optimism in the aggregate results. However, the results still provide insights into fund governance. More details about the governance survey and a summary of responses are presented in appendix C and technical supplement 3, respectively.

The chapter also provides evidence, in whole or part, on the following criteria identified in the Commission's stage 1 report.

- Are there material anticompetitive effects of vertical and horizontal integration? (C5)
- Are principal–agent problems being minimised? (E8)

9.1 Fund governance: what is it, why does it matter and why is it regulated?

Fund governance is not dissimilar to governance for corporations

While there are various definitions of governance, the Commission has chosen the definition used for ‘corporate governance’ by the Australian Securities Exchange (ASX) Corporate Governance Council:

The phrase ‘corporate governance’ describes the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled within corporations. It encompasses the mechanisms by which companies, and those in control, are held to account. (ASX 2014, p. 3)

This definition aptly captures the focus of this chapter, but there are some important differences between governance for corporations and governance for superannuation funds. Governance arrangements for corporations predominantly focus on the need to ensure shareholders are protected; governance arrangements for superannuation funds seek to ensure the interests of members prevail over other interests including those of (fund owner) shareholders, trustees and other ‘agents’ who make decisions on behalf of members.

Good governance is central to fund performance

In essence, good governance promotes better decision making on behalf of members, greater transparency and accountability, stronger management of risks and, overall, superior performance on behalf of members. The Cooper Review and the Financial System Inquiry both highlighted the importance of good governance to the performance of the superannuation system:

In superannuation, just as in other areas of corporate activity, good governance plays a major role in promoting better decisions, greater accountability and in reducing unintended operational and investment risks. (Cooper et al. 2010b, p. 44)

Although there is little empirical evidence about the relationship between quality of governance in Australian superannuation funds and their performance, high-quality governance is essential to organisational performance. (Murray et al. 2014, p. 133)

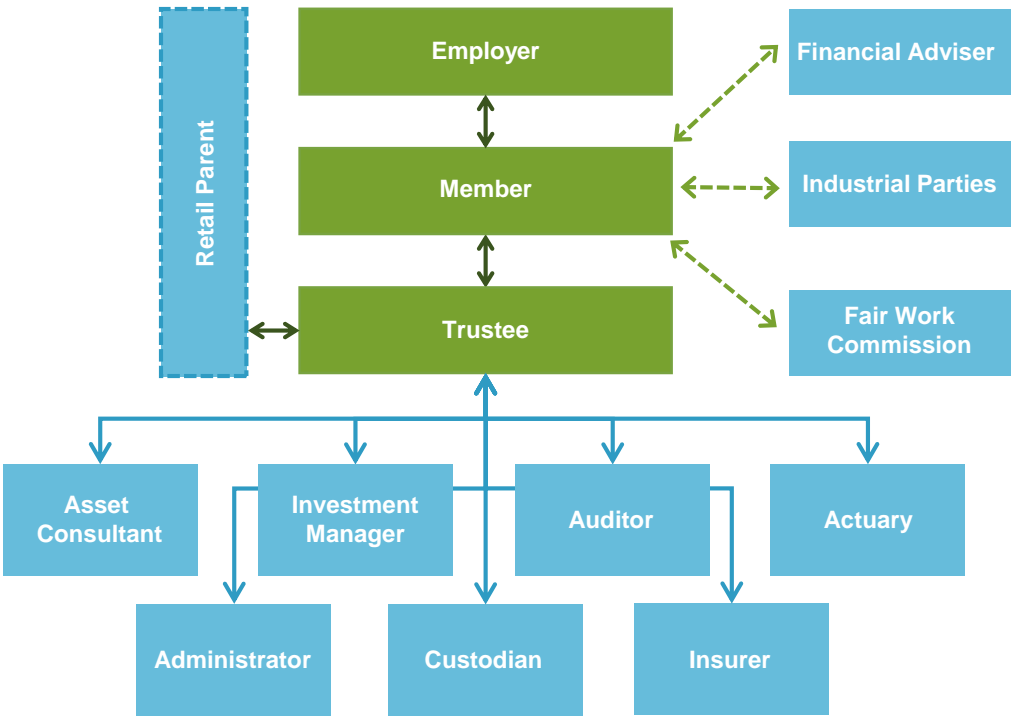
Principal–agent risks give rise to regulation of fund governance

The need to place the interests of members first is enshrined in legislation and reflects the acceptance by governments and system participants that superannuation funds are a product of member compulsion and government policy. The compulsory nature of superannuation, coupled with its preferred taxation treatment, contribute to an expectation that the government will provide a level of regulatory assurance that members’ interests will be protected. A failure to do place members first will result in significant costs — first and foremost to members but also ultimately to taxpayers.

The superannuation system is characterised by a number of principal–agent relationships, that is, relationships in which other parties (agents) makes decisions on behalf of members (principals) (figure 9.1). Problems can arise when the interests of members and agents are not aligned and the agent has the opportunity to exploit information that they hold and the member does not, to the detriment of the member (box 9.1).

Effective management of principal–agent issues by both the agents making decisions on members’ behalf and regulators is important in ensuring the superannuation system remains not only efficient and competitive but fair to members. It also promotes integrity, transparency and confidence in the superannuation system.

Figure 9.1 **Principal–agent relationships abound in superannuation**



Box 9.1 Key principal–agent relationships in the superannuation system**Employers and members**

Under current superannuation arrangements, employers are required to nominate a default fund for those employees who do not choose a fund for themselves. Employer decisions in this context may not be the same as those had the employee made their own choice, and employers are under no legislative requirement to make a choice in the best interests of their employees.

In cases where an employer is free to choose from a number of default funds, they might face an incentive to make a decision that is not in the best interests of their employees (PC 2012). For example, they may choose a fund on the basis of less onerous administrative requirements. Further, employers may be targeted by superannuation funds that wish to be the employers' default fund. A recent ASIC survey of trustees highlighted that superannuation funds commonly provide benefits to employers such as free educational materials, free tickets to sporting events and corporate hospitality (ASIC, sub. 90).

Trustees and members

Superannuation fund trustees have a fiduciary responsibility for managing and investing the contributions of members. However, this does not make the relationship immune from conflict. For example, in circumstances where members may benefit from a fund merging, this may not be in the best interests of trustees who face the prospect of losing their role.

For-profit superannuation funds are required to act in the best interests of members, even when doing so may conflict with shareholder interests. Trustees might, for example, have an incentive to outsource activities to related parties when they could be provided more cheaply or effectively by an unrelated party (Neal and Warren 2015). Not-for-profit funds can also be subject to conflicts of interest. For example, sponsoring entities could seek to influence investment decisions based on industrial relations concerns. In 2012 and 2013 the CFMEU (a sponsoring entity of Cbus) expressed concern that Cbus had entered into a contract with Grocon, a company with which the CFMEU was involved in a heated industrial dispute. Subsequently, a 'Building Industry Group Consultative Forum' was formed to liaise between Cbus and the CFMEU and address matters of concern identified by the CFMEU (RCTUGC 2015, pp. 467–8).

Financial advisers and members

Whether employed in-house (possibly as part of a vertically integrated entity) or by third parties, financial advisers have traditionally received commissions or other remuneration benefits from product providers for placing clients with particular products. These arrangements potentially encourage advisers to sell particular products rather than give unbiased advice focused on their clients' interests. Advisers might also face conflicts where provision of particular advice to clients will result in ongoing payments to the adviser. For example, while SMSFs generally avoid principal–agent issues, there might be incentives for advisers to recommend setting up SMSFs to clients based on potential ongoing fee revenue to the adviser rather than because it is in the client's best interests.

Employees and industrial parties

Industrial parties have traditionally played a major role in determining which superannuation funds are listed in awards and therefore eligible for default contributions. There is potential for conflict given industrial parties are often sponsors of industry funds (Drew and Stanford 2003).

9.2 How do funds perform on board composition and assessment?

A stronger focus on trustees' skills would support better governance

Evidence suggests there has been an increasing focus by boards on ensuring new appointees bring appropriate skills, knowledge and experience. As APRA has recently noted:

To ... support better governance practice, a number of boards have been working to develop strong collaborative relationships with their nominating bodies to ensure that they understand both the board's strategic direction and the type of candidates that are required. Some boards are also recognising the importance of carefully considered succession planning ... This ensures that boards don't just look to fill a vacancy as it arises but ... as part of ongoing renewal planning. (Rowell 2017c, p. 4)

This is consistent with the expectation of APRA's Prudential Standard SPS 510 which requires 'directors, collectively, to have the necessary skills, knowledge and experience to understand the risks of the RSE licensee's business operations, including its legal and prudential obligations' (SPS 510, para. 10).

The results of the Commission's CEO Governance Survey also indicate a recognition of the need to ensure board members are chosen for the experience and skills they can contribute. However, in practice this recognition does not always translate to good recruitment practice. Only 60 per cent of responding CEOs (representing 66 per cent of assets and 68 per cent of member accounts in the system) strongly agree that their boards have effective board recruitment processes (and 30 per cent mostly agree). And some of the confidential comments accompanying the survey highlighted concerns about inadequate board control over the appointment process and the appointment of nominees with skills and experience that were not well suited to the board's needs.

Furthermore, only a little more than half of responding CEOs (representing around 60 per cent of assets and members accounts in the system) strongly agreed that their board examines and improves its mix of capabilities over time. Likewise, it is concerning that only 55 per cent of responding CEOs (representing around 65 per cent of assets and 62 per cent of member accounts in the system) strongly agree that their board has the right mix of capabilities.

Good outcomes are most likely when sponsoring entities recognise that recruitment of appropriately skilled directors is of critical importance — but not all sponsoring entities do. Following ten interviews with superannuation board directors (seven from the not-for-profit segment, and three from retail funds) in 2015 and 2016, Donald and Le Mire (2016, p. 17) found that the nominees of sponsoring entities were 'typically appointed without further review or interference'. Some board members stated there were benefits in boards discussing skill gaps with nominators in advance to seek to ensure board appointments reflected skill gaps. However, Donald and Le Mire (2016, p. 18) noted that such 'efforts appeared to meet with mixed success'.

APRA has identified board composition as an ongoing area of concern following their recent thematic review of governance:

Unfortunately, however, very few boards that were part of the thematic review were able to articulate, or had formally documented, what the optimal composition of the board should be now and how this might change into the future in accordance with the strategic direction of their operations. (Rowell 2017c, p. 4)

The ASX recommends that publicly listed companies ‘should have and disclose a board skills matrix setting out the mix of skills and diversity that the board currently has or is looking to achieve’ (ASX 2014, p. 15). The Commission considers that skills matrixes represent best practice for making board appointments. Such matrixes should be informed by external evaluation of board performance, and should detail the skills, experience and knowledge of board members, and enable identification of gaps in the collective skills of boards, and future requirements. Identified gaps should be addressed through professional development initiatives and board appointment processes (as recommended by the ASX for listed companies).

The use of skills matrixes also provides boards and CEOs with greater ability to pushback against substandard or unsuitable board nominations by sponsoring entities — and appointment of such people to boards is simply no longer tolerable given the size and significance of the superannuation system. There is a strong case to amend the Superannuation Industry (Supervision) Regulations 1994 (Cwlth) to require boards to annually publish a consolidated summary of their completed skills matrix.

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Although there have been improvements to trustee board appointment processes to better ensure boards have the necessary skills and experience, there is still much room for trustee boards to do better in this area. Use of a skills matrix (informed by external evaluation of board performance, skills, experience and knowledge) to guide the appointment process should be considered best practice by superannuation trustee boards.

The value add of independent directors is strongly contested

In relation to raising levels of skills and experience on superannuation boards, much recent debate has focused on the merits of increasing the number of independent directors. Murray et al. (2014) suggested that a focus on independents would see an increase in the skills of board members, and both the Cooper and Murray reviews recommended an increase in the number of independent board members. This is also a priority for APRA (Rowell 2017c, p. 5), and the Australian Government is seeking to mandate that a minimum of one third of superannuation board positions be held by independent directors (O’Dwyer 2017c).

Results of the Commission's governance survey suggest about one quarter of directors are independent (that is, on average there are two independents on each board, with an average board size of eight). However, the composition of boards varies significantly, with 22 CEOs (representing 6 per cent of assets and 4 per cent of member accounts in the system) responding that their boards have no independent directors and 18 (40 per cent of assets and 47 per cent of member accounts) responding that the majority of members were independent. Moreover, the Commission's analysis of the composition of boards, and other evidence (Liu and Ooi, sub. 92), indicates that some retail fund board members, although considered 'independent', are on a number of related party boards, which raises questions about their independence and fuels perceptions of conflicts of interest.

The debate over mandating independent directors has become highly polarised between the retail and industry fund segments. Retail funds have generally supported mandating a number of independent directors on superannuation boards, while many industry funds have been resistant. The concept of independent directors has a different meaning in the two segments. In the retail fund segment, independence refers to being independent from the management of the parent company. In the industry fund segment it is more about independence from the sponsoring entities.

Advocates of mandating independent directors generally argue that the requirement for equal representation of employer and employee representatives on boards in the industry segment is less relevant than when originally introduced, due to the move away from defined benefit funds, the perception that individual trustee-directors are dictated to by the organisations that appointed them and concerns that equal representation can leave some groups 'unrepresented', such as pensioner members or members who have joined the fund because they exercised choice.

Opponents of mandating independent directors typically point to the outperformance of the not-for-profit segment relative to for-profit funds, and generally argue that independent directors are not required in the not-for-profit segment because conflicts between the interests of shareholders and members do not exist.

While the legislated requirement of equal representation on industry fund boards only applies to those that are not public offer, anecdotal evidence suggests that some boards want to appoint independent directors but are facing pressure not to from sponsoring entities.

Independent directors can improve governance but skills, experience and fewer potential conflicts are just as important ...

The Commission considers that best practice from a corporate governance perspective would include the presence of a 'critical mass' (to use the Cooper Review's term) of independent directors (which, in practice, would equate to a minimum of one third of directors on the board, as recommended by the Cooper Review and proposed in the Government's recent legislation). However, it is of equal importance (and arguably matters more) to ensure that

funds have thorough processes in place to recruit highly skilled and experienced boards as it is to focus on the number of independent directors.

DRAFT FINDING 9.2

Best practice governance for superannuation trustee boards would involve a 'critical mass' (at least one third) of independent directors. However, ensuring boards have processes in place to recruit highly skilled and experienced directors is at least as important as the number of independent directors.

... but the definition of 'independent' needs to be tightened

There are varying definitions of an independent director. The *Superannuation Industry (Supervision) Act 1993* (Cwlth) (SIS Act) definition relates only to equal representation structures and provides retail funds with considerable latitude.

The Financial Services Council (FSC) Governance Policy, a product of industry self-regulation, requires members to have an independent Chair and a majority of independent directors and to ensure that a quorum of independent directors is involved in making board decisions. Under the FSC definition, a parent company director cannot be treated as independent on a subsidiary RSE licensee board under any circumstances. However, an independent director on the board of a related entity (but not the parent company board) of an RSE licensee may be treated as an independent director of the RSE licensee if a 'no conflicts' rule is satisfied (that is, if this does not give rise to any real or perceived conflict or the possibility of such a conflict) (FSC 2013, p. 11).

While the FSC's focus on independence is appropriate given the inherent conflicts for retail funds, in practice members' interests would be better protected if the definition of independent director were tightened to limit the potential for conflicts on boards. A recent study by Liu and Ooi (subsequently submitted to this inquiry) concluded:

... on average, 78 per cent of retail fund trustee directors are affiliated, where 34 per cent of these trustee directors are either executives or employees of a related entity within the service provider group, and the remaining 44 per cent are directors of a related entity within the service provider group. (sub. 92, p. 14)

The Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017 has a much more comprehensive definition (box 9.2) of what would constitute an independent director. The adoption of this definition would lead to better handling of conflicts of interests between trustee boards and related parties by reducing the scope for conflicted board members. The Commission considers that APRA should subsequently interpret this definition in a manner that would minimise the potential for conflicts of interest.

Box 9.2 **The Strengthening Trustee Arrangements Bill has proposed a more comprehensive definition of independence**

(1) A person is **independent** from an RSE licensee of a registrable superannuation entity unless the person:

- (a) if the RSE licensee is a body corporate that has a share capital — has a shareholding interest in 5% or more of the share capital of the RSE licensee; or
- (b) if the RSE licensee is a body corporate — has a shareholding interest in 5% or more of the share capital of a body corporate that is related to the RSE licensee; or
- (c) if the RSE licensee is a body corporate — is, or has been at any time during the preceding 3 years:
 - (i) an executive officer (other than a director) or an employee of the RSE licensee; or
 - (ii) a director or executive officer of a body corporate that is related to the RSE licensee; or
- (d) has, or has had at any time during the preceding 3 years, a business relationship:
 - (i) with the RSE licensee; or
 - (ii) if the RSE licensee is a group of individual trustees — with any of the trustees; that is, or was at the time, material to the person or to the RSE licensee (or trustee); or
- (e) is, or has been at any time during the preceding 3 years:
 - (i) a director or executive officer of a person paragraph (d) applies to; or
 - (ii) a person who, in the capacity of an employee of a person paragraph (d) applies to, is or was involved in the business relationship referred to in that paragraph; or
- (f) if the RSE licensee is a trustee of a regulated superannuation fund — is, or has been at any time during the preceding 3 years, a director or executive officer of:
 - (i) an employer-sponsor of the fund who is a large employer in relation to the fund within the meaning of section 29TB; or
 - (ii) an organisation, representing the interests of one or more employer-sponsors of the fund, that has the right to appoint, or nominate for appointment, directors or trustees of the RSE licensee; or
 - (iii) an organisation, representing the interests of members of the fund, that has the right to appoint, or nominate for appointment, directors or trustees of the RSE licensee;
- (g) is a person to whom circumstances of a kind prescribed by regulations made for the purposes of this paragraph apply.

Source: Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017.

... and the barrier to independent director appointments needs to be removed

SIS Act restrictions on the appointment of independent directors for non-public offer employer-sponsored (corporate and industry) funds should be removed. Where funds consider that their governance would be enhanced by the presence of additional independent directors, they should be free to appoint them.

More external assessment of board skills and performance is needed

Board performance and capability assessments are recognised internationally as contemporary best practice for detecting potential gaps in performance and determining

whether boards are appropriately skilled. Under SPS 510, APRA requires boards to assess their performance — and that of individual directors — at least annually. Additional guidance (SPG 510) sets out APRA’s *expectations* that a board assessment (which would cover both board performance and director capability) be undertaken by an external party at least every three years.

Assessments were an area of concern for APRA from its 2015 thematic review of board governance. APRA highlighted the importance of boards seeking independent assessments (rather than relying on self-assessment), and of taking steps to remedy any identified underperformance (Rowell 2017c).

While the majority of respondents to the Commission’s governance survey reported that their boards seek independent review of trustee capabilities to ensure they are optimal, 22 per cent (representing 25 per cent of assets and 30 per cent of member accounts in the system) either disagreed or only slightly agreed that this was the case. And only around 60 per cent of responding CEOs (representing 73 per cent of assets and 70 per cent of member accounts in the system) ‘strongly agreed’ that their boards examine and improve their effectiveness on a regular basis, which the Commission does not view as a reassuring result.

Arrangements should be tightened to explicitly *require* trustees to have and disclose a process to:

- assess, at least annually, the board’s performance relative to its objectives and the performance of individual directors (as required by APRA’s standard SPS 510)
- seek external third party evaluation of the performance of the board (its committees and individual trustee directors) and capability (against the skills matrix) at least every three years. The assessment should consider whether the matrix sufficiently captures the skills that the board needs (and will need in the future) to meet its objectives, and highlight any capability gaps. APRA should be provided with the outcomes of such evaluations as soon as they have been completed.

DRAFT FINDING 9.3

Despite widespread recognition that evaluation of board performance and capability by external third parties are crucial to identifying skills gaps on boards, many boards fail to undertake such evaluations.

9.3 How well do funds deal with conflicts of interest?

Given superannuation operates within a world of compulsion and principal–agent relationships, but where the key focus must be on the interests of members, effective management of conflicts of interest and the issues they give rise to is paramount.

Related-party outsourcing merits stronger assessment and disclosure

A number of regulatory measures stemming from the Stronger Super reforms seek to mitigate against the use of related parties that is not in members' best interests:

- SPS 521 (APRA 2013b) introduced the requirement that funds have a conflicts management framework
- SPS 231 (APRA 2012) requires that boards are able to demonstrate to APRA that agreements on outsourcing are made on an arms-length basis and with the benefit of a 'tender or other process', and that funds notify APRA when an agreement is entered into, ceased or changed
- SRS 331 (APRA 2015b) sets out reporting requirements related to associate parties
- legislative changes passed in 2013 under the *Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Act 2013* (Cwlth) mean that RSE licensees can no longer be bound by trust deeds that might require them to engage particular service providers
- SIS regulation 2.38 (set in July 2014 and overseen by ASIC) requires funds to publish 'the name and Australian Business Number of each outsourced service provider who provides a service which may affect a material business activity of the entity'.

Despite these measures, related-party transactions remain a concern.

An APRA thematic review of conflicts of interest in 2015 broadly found that those funds with a strong risk management framework performed relatively well in dealing with conflicts of interest, but that there were also funds that 'tended to adopt a more minimalist approach to implementing the prudential requirements, designed simply to comply with, rather than meet the spirit and intent of, the requirements' (APRA 2015c, p. 29). This led to 'poor recognition of related-party conflicts, poor conflicts management practices (including registers which were deficient or out of date), and a lack of challenge or review from other independent or expert parties' (APRA 2015c, p. 29). There was 'a lack of consistency across the industry ... in relation to RSE licensees identifying and managing conflicts when dealing with intragroup service and product providers and other related parties' (APRA 2015c, p. 34).

The review also noted that many conflicts management frameworks were 'lacking in their consideration' (APRA 2015c, p. 34) of these legislative changes relating to trust deeds.

APRA is reviewing related-party transactions, suggesting that they retain concerns in this area; but there is no evidence of any conduct regulation action against any trustee board to date.

Reporting of related-party transactions leaves a lot to be desired, and analysis of the relationship between service costs and the use of related party providers (chapter 7) strongly suggests that the arrangements used by some funds are not sufficiently cognisant of members' best interests.

Participants have mixed views on current regulatory protections

Participants expressed differing views on the materiality of the risks associated with related-party transactions and the efficacy of existing regulations. MLC (stage 1, sub. DR115, p. 33) submitted that contestability amongst outsourced providers is reasonably unfettered.

Other participants considered that existing regulatory protections are inadequate. The Australian Institute of Superannuation Trustees (AIST) submitted that conflicts of interest reporting should be strengthened to bring due diligence for related parties into line with outsourcing requirements (AIST, stage 1, sub. 30, pp. 31–2). Hartley (stage 1, sub. DR82, p. 1) submitted that there continues to be a lack of effective transparency on (among other things) the fees that are paid to related third parties, and that APRA would be well placed to collect more information on material outsourcing arrangements which could subsequently be used to provide summary benchmarking information to funds regarding market rates.

Recent regulatory changes are a step forward but should be further strengthened

The prudential standards and changes to the legislative and reporting framework introduced in 2012 and 2013 represented a significant step forward in seeking to mitigate the risks to members' best interests potentially posed by related-party outsourcing. However, the current requirement for funds to demonstrate to APRA that they had undertaken a 'tender or other selection process' for selecting the best service provider could conceivably cover a range of processes of varying robustness. It does not explicitly require trustees to demonstrate that they have paid a market-equivalent price for related party services, nor that ongoing arrangements continue to be value for money, given current market prices.

Given the lack of demand side pressure on funds to ensure related-party services are provided on a truly commercial basis, prudential standards should be strengthened to require funds using related parties to conduct formal due diligence of related-party outsourcing arrangements every three years. This would ensure that the arrangements continue to provide value for money, and that information relating to this due diligence be provided to APRA.

FoFA reforms should go some way to mitigate conflicts inherent in vertical integration

Although focused on financial advisers, the 2012 Future of Financial Advice (FoFA) reforms (box 9.3), have led to improvements in the way conflicts of interest have been dealt with within the superannuation system (with superannuation-related advice accounting for the majority of revenue for the financial advice industry (PC 2018)). Not least, the FoFA regime has created tensions for vertically integrated financial institutions with a financial advice or wealth management arm that offers superannuation products — a structure in which conflicts of interest are inherent.

Box 9.3 **Future of Financial Advice reforms**

The 2012 Future of Financial Advice laws were designed to improve governance arrangements, particularly relating to conflicts of interest and transparency, in all fields of financial advice. The reforms included:

- bans on conflicted remuneration structures, including commissions and volume payments, in relation to the distribution of, and provision of advice about, retail investment products including managed investments, superannuation and margin loans
- bans on up-front and trailing commissions and like payments for both individual and group risk insurance within superannuation
- a ban on soft-dollar benefits (monetary and non-monetary benefits) received by financial planning firms, representatives and associates in relation to both retail investment products and insurance within superannuation, where a benefit is \$300 or more
- requirements for advisers to request retail clients to opt in (or renew) their advice agreement every two years, with the Australian Securities and Investments Commission being given the power to exempt advisers from the opt-in obligation where it is satisfied that the adviser is signed up to a professional code which obviates the need for opt in
- the introduction of a best interests duty so that advisers must act in the best interests of their clients, subject to a 'reasonable steps' qualification, and place the best interests of their clients ahead of their own when providing personal advice to retail clients (PC 2012).

Minor amendments to these laws were made in November 2015, with the most substantial change being an extension in the timeframe (from 30 days to 60 days) for financial advisers to send renewal notices and fee disclosure statements to clients (O'Dwyer 2015a).

In a recent study of vertically integrated financial advice providers, ASIC stated:

[ASIC] strongly support the FOFA reforms and believe they have gone a long way to addressing some of the problems in the financial advice industry. While the FOFA reforms prohibit certain types of conflicts of interest in the financial advice industry (i.e. conflicted remuneration), they allow the conflict of interest that arises from a vertically integrated business model. Importantly, this conflict of interest is addressed through requirements such as the best interests duty and the obligation to prioritise the interests of the client over the interests of the adviser and related parties. (ASIC 2018a, p. 15)

That said, ASIC also determined that advisers had not demonstrated compliance with the FoFA best interests provisions of the *Corporations Act 2001* (Corporations Act) in 75 per cent of the customer files reviewed through the study. Ten per cent of the files reviewed raised significant concerns about the impact of the non-compliant advice on the customer because switching to a new superannuation platform resulted in either inferior insurance arrangements and/or a significant increase in ongoing product fees without additional benefits being identified. ASIC did note there were some improvements in the practices of advisers when compared with the findings from previous surveillance work undertaken before the FoFA reforms became mandatory in 2013 (ASIC 2018a).

Given that the FoFA reforms are still relatively recent, and that poor practices were heavily entrenched in parts of the financial advice industry, it is likely that many financial advisers are yet to change their practices to reflect the FoFA requirements.

It is also noteworthy — and appropriate — that ASIC is likely to more aggressively pursue what it perceives to be breaches of the FoFA requirements over time as the FoFA reforms become more entrenched. A major test case of the FoFA reforms is currently awaiting judgment (box 9.4).

Box 9.4 ASIC civil action against Westpac

ASIC commenced civil penalty proceedings in the Federal Court in December 2016 against two Westpac subsidiaries (Westpac Securities Administration Limited and BT Funds Management Limited) alleging a number of contraventions, including failures of the ‘best interests duty’ introduced under the Future of Financial Advice reforms.

The proceedings stem from an ASIC investigation into telephone sales campaigns targeting superannuation fund members. ASIC alleges that during the two telephone campaigns, the entities provided personal financial product advice to customers, specifically recommending that customers roll out of their other superannuation funds into their Westpac-related superannuation accounts. ASIC alleges both that the entities provided personal financial product advice not permitted under their Australian Financial Services Licences, and that they did not undertake a proper comparison of the superannuation funds as required by law.

Source: (ASIC 2016a).

Although not necessarily determinative, since the introduction of the FoFA reforms, a number of financial conglomerates have either sold their wealth management divisions, or announced they are considering doing so. While vertical integration can be beneficial for consumers (from a ‘one stop shop’ and economies of scale perspective), the tensions and conflicts involved with these vertically integrated structures are obvious and undeniable and as have been highlighted in the early evidence provided to the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*.

Overall, the FoFA reforms have made a positive contribution towards dealing with the conflict of interest problems inherent in the provision of superannuation products by vertically integrated financial institutions. The proposed creation of a shortlist of superior superannuation products as part of the Commission’s recommendations to improve default arrangements would further assist regulators in dealing with conflicts of interests. While there would be no requirement to choose funds from the shortlist, the list would provide information on quality products which would be suitable for many clients, and presumably make it more difficult for advisers to justify recommending similar products that were not shortlisted.

ASIC has informed the Commission that should a robust, independent best in show list be developed and implemented by government to ensure better outcomes for consumers, it would seek to take this into account in its guidance to financial advisers, particularly around

the application of the best interests duty. With regard to financial advisers providing advice to individual clients, ASIC would likely indicate proper research would include consideration of the best in show list, although the choice of fund would ultimately depend on an individual client's circumstances.

With regard to financial advisers providing advice to employers, ASIC's guidance would likely be stronger given that this impacts consumers who are not actively involved in choosing a fund, emphasising that consideration of the best in show list should be part of the process for considering a default fund. Assuming the list was compiled in a robust manner, ASIC could consider emphasising failure by a financial adviser to consider the list before advising an employer could be seen as creating additional risks of the adviser breaching the best interests duty.

ASIC has also indicated it would see merit in considering reform to mandate advisers to consider a best in show list, although such a requirement would need to be legislated (ASIC, pers. comm., 11 April 2018).

On a related issue, the Commission's *Competition in the Australian Financial System* draft report (PC 2018) discussed the potential for consumer confusion over the term 'general advice'. This term is defined in the Corporations Act, and refers to information regarding financial products and services that is not tailored to take into consideration an individual's circumstances. In practice, much of the material provided under the 'general advice' label is sales and marketing material. As discussed in the *Competition in the Australian Financial System* draft report (PC 2018), the Commission considers the term 'general advice' is misleading and should be changed, because 'advice' has a clear lay connotation of guidance that is intended to be helpful to the recipient. The word 'advice', especially in the compulsory world of superannuation, should therefore only be used for 'personal advice' — that is, advice that takes into account an individual's personal circumstances. For material hitherto falling under the general advice banner, there should be consumer testing of alternative terminology (PC 2018).

In response to the *Competition in the Australian Financial System* draft report, ASIC submitted that 'relabelling general advice is potentially a useful step towards achieving the aims set out by the Productivity Commission' (ASIC 2018c, p. 12), while also noting the 'broad nature of conduct that falls under the general advice definition may mean that there may not be one term to replace the term 'general advice' that is reflective of all conduct' (ASIC 2018c, p. 14).

9.4 How do funds rate on transparency?

Not all is well ...

Increased disclosure requirements that took effect in mid-2014 — following from the Stronger Super reforms and contained in the Superannuation Industry (Supervision) Act

Regulations 1994 (for example, details of remuneration, trust deeds, board appointment and removal processes, trustee qualifications and conflicts of interest policies) — have led to improvements in disclosure.

However, in looking into how prominently this information is displayed, it is clear the industry has a mixed record. A large proportion of funds — including most of the larger ones — place this information prominently on their websites, or at least under logical headings where a member seeking such information would readily find it within minutes. However, on a significant minority of websites the same information is effectively ‘buried’, with no obvious pathway for members to find it.

ASIC recently also raised a number of issues relating to disclosure following work on members’ experiences with superannuation funds, including their experiences in joining a fund, participating in a fund, and changing or leaving a fund. Concerns were raised in regard to areas such as:

- poor disclosure of insurance details to members in areas such as exclusions and cessation of cover
- the prominence on fund websites of product dashboards, and inconsistencies between funds regarding the contents of dashboards
- trustees using marketing material to promote fund consolidation, and sometimes understating the risks associated with consolidating superannuation accounts while highlighting the benefits
- poor claims handling processes and poor provision of information about dispute resolution processes (ASIC 2017e).

ASIC also recently issued Infringement Notices against Spaceship Financial Services and Tidswell Financial Services in their respective roles as promoter and trustee of the Spaceship Fund, citing concerns that ‘promotional statements prioritised marketing over accurate disclosure’ (ASIC 2018f, p. 1). Spaceship and Tidswell subsequently each paid a \$12 600 penalty which did not represent an admission of a contravention of the *Australian Securities and Investments Commission Act 2001* (Cwlth) (ASIC 2018f).

As discussed at a number of points in this report, there are concerns about the adequacy of some data provided to regulators. In particular, widespread reporting of ‘zero’ investment costs by funds makes assessment of performance problematic, and warrants action by regulators and government (chapter 10). There are current reform proposals seeking to provide APRA with increased ability to assess transactions on a ‘look through’ basis and the Commission supports these initiatives (which are discussed in more detail in chapter 10).

In short, funds have a mixed record in terms of disclosure. Based on the Commission’s observations, all funds meet their legal requirements contained in the Superannuation Industry (Supervision) Act Regulations 1994. However, there have been a number of issues identified relating to disclosure — particularly regarding insurance offerings that are not

well understood by members — and funds have considerable room for improvement in this area. There is also a role for regulators in ensuring improvement occurs.

9.5 What is the evidence on funds' investment governance performance?

'Peer-risk' appears alive and well

It is often argued that regardless of what trustees consider to be the fund's best long-term investment strategy, many will mimic (at least to some degree) the strategy of rival funds (sometimes referred to as 'herd behaviour'), fearing that they will otherwise perform relatively poorly in the short term and therefore lose members. These effects are likely to be particularly strong during periods where asset prices are growing strongly and trustees 'going against the trend' could see short-term results well below those of rival funds.

However, for funds employing such strategies, *long-term* returns (which should be the core focus for superannuation funds) are likely to be lower than they otherwise would have been (hence the term 'peer risk'). In addition to distorting investment away from those assets likely to produce the best long-run returns, the strategy is also likely to lead to more frequent trading and therefore higher transactions costs.

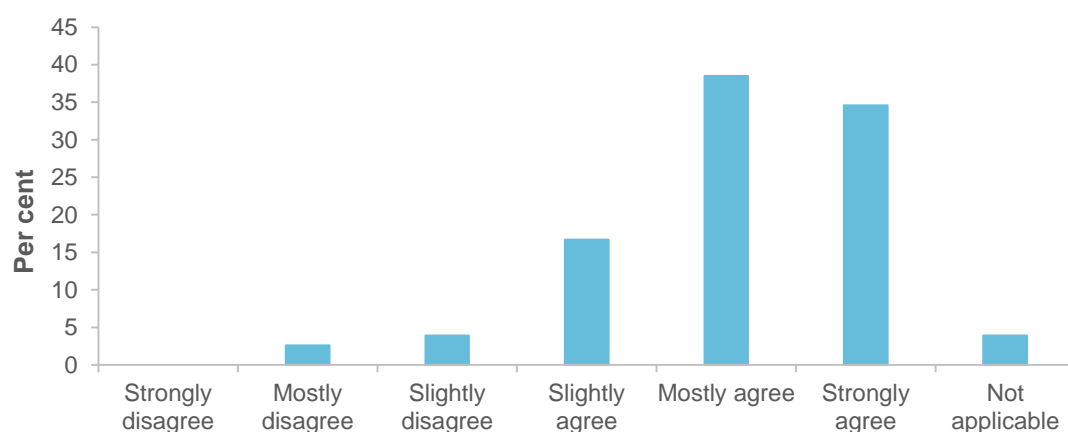
The evidence points to some degree of clustering in asset allocation portfolios. Much of this, however, is likely to stem from funds 'following the leader' with regard to investment strategies (such as investing in unlisted infrastructure) that are perceived to have been successful, and adoption of a similar (asset allocation) investment strategy for many members in accumulation is unsurprising (as long as it delivers strong long run net returns). This is likely to be positive for members.

However, the wide range of responses to the question on peer risk in the Commission's governance survey suggests some funds' investment strategies are influenced by the short-term performance of peer funds and that there is also likely to be an element of clustering to avoid being a poorly performing outlier in the short term (which would not be in the long-term interests of members). In response to the statement 'my board's investment strategy is not materially influenced by the performance of peer funds', only 35 per cent of CEOs strongly agreed; 39 per cent mostly agreed, 17 per cent slightly agreed and a further 6.5 per cent slightly or mostly disagreed. A reasonable interpretation of these results is that peer performance is a consideration in the investment strategy for a significant number of funds (figure 9.2).

DRAFT FINDING 9.4

Many funds mimic (at least to some degree) the strategy of rival funds for fear they will otherwise exhibit poor short-term performance relative to their peers ('peer risk'). This short-termism is likely to be at the expense of long-term returns to members.

Figure 9.2 Investment strategies in some boards are influenced by the performance of peers^a
My board's investment strategy is not materially influenced by the performance of peer funds



^a Disagrees and slightly agrees represented around 15 per cent of assets and member accounts in the system.

Source: Governance survey.

Performance attribution

The Commission views ongoing performance attribution by funds (including by asset class) as critical to funds understanding and improving their performance over time. Ideally, such attribution would be done independently of the fund.

Almost 85 per cent of CEOs (representing 90 per cent of assets and 92 per cent of member accounts in the system) who responded to the Commission's governance survey either strongly (53 per cent) or mostly (32 per cent) agreed that their board regularly assesses and fully understands the attribution of investment performance outcomes (including by asset class). In response to a similar question in the funds survey, 81 per cent of funds reported undertaking performance attribution analysis (generally quarterly or monthly). Taken at face value, these results would suggest funds were performing well in this area and that, although there was room for improvement at some funds, there is little need for concern.

However, many funds were unable to provide data in response to the Commission's funds survey regarding the performance of different asset classes. For example, only 42 per cent of responding funds (representing 59 per cent of assets and 62 per cent of accounts) were able to provide data on net rates of return for Australian listed equities. While this is in the context of the disappointing response to the funds survey overall, it also raises questions about the adequacy of any performance attribution work being undertaken. Such work should have rendered such a question easily answerable — and could arguably imply a contemptuous disregard for members by those who elected not to respond.

The Commission can therefore reasonably conclude that funds have considerable room for improvement with regard to the use of performance attribution.

9.6 What do funds' merger decisions look like?

While mergers have been plentiful, more could have been expected

As detailed in chapter 7, there has been consolidation in the number of APRA-regulated funds over the past decade through funds winding down or merging. Most of the consolidation, however, has been due to the decline in the number of corporate funds (an inevitability with the move away from defined benefit arrangements), and it is clear, given the economies of scale in superannuation (chapter 7), that members stand to benefit from an increase in merger activity, particularly activity involving the remaining large number (some 110) of smaller funds.

Moreover, the industry contains a not insignificant number of struggling funds displaying consistently inferior performance (chapter 2). And APRA noted the problems confronting a number of poorly performing funds in a letter sent to trustees on 31 August 2017:

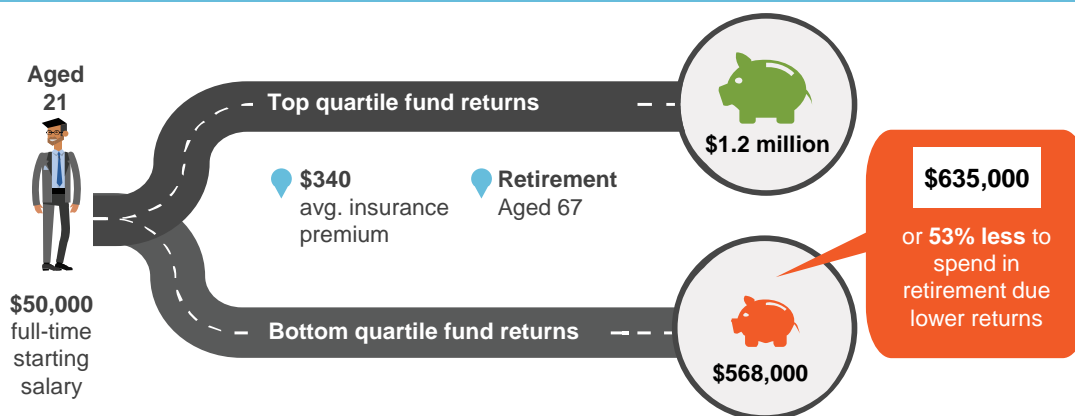
APRA's ongoing supervision has identified some RSE licensees that appear not to be consistently delivering quality member outcomes, leading APRA to question whether these RSE licensee's business operations are appropriately positioned for future effectiveness and sustainability in an increasingly competitive industry environment. (Rowell 2017a, p. 1)

As the Commission's cameo modelling (chapter 1) illustrates, membership of an underperforming sub-scale fund can impose large costs — a typical full-time worker who spends their working life contributing to the median bottom-quartile fund on investment performance, for example, is projected to retire with a balance 53 per cent (or \$635 000) lower than if they were in the median top-quartile fund (cameo 9.1).

The proposed outcomes test (chapter 10) should assist in bringing about rationalisation. But hitherto, although there has been a number of mergers in recent years, a number of smaller, poorly performing funds have survived. Which poses the question — why we have not seen more mergers?

Cameo 9.1 Underperforming funds drain retirement balances^a

Super problem: Underperforming fund = 13 years' lost pay



^a The assumptions underpinning this cameo are set out in chapter 1.

BT Financial Group questioned the reasons for the reluctance of some trustees to merge:

There have been a number of instances in the past few years of trustee board directors (and their sponsoring bodies) having an incentive to avoid mergers that would force them to relinquish their position on the merged fund's board, which may have resulted in the merger not proceeding, regardless of whether or not the merger would be in the best interests of the members. (sub. 32, p. 7)

The ACTU took a different view:

The ACTU is unaware of any circumstance in which a trustee or a sponsoring organisation has opposed a merger because that merger would have led to a loss of a position or a level of representation. The ACTU would be pleased to respond to specific cases and would welcome the opportunity to provide the Commission with a factual account of events around failed mergers so that we can avoid further unsubstantiated, vague assertions. (stage 2, sub. DR71, p. 8)

The Commission is aware of a number of concerns that mergers have been abandoned due to debates about composition of the merged board (or, to put it more bluntly, due to concern by trustees that they would not be part of the board of the merged entity). Recently, the CEO of Australian Catholic Super, Greg Cantor, was quoted in the media acknowledging that disagreement over who would Chair the merged entity was one factor (of many) in the collapse of a proposed merger between Australian Catholic Super and the Australian Superannuation and Retirement Fund (Patten 2017).

However, there have been success stories, such as the 2011 merger between AustralianSuper and Westscheme (box 9.5). More recently, the merger between Equip Super and the Rio Tinto Staff Superannuation fund has reportedly resulted in larger savings than originally anticipated, and therefore larger fee reductions for members (Equipsuper 2018), and

significant cost savings and fee reductions have reportedly also stemmed from the merger between Sunsuper and Kinetic Super (Sunsuper 2018).

Box 9.5 AustralianSuper and Westscheme merger — a best practice exemplar

The 2011 merger between AustralianSuper and Westscheme, described in the media at the time as ‘a surprise to many within Australia’s super industry’ (Taylor 2011, p. 10), is viewed by many industry participants as an example of best practice in fund merger procedures.

The Chief Executive of Westscheme noted at the time of the merger — following shortly after the Cooper Review and a renewed Government push to promote fund mergers — that it had become challenging for the fund to deliver services in a cost-effective manner and that this prospect was unlikely to change. Westscheme had \$3.4 billion in assets under management and 200 000 member accounts. Scale issues did not represent the predominant driver of the merger.

Significantly, 35 per cent of Westscheme’s member base was inactive (that is, not making contributions) and the Government was looking to minimise the number of inactive accounts across the system. Westscheme faced the prospect of spreading its costs across 130 000 members instead of 200 000 (Taylor 2011, p. 10). Although the fund’s viability was not compromised, following an independent report by PwC (acknowledged at the time as the Board’s recognition of an inevitable conflict in considering the merger had it not sought independent advice), a merger with AustralianSuper — rather than with a smaller fund, which might have raised the possibility of further subsequent mergers and therefore member transfers — was seen as strongly in the long-term best interests of members. Westscheme approached AustralianSuper with the merger proposal.

The timing of the merger (30 June 2011) was also cognisant of the deadline for tax relief on successor fund transfers, which was reportedly a major issue for Westscheme given parts of its investment portfolio had suffered significant write-downs following the global financial crisis.

The merger did not involve any insistence of Westscheme board members being transferred to the AustralianSuper board.

Sources: (Investment Magazine 2011; Investor Daily 2011; Taylor 2011).

There is a lack of transparency about mergers that do not proceed

The stage 2 draft report noted that there is a general lack of transparency for both members and APRA in situations where a fund was approached for a merger, but the merger did not go ahead — in stark contrast to the extensive information provision requirements for listed companies (at all stages of the merger process) under Part 6.5 of the Corporations Act. The Commission proposed the introduction of a requirement for trustees to disclose all merger approaches, and the reasons for any subsequent decisions, to both their members and APRA.

In response to the stage 2 draft report, a number of participants supported introducing a framework incorporating greater transparency around merger proposals. For example, BT Financial Group stated:

... there is a case for the Government to develop a clear, transparent and accountable framework to guide trustees when proposing or considering mergers, including:

- clear guidelines for funds on how to approach another fund with a merger proposal;
- an obligation for trustees to give genuine consideration to merger proposals in the context of member interests; and
- disclosure by trustees to their members and APRA of all genuine merger approaches and the reasons for any decisions. (sub. 32, pp. 7–8)

But a number of participants also suggested that requiring funds to disclose all merger approaches could discourage early merger approaches and, by extension, prove counterproductive in encouraging merger activity. PwC stated:

... preliminary informal work is required to better understand the potential strategic, cultural and operational fit and therefore whether the significant costs and time involved in undertaking a detailed due diligence are worth incurring. In our view, forcing trustees to disclose the nature of all these early and informal discussions would be counterproductive in that they would likely result in an avoidance of undertaking these important early informal discussions by Trustees. (stage 2, sub. DR85, p. 4)

AIST saw timing of disclosure as critical:

AIST would have no objection to funds being required to advise members by way of the annual report in respect of merger proposals which had been commenced but not proceeded with. There should not be a requirement to disclose merger proposals to members where the outcome had not yet been determined, as that could of itself impact the merger discussions. (sub. 39, p. 31)

BT Financial Group suggested the trigger for disclosure could be at the memorandum of understanding stage:

... the requirement to disclose merger negotiations to APRA could be established so that it only takes effect once a certain point is reached, such as when a Memorandum of Understanding (MOU) is agreed between the parties. (sub. 32, p. 8)

Any proposal for merger transparency carries a risk that some potential merger participants might be dissuaded from initiating merger discussions. Against this, in the absence of transparency it appears that a number of mergers that would be in the interests of members are foundering for questionable reasons. To strike a balance between these considerations, and in response to the feedback received, the Commission has refined its proposal from the stage 2 draft report.

The Commission recommends a framework involving disclosure to APRA (at the time) of all merger attempts that reached a memorandum of understanding between two funds. This reporting should include disclosure of why any mergers failed to proceed, and an assessment of whether the merger would have been in the interests of members. This framework should provide APRA with increased information to promote mergers, but also encourage APRA to be more proactive in promoting mergers that would be in the best interests of members.

Due to concerns that members' best interests have not always represented the predominant concern of trustees during merger discussions, ASIC should proactively investigate recent questionable cases where mergers between superannuation funds stalled or did not proceed. This investigation should include examination of trustee attitudes to mergers and the reasons mergers did not proceed. Where APRA has concerns about the motivations for a merger not proceeding, it should refer these concerns to ASIC for further inquiry.

Impediments to mergers exist but are often overstated

Participants have raised a number of areas they see as representing impediments to mergers (for example, tax considerations and successor transfer rules). On the other hand, APRA has stated that it does not consider that the current legislative or regulatory settings create any material barriers to mergers.

In APRA's experience, there are a range of other factors, such as differing philosophies behind an RSE licensee's approach to board composition, views of shareholders and differences in strategy and business model, that are more likely to have contributed to some proposed mergers not proceeding. (sub. 89, p. 1)

While rules relating to successor fund transfers (and particularly requirements to ensure no fund members are disadvantaged) have traditionally been cited as an impediment to mergers, AIST saw APRA's latest guidance on successor fund transfers as assisting in removing an often cited impediment to mergers (namely the 'equivalence test' requiring merging funds to ensure members' rights with respect to benefits in the successor fund are equivalent to their rights in the transferring fund):

AIST welcomes APRA's release of SPG 227 Successor Fund Transfers. This guidance provides clarity around the operation of the 'equivalence' test in a way that should facilitate future merger activity from the perspectives of both exiting and receiving funds. (sub. 39, p. 30)

However, ASFA suggested capital gains tax issues would be a merger impediment in the absence of permanent relief:

With respect to CGT rollover relief, ASFA welcomes the government's decision (in the 2017-18 Budget) to extend CGT relief on fund mergers (until July 1, 2020). However, ASFA considers that relief should be made permanent. (sub. 47, pp. 24-25)

AustralianSuper suggested a number of measures designed to facilitate mergers, including extension of capital gains tax relief for superannuation fund mergers indefinitely and encouraging APRA to report annually to the Council of Financial Regulators on their progress and results in the application of the scale/outcomes test in MySuper products (sub. 43, pp. 21-22).

Two measures to better facilitate mergers and regulator accountability

The Commission does not see a significant number of impediments to mergers and has focused on two proposed mechanisms to better facilitate mergers where they are in the interests of members: namely permanent capital gains tax (CGT) relief, and reporting by APRA to the Council of Financial Regulators on progress on fund mergers stemming from the application of the scale or outcomes test.

Permanent Capital Gains Tax relief

The loss relief and asset roll-over provisions to provide relief from CGT were originally introduced as a temporary concession to assist the superannuation industry to cope with the severe economic and financial market conditions in late 2008. The temporary loss relief and asset roll-over was granted for transfer events happening on or after 24 December 2008 and before 1 October 2011 (Treasury 2012).

In initially extending (with some modifications) these provisions in 2012, the Australian Government noted the purpose of doing so was to promote mergers, and that mergers would be a likely outcome of the Stronger Super reform process:

Given the potential benefits to members of facilitating industry consolidation and the possible costs for some entities transitioning to Stronger Super, temporary taxation relief in the form of loss relief and asset roll-over for mergers of superannuation funds is appropriate. (Treasury 2012, pp. 4–5)

The arguments for extending CGT relief in 2012 (with an announcement of a further extension to 2020 in the 2017-18 budget) were strong and apply equally today. Given the Commission considers the push towards consolidation requires further impetus, CGT relief in the event of mergers should be made permanent.

Annual reporting by APRA to the Council of Financial Regulators

The suggestion by AustralianSuper that APRA report each year to the Council of Financial Regulators on the progress stemming from the application of the scale test (or the outcomes test if that becomes law) is supported by the Commission. APRA has a clear role in facilitating and encouraging mergers to ensure members are protected, and it is appropriate that they should report on progress in this area. APRA is also uniquely placed to provide such a summary. Such reporting would also improve transparency to members regarding activities that would otherwise occur away from public view. Further discussion of APRA's regulatory role is in chapter 10.

9.7 Trustee boards' decisions on uses of members' money

Expenditure by funds of the members' balances is an important consideration in determining how well funds are acting in the interests of members. The Commission has particularly focused on two areas of expenditure: advertising and trustee remuneration.

Advertising to build market share can benefit members

A number of participants raised concerns about whether the level of advertising by some superannuation funds was consistent with a focus on member interests. APRA has also recently indicated it will be heavily monitoring activity in this area. Although there is the potential for excessive advertising to reduce returns to members, it is also true that members stand to benefit from greater utilisation of economies of scale within funds and advertising represents one of the major ways (together with mergers) in which funds can build scale. Given the potential efficiency benefits from economies of scale, the Commission does not consider that current advertising levels warrant a stronger regulatory response at this time.

Some participants have also raised whether advertising by funds that is of a political or lobbying nature (such as the 'fox in the hen house' advertisements run by Industry Super Australia in 2017) was consistent with a 'members first' focus. Advertising of a political nature can be more problematic, particularly if it is not directly focused on gaining new (or retaining existing) members (although this outcome might be the ultimate intent of the advertising where it seeks to create or maintain a more positive policy environment for the advertiser). The Commission does not support a blanket prohibition on such advertising (as this would only be justified if such advertising could never be in the interests of members), but does see a case for ASIC, as the predominant conduct regulator (chapter 10), to maintain oversight on such campaigns to ensure the interests of members are protected.

Participants provided feedback suggesting there are issues relating to sporting sponsorships, news websites, and provision of travel and commercial deals with sponsoring entities. While the Commission agrees there are concerns in these areas (particularly as they raise questions about whether expenditure in these areas is consistent with protection of the members' best interests), it is not clear that these issues are of a material nature or that such expenditure is necessarily inconsistent with member interests. However, such expenditure should be an ongoing focus of ASIC to ensure trustees always prioritise the interests of members. At a minimum, going forward, ASIC should readily be able to request and sight the robust business case presented to a trustee board authorising such expenses and demonstrating that they are in members' best interests.

The Commission notes that ongoing work by ASIC, and evidence to the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, might shed further light on these issues. Proposed transparency measures enabling APRA to better look at management and operating expenditure on a 'look through' basis should also assist

in determining whether there are problems in these areas. Where these data raise questions about trustee conduct, APRA should raise these concerns promptly with ASIC.

Benefits to employers

The relationship between funds and employers

Over the course of 2017, ASIC surveyed 46 funds about whether they have provided benefits to employers involved in making default fund choices for employees. Based on the results of their initial survey, they have followed up with a small number of funds to further explore the nature of benefits provided.

The initial work found that, of surveyed trustees:

- 80 per cent had provided advice to employers
- 77 per cent had provided product disclosure to employers beyond just a PDS
- 33 per cent had provided free educational materials to employers, while 24 per cent had provided free tickets to sporting events or corporate hospitality (sub. 90).

ASIC concluded that:

While not the primary focus of the project, in seeking further information about benefits we may need to consider the application of the inducement prohibition in s68A of the *Superannuation Industry (Supervision) Act 1993*. (sub. 90, p. 2)

The results from ASIC's initial work raise concerns about the potential for benefits from funds to influence employer decisions on default fund choices, potentially in ways that are detrimental to members. ASIC's follow up work will go some way towards clarifying whether these concerns are borne out in fact.

The Commission considers it is ultimately implausible to impose an obligation on employers to act in the best interests of employees, not least because the best interests of employees are likely to vary and employers cannot know what they are. The most effective way of ensuring employers' actions are consistent with the best interests of employees is therefore to place obligations on superannuation fund trustees (seeking to ensure benefits are not offered in the first place).

Providers should be prevented from offering employers benefits (including preferable deals on non-superannuation products) to choose their products as defaults, and regulators should actively enforce this. However, the only wholly effective way of dealing with employer inducements (and principal-agent issues involving employers more generally) is to remove employers from the process of selecting superannuation products for employees. This is discussed further in chapter 12.

9.8 Overall conclusions on fund governance

The Commission's overall assessment of superannuation fund governance is that there have been material advances in recent years, in large part due to improvements in the regulatory environment (chapter 10), but there remains considerable room for improvement. Moreover, the prevailing 'behind closed doors' approach to regulation (chapter 10) in the superannuation sector also means that it is difficult to draw definitive conclusions about the quality of governance given many governance concerns are dealt with (or otherwise) away from public scrutiny. (This is a further reason why greater public disclosure of regulatory activity is desirable, as discussed in chapter 10.)

There is evidence that funds have become increasingly aware of the need for greater professionalism as the value of funds under management has grown. Recent reforms have improved disclosure — a good thing — but have shone a light on problems in the system.

For all the progress, a number of governance practices remain that raise not inconsiderable doubts about whether funds always act in the best interests of members, as they are required to. In particular:

- not all funds employ satisfactory practices for appointing adequately skilled and qualified board members, and it appears that some sponsoring entities do not take this process seriously
- some 'independent' retail fund board members are on a number of related-party boards, which raises, at least, perceptions of conflicts of interest
- there is inadequate independent assessment of board capability at some funds
- some funds have poor disclosure practices, and while regulatory requirements regarding the information that must be displayed on websites are met, many funds make such information difficult to find
- not all funds have adequate practices in place to deal with related-party transactions
- many funds acknowledge that they are at least somewhat focused on peer risk (their short-run performance relative to their peers)
- many fund CEOs claim that their boards regularly assess and fully understand the attribution of investment performance outcomes, but relatively few funds were able to provide the data that they would hold if they had undertaken this activity
- many funds have failed to merge when it appears likely mergers would have been in the best interests of members.

Chapter 13 discusses the Commission's recommendations for improving fund governance.

10 System governance

Key points

- Governance of the superannuation system has evolved much over time and is still evolving. The Stronger Super reforms have better equipped regulators to influence governance outcomes and have improved governance standards significantly. But considerable room for improvement remains.
- More recent policy improvements (both implemented and proposed) should bring further advances. The MySuper scale test has proven inadequate in protecting default members from poorly performing funds, and the proposed outcomes test should better enable APRA to promote fund consolidation and protect members from poorly performing funds. Of the other reforms proposed in the same package, the ability to refuse ownership changes and enhanced expense reporting are considered to be of particular import.
- Conduct regulation arrangements for the superannuation system are confusing and opaque, with significant overlap and no clear delineation between the roles of APRA and ASIC. As a consequence, strategic conduct regulation appears 'less than it ought' and regulator accountability is inevitably reduced. To improve outcomes, APRA and ASIC's respective roles need to be more clearly delineated and better align with their distinct 'regulatory DNA'.
 - APRA should be distinctly focused on prudential health — ensuring high standards of system and fund performance. And ASIC should focus on the behaviour of the system — the conduct of trustees, advisers and the appropriateness of products (including for particular target markets).
 - The Commission is seeking participant feedback on whether the proposed allocation of responsibilities between the two regulators would lead to better strategic conduct regulation and clearer accountabilities.
- Regulators also need to be more confident and member-focused in the manner in which they regulate — becoming 'member champions'. The role of regulators is ultimately to protect member interests, although the absence of member voices in major industry debates means the interests of funds can sometimes dominate.
- The formation of the new Australian Financial Complaints Authority (which will deal with superannuation complaints), whilst a welcome initiative, needs to be adequately resourced to deal with the large quantum of superannuation complaints.
- Poor and incomparable data constrain members — or their agents — from ascertaining the most suitable products for their needs. Rather incongruously, the relative wealth of information on MySuper products for default members, is in stark contrast to the dearth of information to ascertain member outcomes in the choice segment.
- The pace and frequency of superannuation policy change has been significant in recent years, unavoidably imposing heavy compliance burdens during implementation. However, most (especially Stronger Super, SuperStream and MySuper) will deliver demonstrable and compounding benefits to members and should reduce compliance costs over time.

Chapter 9 focused on governance within funds (from a system perspective). This chapter focuses on system governance and, in particular, the role of regulators.

The chapter also provides evidence, in whole or part, on the following two of the criteria identified in the Commission's stage 1 report.

- Are principal-agent problems being minimised? (E8)
- Are there material systemic risks in the superannuation system? (E10)

10.1 System governance is a work in progress

Governance evolved as the system matured ...

The maturation and growing importance of the superannuation system within Australia over the past 30 years has led to a progressive re-evaluation of governance and regulatory arrangements for the sector, with a number of significant policy changes (often stemming from major reviews) (figure 10.1).

Prior to 1987, regulation of superannuation was reliant on taxation law. By the 1980s, with superannuation becoming more widespread in the workforce, it became apparent that the *Income Tax Assessment Act 1915* (Cwlth) provisions were inadequate. Regulation was not focused on members, who had no ownership or portability of balances and no adequate protection against their balances being diverted to other purposes by employers.

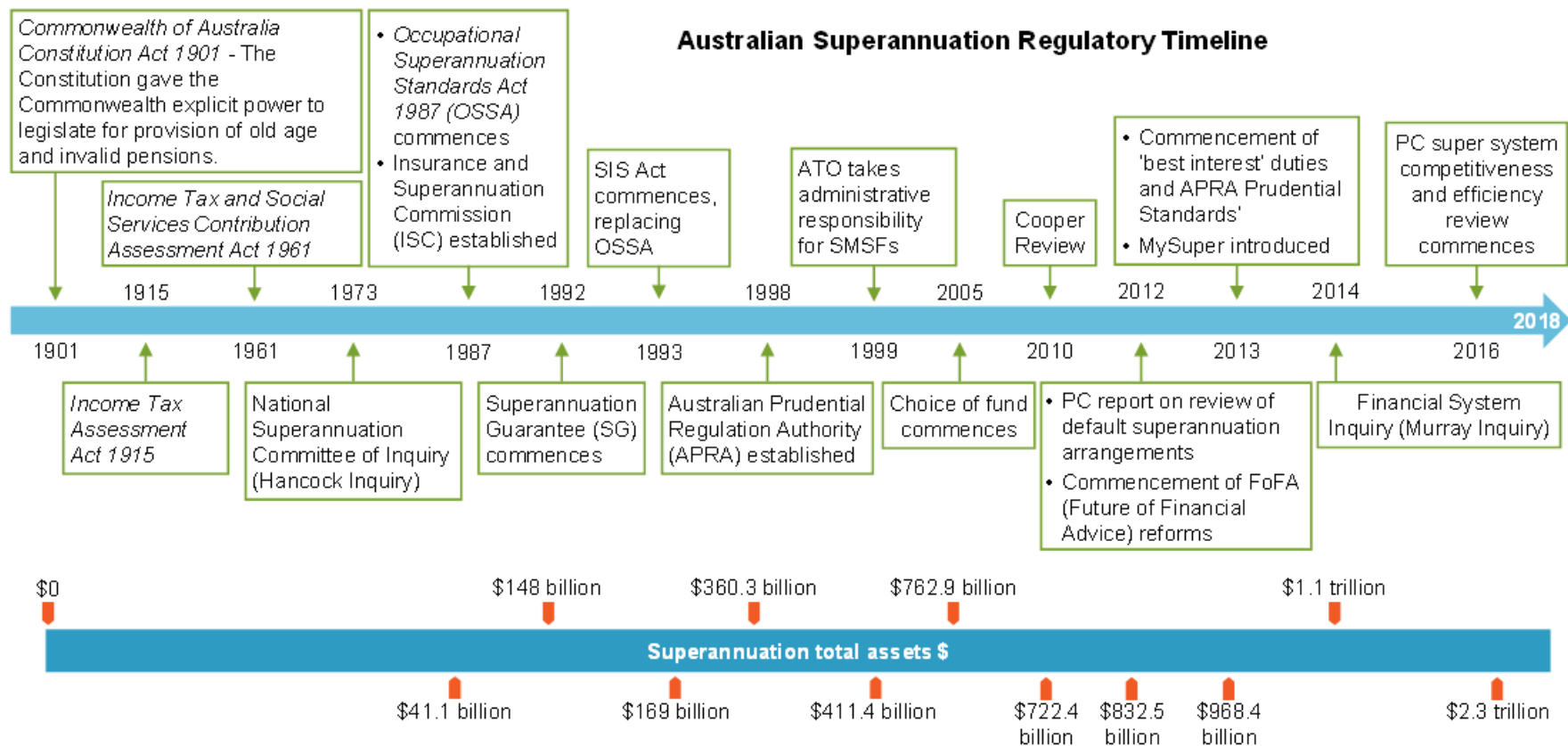
The *Occupational Superannuation Standards Act 1987* (Cwlth) (OSS Act) represented the first major attempt at improving regulation of superannuation (box 10.1). However, the OSS Act really only represented a first step, and the Act's lack of penalty provisions for trustees meant the regime lacked teeth. The OSS Act was replaced by the *Superannuation Industry (Supervision) Act 1993* (Cwlth) (SIS Act) within seven years, and the SIS Act — still the major instrument for regulation of the superannuation sector — represented a major step forward in raising expectations regarding the quality and performance of trustees.

However, regulation of the superannuation system was still far from perfect. A wide-ranging review in 2010 (the Cooper Review), found no evidence of systematic governance failure, but saw a number of areas for improvement. Issues relating to conflicts of interest and duty were seen as especially problematic. In particular, there was concern that trustees were often unclear about whether their main duty was to their employer or to fund members (Cooper et al. 2010b).

A number of governance reforms were implemented in response to the Cooper Review, including:

- a duty for trustees and directors to give priority to the interests of fund members when that duty conflicts with other duties

Figure 10.1 Superannuation regulation has evolved considerably, particularly in recent years



Sources: (Swoboda 2014); APRA Annual Reports (various); Commission analysis.

Box 10.1 **The road to the SIS Act**

Prior to 1987, regulation of superannuation was reliant on the *Income Tax Assessment Act 1915* (Cwlth) (ITA Act) and its various updates. The ITA Act focused on taxation arrangements for superannuation, and deductions and exclusions from income tax were generally provided to employers for money set aside to benefit workers in their retirement.

The *Occupational Superannuation Standards Act 1987* (Cwlth) (OSS Act) commenced on 21 December 1987. ‘Superannuation’ and ‘superannuation fund’ were first defined with the introduction of the OSS Act. These definitions incorporated the sole purpose test — that the fund be maintained solely for the purpose of providing benefits to employees in their retirement.

The OSS Act also introduced measures relating to vesting, preservation and portability of superannuation entitlements, allowing members to identify their benefits, take ownership of them and change jobs without losing them. A new regulatory body, the Insurance and Superannuation Commission (ISC) was introduced to supervise the superannuation industry.

In the years following the introduction of the OSS Act, there was a recognition that governance standards in superannuation needed to improve further. The *Superannuation Industry (Supervision) Act 1993* (Cwlth) (SIS Act), providing for the prudential management of funds, commenced on 1 July 1994. The SIS Act introduced penalty provisions for trustees for breaches, and provided the regulator with powers to disqualify and remove trustees. Eligibility requirements for trustees were introduced, and covenants specified that trustees had to abide by.

In July 1998, the Australian Prudential Regulation Authority (APRA) replaced the ISC and took over administration of those parts of the SIS Act that the ISC had previously taken responsibility for. In 2004, licensing of superannuation trustees commenced (excluding SMSF trustees), and superannuation funds had to register with APRA.

Source: Cleary (2010).

- expansion of the covenants to which APRA-regulated fund trustees must have regard including expected costs and expected taxation consequences
- an increase in the standard of care, skill and diligence required of trustees and directors of corporate trustees to that of a ‘prudent superannuation trustee’ (PC 2012).

These ‘Stronger Super’ reforms represented further improvements to governance. However, by increasing transparency, raising the standard of performance reporting and encouraging the development of products such as MySuper, they have also highlighted the need for, and benefits of, further governance reform.

... and development continues

The Australian Government has proposed a number of reforms aimed at improving member outcomes through the Treasury Legislation Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill 2017. At the time of writing, the Bill had not been passed. Proposed reforms include:

- the introduction of an outcomes test to replace the MySuper scale test

-
- providing APRA with enhanced capacity to refuse authority to offer a MySuper product or to cancel an existing authority
 - the introduction of compulsory annual member meetings
 - providing APRA with the ability to prevent ownership or control changes for MySuper products
 - increased powers enabling APRA to intervene early where it has governance or conduct concerns regarding a fund
 - the introduction of civil and criminal penalties for superannuation trustee Board members found to have breached their duties to members (whereas currently, contraventions of governing rules give rise to claims for losses or damages by affected members)
 - enhanced powers for APRA to obtain information on management and operational expenses on a look through basis.

The Commission considers three of these proposals to be particularly important: the outcomes test, the ability to refuse ownership changes, and enhanced expense reporting.

An outcomes test to replace the scale test

The introduction of an outcomes test is the most significant of the proposed reforms. Designed to raise the overall quality of MySuper products, it focuses squarely on the interests of members. Trustees would be required to make, and publish, an annual written determination of whether the financial interests of the members in a MySuper product are being promoted based on:

- the appropriateness of the options, benefits and facilities offered
- the appropriateness of the investment strategy
- the appropriateness of the insurance offering
- whether insurance fees inappropriately erode the retirement income of the beneficiaries
- whether there are scale problems in relation to the MySuper product (potentially in relation to an insufficient number of beneficiaries or assets)
- any other matters, including those prescribed in regulations.

Second, trustees would be required to make a comparison of their MySuper product against other MySuper products based on:

- fees, costs and taxes
- return targets
- returns
- the level of investment risk
- any other matter prescribed in regulations (Australian Government 2017).

Arguments for replacing the scale test with the outcomes test sit in the explanatory memorandum for the Treasury Legislation Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill 2017:

Whilst the scale test was designed to ensure that members were not disadvantaged by being in a small fund with high costs per member, there are limitations to the value of the current test. For example, trustees with a large number of members and assets in the MySuper product can easily pass the scale test, even if they are underperforming relative to other MySuper products. ... member outcomes are influenced by more than just the scale of the superannuation fund. When making their annual assessment, trustees should have regard to not only scale but also to the outcomes that are being delivered to members in that MySuper product. (Australian Government 2017, pp. 7–8)

Some participants saw the proposed outcomes test as likely to promote industry and product consolidation. For example, the Australian Institute of Superannuation Trustees said:

... the creation of an “outcomes” test applying to trustees in respect of both MySuper and choice products should provide further impetus towards mergers or takeovers – as well as requiring trustees to provide greater justification of excess levels of choice of investment strategy within funds. (sub. 39, pp. 30–31)

REST Industry Super stated:

REST believes the proposed [outcomes test] changes ... will help ensure further rationalisation of super funds. (sub. 49, p. 5)

APRA is also progressing stronger supervision of outcomes

Ahead of the outcomes test being legislated, APRA is consulting on draft prudential standard SPS 225 Outcomes Assessment (APRA 2017e) which will require *all* RSE licensees to undertake an annual assessment of outcomes being provided to beneficiaries and identify opportunities for improving them. Metrics that APRA expects funds will take into account include:

- net returns, on an absolute basis and relative to risk/return targets
- costs per member for MySuper products
- cost of insurance cover
- administration and operating expenses as a percentage of average net assets (operating cost ratio)
- net cash flows as a percentage of average net assets (net cash flow ratio)
- net member benefit outflow ratio
- net rollovers as a percentage of average net assets (net rollover ratio)
- trends in membership base
- active member ratio (APRA 2017e).

Funds will be required to compare results against their own benchmarks and targets, and to compare those results both to objective benchmarks and targets and to the outcomes being sought and provided by other RSEs. Where a fund consistently underperforms, they will be expected to actively consider whether their operations are consistent with the best interests of members.

Funds would have to share their assessments with APRA, although unlike in the proposed *legislated* outcomes test, they would not be required to publish them.

Stronger oversight of ownership changes

The proposed new laws would enable APRA to: refuse authority for a change in ownership where it has concerns about the new owner; give directions to relinquish control of a licensee whether that control is through share ownership or exists in practice; or suspend or remove a licensee where they have reason to believe they are unable to satisfy trustee obligations. As such, the laws would bring APRA's powers with regard to ownership changes for superannuation funds more into line with those for other APRA-regulated industries. The proposed changes stem largely from the Trio Capital collapse (box 10.2), which followed an ownership change that did not require regulatory approval (Australian Government 2017).

Enhanced reporting of expenses

The new laws would enable reporting standards to be developed that would require trustees to provide APRA with their management and operational expenses on a look-through basis (such powers already exist for investment assets). This is designed to enable APRA to understand more fully how funds are using member contributions, and to consider whether expenses are in line with trustee obligations under the SIS Act (chapter 9).

Where a fund gives money (or other consideration) to another entity, newly proposed reporting standards would require the licensee to provide information such as the detail of the other entity, the purpose of the transaction, how the money was used by the other entity and any entity with which the other entity deals (Australian Government 2017).

The Commission's view on proposed reforms

The overall reform package in the bill is significant and of much potential benefit to members. The MySuper scale test (or its enforcement) has proven inadequate in protecting default members from poorly performing products (chapter 2), and the proposed outcomes test, in tandem with an enhanced capacity to cancel a MySuper authority, should better enable APRA to eliminate such products and promote fund consolidation. It is also consistent with the Commission's view that the key focus of regulators should be on member outcomes, and that there is a need to raise the standards of superannuation products — particularly (given their target market), MySuper products (chapter 12).

Box 10.2 The Collapse of Trio Capital

The collapse of Trio Capital, following a major fraud, saw the loss of approximately \$176 million of members' superannuation benefits, with over 6000 investors affected. The collapse highlighted flaws in the governance and regulatory framework, and it was a key driver behind many currently proposed regulatory reforms (particularly those relating to ownership changes).

The Parliamentary Joint Committee (Committee) Inquiry into the Collapse of Trio Capital reported in May 2012, and noted that the fraud was highly complex in nature, originating with the establishment of a managed investment scheme (MIS), with trustees, directors and investors deceived throughout the operation of the MIS in respect of the actual existence of underlying assets and the supposed rates of return on investments. The Committee raised a number of concerns about the manner in which APRA and ASIC dealt with problems at Trio Capital.

The regulators — APRA and ASIC — must take their share of the blame for the slow response to the Trio fraud. APRA conducted five prudential reviews between 2004 and 2009. It took no enforcement action as a consequence of any of these reviews. ASIC only began its investigation in October 2009 after [a tip-off from an industry participant about suspicious patterns of returns].

From late 2008 to mid-2009, APRA was unable to obtain from Trio a valuation of certain Trio funds' assets. The committee questions how a trustee can be subject to what APRA describes as 'active supervision' over a period of six years and yet, when essential information was not forthcoming at the end of this period, APRA did not act quickly. For a risk based supervisor, as APRA is, the inability of a trustee to provide basic valuation information should have raised strong concerns.

The committee also has concerns at the length of time it took for ASIC to detect the fraudulent activity. It is particularly concerned that communication between ASIC and APRA was lacking in the months from late 2008 to mid-2009. It seems that APRA had not communicated to ASIC its requests for Trio to provide information. As a result, when ASIC commenced its active surveillance of hedge funds in June 2009, it did not seem aware that Trio was not providing the prudential regulator with basic facts about the existence of assets and their value. This information should have been communicated. The committee also believes that the regulators missed key events that laid the platform for the Trio fraud. The first was the purchase of Tolhurst from its previous owners in late 2003 ... The second event related to investments in Trio products via a pooled superannuation trust called Professional Pensions PST (PPPST). In 2004, the trustee of PPPST, the Trust Company, was replaced after expressing concerns at the new investment approach of the interests associated with Trio. These concerns were either not relayed to APRA or did not lead APRA to take action. (PJCCFS 2012, p. xx)

APRA reported on its investigation into the failure of Trio Capital in April 2016. APRA identified concerns that Trio had failed to conduct adequate due diligence in relation to related party investments, made the investments on terms that were more favourable to the related parties than had the investments been at arm's length and failed to adequately monitor the performance of the investments. APRA also identified concerns that Trio's directors failed in their duties and functions under the *Superannuation Industry (Supervision) Act 1993* (Cwlth), and did not act in the best interests of members (resulting in APRA removing 13 former Trio directors from the superannuation industry for specified periods of time).

Sources: (APRA 2016d); (PJCCFS 2012).

While APRA's prudential standards will also act to improve outcomes, the greater transparency and, therefore, scrutiny that would come with publication of the assessment under the proposed legislated test would be a stronger inducement to improve performance.

The Commission also views proposals to give APRA more power to deal with ownership changes as important. It is unsatisfactory from the perspective of members' best interests that a person or entity can purchase an existing RSE licence and continue to operate without regulatory checks of their suitability or background. Such a regulatory loophole is likely to have played a significant role in the Trio Capital collapse, and should be removed.

The laws to improve reporting of expenses are also important. As highlighted at a number of points in this report (and discussed further below), there are too many gaps and inconsistencies in the data being provided to regulators. Bringing reporting requirements for management and operational expenses into line with those for investment costs would address one gap and contribute to an improvement in the quality and usefulness of reported data. Not least, as highlighted by the Trio Capital collapse (box 10.2), ensuring better data on related party transactions would reduce potential avenues for fraud.

Other proposed reforms (increased capacity to remove or refuse authorisation, and to intervene early) are designed to enable APRA to respond to perceived threats to members' interests more decisively and promptly. Subject to the maintenance of an appeal process (such as those contained in the exposure draft of the bill), the Commission welcomes these measures as providing improved protection for members.

The benefits of annual member meetings are less convincing. The meetings will have the benefit of providing members with increased transparency. However, it is unlikely that they will be widely attended and will come at a cost to members (although allowing the meetings to be conducted electronically should significantly reduce that cost).

DRAFT FINDING 10.1

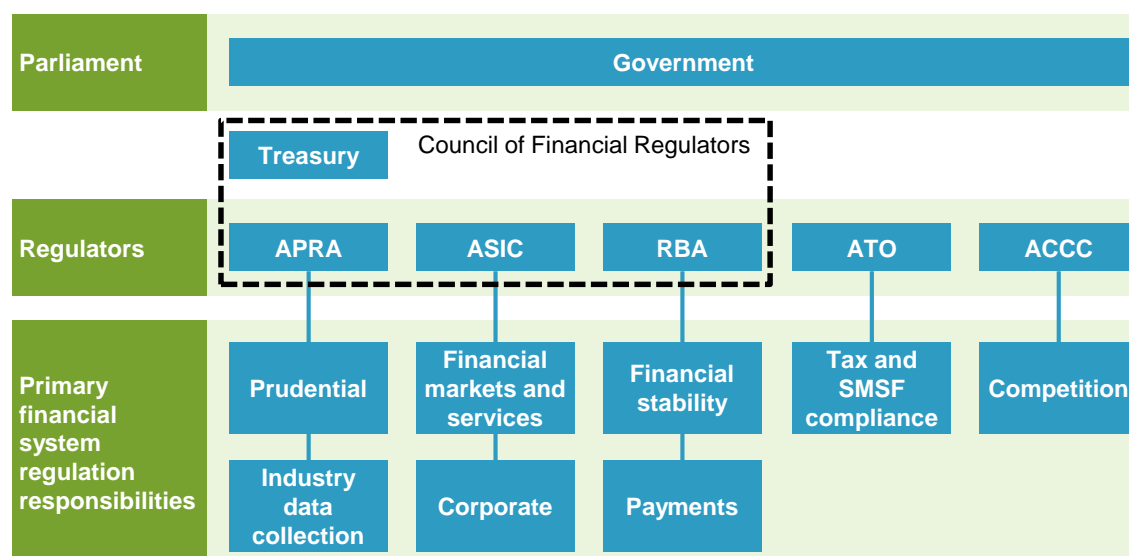
The package of reforms contained in the Treasury Legislation Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill 2017 would improve member outcomes if legislated.

In particular, the proposed MySuper outcomes test should better enable APRA to de-authorise poorly performing products and better promote fund consolidation. Giving APRA more power to deal with ownership changes of superannuation funds would also help.

10.2 Multiple regulators contribute to system governance

Regulation of the superannuation system occurs within the broader financial system regulatory framework (figure 10.2). APRA, ASIC and the ATO are the most prominent regulators, but a number of other agencies regulate specific aspects of the system (box 10.3).

Figure 10.2 The Australian financial system regulatory framework



Source: Figure adapted from (Murray et al. 2014).

Box 10.3 Regulator involvement in the superannuation system

Australian Prudential Regulation Authority (APRA) — prudential regulator of the Australian financial services industry, including superannuation and life insurance from a prudential perspective (including conduct issues that could represent a prudential risk).

Australian Securities and Investments Commission (ASIC) — oversees conduct and integrity of corporations, markets and financial services. ASIC licenses and monitors financial service providers that interact with superannuation funds as well as the funds themselves.

Australian Taxation Office (ATO) — provides administrative oversight of employer contributions, regulates compliance of self-managed superannuation funds (annual returns and auditing requirements) and manages some reporting by APRA-regulated funds. In December 2017, the Government announced an intention to give the ATO responsibility from 2018 for administering early release of superannuation on compassionate grounds (currently a responsibility of the Department of Human Services).

Reserve Bank of Australia (RBA) — uses monetary policy and administers the monetary and payments system to maintain a strong financial system. The RBA is not directly involved in the regulation of participants in the superannuation system.

Council of Financial Regulators (CFR) — the coordinating body for Australia's main financial regulatory agencies, operating as a high-level forum for co-operation and collaboration among members. Membership includes APRA, ASIC, the RBA and the Treasury.

(Continued next page)

Box 10.3 (Continued)

Australian Competition and Consumer Commission (ACCC) — the competition regulator, promotes fair trade in markets to benefit the wider community. The ACCC regulates participants in the superannuation system as part of a broader mandate to ensure that individuals and businesses comply with competition, fair trade and consumer protection laws.

Superannuation Complaints Tribunal (SCT) — an independent dispute resolution body that deals with complaints relating to decisions and conduct of trustees, insurers and other decision makers within the superannuation system. The recently legislated Australian Financial Complaints Authority is scheduled to replace the SCT from November 2018.

Australian Transaction Reports and Analysis Centre (AUSTRAC) — Australia's anti-money laundering and counter-terrorism financing (AML/CTF) regulator and financial intelligence unit.

Office of the Australian Information Commissioner (OAIC) — administers the *Privacy Act 1988* (Cwlth) and seeks to ensure that trustees collect, store and use member information appropriately.

Sources: ACCC (2012); APRA (2016a); ASIC (2016d); ATO (2015a); CFR (2016); SCT (2016).

The Australian Prudential Regulation Authority

Under the *Australian Prudential Regulation Authority Act 1998* (Cwlth), APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia. In the superannuation context, APRA's role can be thought of as monitoring system performance and intervening where funds are performing poorly from a prudential perspective.

Since the collapse of Trio Capital (box 10.2) there have been no major fund failures, although persistently underperforming funds exist (chapter 2), and APRA's ongoing supervision:

... has identified some RSE licensees that appear not to be consistently delivering quality member outcomes across many of the metrics considered, as well as others that have room to improve some specific aspects of their operations. The initial group which APRA has identified for heightened scrutiny and engagement in the near term includes 28 RSEs under the trusteeship of 15 RSE licensees, with RSEs on this list coming from all RSE licensee- and fund-types. The majority of these RSEs are public offer funds and approximately half have a MySuper product. (sub. 89, p. 4)

In recent years, APRA's role in regulating superannuation has been expanded. The 2011 Stronger Super reforms gave APRA the power to develop prudential standards for super funds. It was also given responsibility for authorisation of MySuper products and enforcement of the scale test. As discussed, proposed reforms would further expand APRA's role and increase their powers to intervene where they have prudential concerns. All of these additions to APRA's role, while positive, potentially create overlap and gaps in the roles of

APRA and ASIC in regulating conduct in the superannuation industry. The need to better clarify those roles is discussed later in the chapter.

The Australian Securities and Investments Commission

ASIC is the conduct and integrity regulator of the superannuation system.

Although the Financial System Inquiry (Murray et al. 2014) recommended no fundamental change to financial system regulatory arrangements it did find that there were significant weaknesses in regulator funding arrangements and enforcement tools, particularly for ASIC.

Proposed legislation will expand the ASIC toolkit

Recognising that ASIC was often restricted from intervening until after legal breaches (and therefore potential consumer harm and detriment) became apparent, the Financial System Inquiry recommended that ASIC be given a product intervention power (enabling intervention without a demonstrated or suspected breach of the law). It recommended the regulator be given power to require or impose:

- amendments to marketing and disclosure materials
- warnings to consumers, and labelling or terminology changes
- distribution restrictions
- product banning.

The government released exposure draft legislation for the intervention power in December 2017. The draft proposed that interventions can last for up to 18 months to enable determination of whether they should become permanent. It is also proposed that:

... in order to use the power, ASIC must identify a risk of significant consumer detriment, undertake appropriate consultation and consider the use of alternative powers. ASIC must determine whether there is a significant consumer detriment by having regard to the potential scale of the detriment in the market, the potential impact on individual consumers and the class of consumers likely to be impacted. (Treasury 2016a, p. 5)

The Australian Government also accepted a recommendation for the introduction of a targeted and principles-based product design and distribution obligation. Under the new proposed law:

- offerors of financial products must make a target market determination for most products
- offerors and distributors are prohibited from dealing and providing advice in relation to a product unless a current target market determination is in place
- offerors and distributors must take reasonable steps to ensure dealings in, and advice provided in relation to, a product are consistent with the target market determination.

ASIC is to be given powers (contained in the same exposure draft legislation as the proposed intervention power) to enforce the new arrangements, including the ability to issue stop orders. People suffering loss due to contraventions of the obligation would be able to take civil action.

But ASIC's capability was found not quite fit for the future

A 2015 Capability Review of ASIC found the effectiveness and efficiency of ASIC's capabilities varies widely across areas.

The Review found 'ASIC has a tendency to be reactive in the way it uses the regulatory tools at its disposal and is often excessively issue driven (that is, responding to high profile events) rather than more consistently strategic in its focus' (Chester, Gray and Galbally 2015, p. 11). ASIC was particularly seen as too heavily focused on *reactive* as distinct from *strategic* enforcement.

The Review also highlighted that dealing with policy and customer needs around superannuation (and asset decumulation during retirement) was likely to be a key challenge for ASIC in coming years. Along with other challenges, this was seen as requiring ASIC's regulatory decision making 'to be better informed, more evidence and analytically based, more strategic and ultimately more transparent' (Chester, Gray and Galbally 2015, p. 38).

In discussing reforms prompted by the review, ASIC's Deputy Chairman Peter Kell acknowledged:

ASIC's regulatory framework ... places too much emphasis on investigation and punishment after the event, with few tools to address problems as they emerge or before major losses are suffered. Further, the only available remedy has often been criminal prosecution, again limiting options for ASIC for a range of misconduct. (Kell 2017, p. 3)

The additional powers and tools discussed above have the potential to support ASIC in becoming a more strategic and proactive conduct regulator.

Strategic conduct regulation — where regulators proactively identify actual or potential instances of material member harm, investigate the occurrence and underlying conduct and then take strategic enforcement action — needs to be a key regulatory focus. The regulation is strategic in that the enforcement action pursued not only remediates the identified instance of member harm but provides a valuable public deterrent to future poor conduct (and subsequent member harm).

Or, as put more succinctly by Sparrow (2012):

Pick important problems, Fix them, Then Tell Everybody!

The respective roles of APRA and ASIC merit attention

Overlapping responsibilities are a problem ...

The provision of greater powers to APRA to set prudential standards, and its role in MySuper authorisation, mean it has shifted considerably from being a prudential regulator to one that is heavily involved in regulating the conduct of trustees and other agents involved in the superannuation industry — traditionally ASIC’s territory.

APRA Chairman Wayne Byers has stated:

While most matters of conduct are primarily the responsibility of our colleagues at ASIC, these issues are nevertheless of great interest to a prudential regulator for what they say about an organisation’s attitudes towards risk. So as with the balance sheet strengthening of the financial system over the past few years, we have also taken a greater interest in efforts to strengthen behaviours and cultures. We can’t regulate these into existence, but we have been working to ensure Australian financial institutions have been giving greater attention to these matters than may have traditionally been the case. (Byers 2018, p. 3)

Current arrangements stem from recommendations of the Cooper Review. The Cooper panel recognised the potential for overlap between the regulators (both before and after the suggested expansion in APRA’s role), recommending ‘the Government should explore with APRA and ASIC ways in which the two regulators can work more closely together in discharging their superannuation mandates’ (Cooper et al. 2010b, p. 316). However, while the (then) Government legislated to provide APRA with standards-making powers, the potential for (increased) overlap was not adequately addressed.

The result is that regulatory arrangements for the superannuation system have become confusing and opaque with significant overlap and no clear delineation between the roles of APRA and ASIC in many areas. As a consequence, strategic conduct regulation appears to be less effective than it needs to be and regulator accountability is inevitably reduced. It also poses the very real and ongoing risk that regulatory breaches could ‘fall through the cracks’ as a result of divided responsibilities (with each regulator believing the other was dealing with a matter), leading to poor outcomes for members.

Areas of potential overlap identified by the Commission include the following.

- APRA is responsible for the vast majority of the SIS Act, including the Section 52 covenants, covering directors’ responsibilities and duties. These include general covenants, investment covenants, insurance covenants, and covenants relating to risk. ASIC is responsible for provisions of Parts 3 and 6 of the SIS Act (including the Section 52 covenants) *to the extent to which they relate to keeping of reports or disclosure of information*.
 - There is potential for overlap between the regulators (for example, a failure to exercise care by trustees, or a failure to enable beneficiaries to receive information — both contained in the general covenants — could in part relate to disclosure or record keeping).

-
- ASIC is responsible for the Australian Financial Services Licence (AFSL) regime under the Corporations Act. This requires public offer superannuation funds to hold an AFSL and also requires an AFSL where fund trustees give financial product advice or provide another financial service. There is potential overlap, for example between conditions placed on licences, between AFSL and APRA superannuation entity licensing (a SIS Act responsibility).
 - The SIS Act was amended in 2012 to give APRA power to develop prudential standards. APRA can develop standards in various areas relating to conduct of superannuation entity licensees and connected entities, including to protect the interests of beneficiaries, to ensure funds maintain a strong financial position and to ensure the activities of funds are undertaken with integrity, prudence and professional skill.
 - Prudential standards cannot be in conflict with the SIS Act or the SIS Regulations, but are not legally constrained by traditional areas of regulator responsibility, leading to potential overlap. Prudential standards dealing with management of conflicts could, for example, overlap with *Corporations Act 2001* (Cwlth) provisions (an ASIC responsibility) in this area. APRA consults with ASIC when developing prudential standards.
 - Where a trustee Board had failed to undertake a merger that was clearly in the best interests of members, it is unclear whether APRA or ASIC would deal with this matter (as both deal with the requirement to act in the best interests of members, APRA through the SIS Act, and ASIC through the Corporations Act). The Commission's conclusions on resolving this potential overlap are discussed in chapter 9.

... and the roles of each regulator need clarification

With the increasing overlap in the regulators' roles over time, it is timely to revisit their respective roles and to better align them with the respective and distinct 'regulatory DNA' each possess.

The Commission considers it important to clarify that APRA, as the prudential regulator, should focus on high level system performance (and, consistent with the recommendations of the Cooper Review, particularly on ensuring funds deliver in the best interests of *members*). This would involve APRA monitoring both system and fund performance and intervening when a fund's overall performance is inconsistent with the best interests of members. It should encourage such funds to 'lift their game' or, alternatively, manage a merger or exit and ensure the interests of members are protected during the process. APRA would continue to use its risk assessment tool (the Probability and Impact Rating System, or PAIRS) and supervisory response system (the Supervisory Oversight and Response System, or SOARS) to supervise the ability of trustees to prudently manage risk on behalf of members, and to maintain the stability of the overall system.

It should be clearly articulated that ASIC be the strategic conduct regulator for the superannuation system. Its focus, to ensure *members'* interests are protected, should be on

the conduct of trustees, financial advisers and the appropriateness of product offerings (including to particular target markets). It would not be expected that ASIC would seek to prosecute every breach of trustee duty (although it might be expected to raise issues with trustees and seek to have breaches remedied), but rather that its enforcement activities be strategic based on what Sparrow (2000) has referred to as ‘risk reduction strategies’.

ASIC’s enforcement activities would be public, and focused on matters that would provide a strong demonstration effect to all trustees. The ‘behind closed doors’ nature of APRA’s supervisory activities — examples of public enforcement action by APRA relating to superannuation are extremely rare and seemingly restricted to particularly egregious cases — means that there is little potential for such demonstration effects. Even if poor behaviour is curtailed at one fund, there is limited capacity for it to be discouraged at others.

It is likely that legislative change would be required to more clearly delineate the regulators’ respective roles given that current arrangements provide for much of the overlap.

The memorandum of understanding between APRA and ASIC would also need to be updated to reflect the new delineation of roles, and would continue to be critical to ensuring the regulators performed effectively and in tandem. In the event of concerns about poor quality products or trustee behaviour, it would be important for APRA and ASIC to work in parallel to overcome information asymmetry and to ensure member interests were protected (for example, to prevent ‘runs’ on institutions where there were governance concerns, or to ensure poor trustee behaviour is dealt with).

Clarifying the respective roles of APRA and ASIC should also assist them in becoming more confident, member-focused regulators — ‘member champions’ — and increase their accountability for outcomes. There is some evidence of this member focus emerging with, for example, moves towards the adoption of the outcomes test for APRA and recent enforcement actions by ASIC (chapter 9), but there is still a way to go before either regulator could really be seen as truly member-focused. Although the key focus of regulators should be to protect member interests, the absence of member voice in major industry debates means the views of funds will often prevail.

DRAFT FINDING 10.2

Conduct regulation arrangements for the superannuation system are confusing and opaque, with significant overlap between the roles of APRA and ASIC. These arrangements have the potential to lead to poor accountability and contribute to the lack of strategic conduct regulation, with poor outcomes for members.

INFORMATION REQUEST 10.1

Would a clearer division of responsibilities between APRA and ASIC (for superannuation) lead to better strategic conduct regulation and better regulator accountabilities? Is APRA best placed to specifically focus on ensuring high standards of system and fund performance, and ASIC to specifically focus on the conduct of trustees and the appropriateness of products (including for particular target markets)?

Guidance to APRA and ASIC has not been updated for some time

Statements of Expectations are an important mechanism for clarifying the Government's expectations of regulators and a vehicle for ministers to provide guidance on regulatory priorities. In the absence of such guidance regarding 'public interest' matters that are traditionally the preserve of ministers, regulators are left to determine which objectives to prioritise. Governments should ensure these Statements are updated regularly to ensure they reflect current priorities.

In its response to the Financial System Inquiry, the Australian Government pledged to update the Statement of Expectations for APRA and ASIC by mid-2016 'to provide additional guidance about the Government's expectations for their strategic direction and performance and improve regulator accountability' (Australian Government 2015, p. 8). However, the Commission's draft report into *Competition in the Australian Financial System* noted that the current Statements have not been updated since 2014 (PC 2018, p. 425). The Government has since foreshadowed the release of a new Statement of Expectations for ASIC. No announcements have been made regarding a Statement for APRA.

Regulators issued with Statements of Expectations should respond by publishing Statements of Intent, outlining how they intend to meet the Australian Government's expectations (Chester, Gray and Galbally 2015). Further, they should include information on the actions taken that are in line with their Statements of Intent in their annual reports to ensure they remain accountable to the Government and the community. The public nature of this process should assist in ensuring both the accountability and independence of regulators by providing transparency regarding the expectations placed on regulators by Government, and communication between the Government and the regulators.

New arrangements are in train for dealing with complaints

The external dispute resolution body for the superannuation system has been the Superannuation Complaints Tribunal (SCT), a statutory body with legal authority to effectively 'stand in the shoes' of a trustee and exercise all the powers and discretions available to the trustee under its deed, legislation and trust law.

The Australian Government has legislated to replace the SCT with the Australian Financial Complaints Authority, operating across the entire financial services sector, and the new body is scheduled to start receiving complaints no later than 1 November 2018. The change stems from a review (the ‘Ramsay Review’) of current dispute resolution procedures (that is, procedures where an impartial person such as an Ombudsman assists in obtaining resolution of an issue) which are shared between the Financial Ombudsman Service, the Credit and Investments Ombudsman and the SCT.

At a general level, the Ramsey Review found that the existence of a number of schemes has led to confusion, difficulty in pursuing complaints where financial services businesses were involved in multiple schemes, and unnecessary duplication. The Panel’s central recommendation was therefore the establishment of a new single external dispute resolution body to deal with all financial disputes (including superannuation disputes) (Ramsay, Abramson and Kirkland 2017).

Specific concerns with regard to superannuation identified by the Ramsay Review included:

- significant delays in resolving disputes
- chronic underfunding and resourcing, with a lack of flexibility in these areas
- a lack of focus on achieving system-wide improvements as well as identifying recurring or systemic issues
- outdated, passive and indirect oversight and accountability arrangements
- restrictive and inflexible dispute resolution processes
- lack of stakeholder engagement.

The Ramsay Review noted the average time for the SCT to resolve a dispute from lodgement to determination was 635 days in 2010, which had increased to 796 days by 2015-16 (although 87 per cent of cases in 2015-16 were resolved before the determination stage). Funding for the entity is not linked to the number of cases dealt with, and the number of staff employed by the SCT fell from 44 to 32 between 2010 and 2015-16 (Ramsay, Abramson and Kirkland 2017).

The Review therefore found ‘dispute resolution arrangements for superannuation are broken’, with the SCT ‘unable to resolve disputes quickly’ (p. 9). It further concluded that:

The pressures on SCT will increase in the absence of significant reform, as the superannuation system matures and an increasing proportion of the population moves from the accumulation to the drawdown (retirement) phase. Fundamental reform will be required to manage ongoing changes in demand and to provide more effective dispute resolution for consumers. (Ramsay, Abramson and Kirkland 2017, p. 9)

The new Australian Financial Complaints Authority is a positive reform. Given past funding issues with the SCT, ensuring the new complaints body is adequately resourced to deal with what the Ramsay Review correctly identifies as a workload likely to grow in future years, needs to be a high priority (Ramsay, Abramson and Kirkland 2017, p. 87).

DRAFT FINDING 10.3

The formation of the new Australian Financial Complaints Authority should be a positive reform for members, provided it is adequately resourced to deal with the level of complaints received.

The Commission's stage 1 study foreshadowed that the proportion of successful complaints to the SCT would be reported in stage 3 as one indicator of whether principal-agent problems are being minimised. In view of the workings of the SCT, it is difficult to draw any strong conclusions from this indicator. Many complaints are withdrawn by complainants, or are considered withdrawn by the SCT if, for example, they are considered to be misconceived, lacking in substance, trivial or vexatious. Complaints can also be withdrawn if the subject matter has been, or could be, more effectively dealt with by another statutory authority, or has already been dealt with by the SCT.

Where complaints proceed beyond this point, the SCT may also require parties to attend a conciliation conference to attempt to settle the complaint. Only if this is unsuccessful, and the complaint is not withdrawn, will the complaint proceed to review.

If complaints proceed to the review stage, the SCT may:

- affirm a decision
- remit a complaint to the trustee, insurer, ... or other decision maker for reconsideration of its decision in accordance with the directions of the Tribunal
- vary a decision
- set aside a decision and substitute its own decision (SCT 2017b, p. 7).

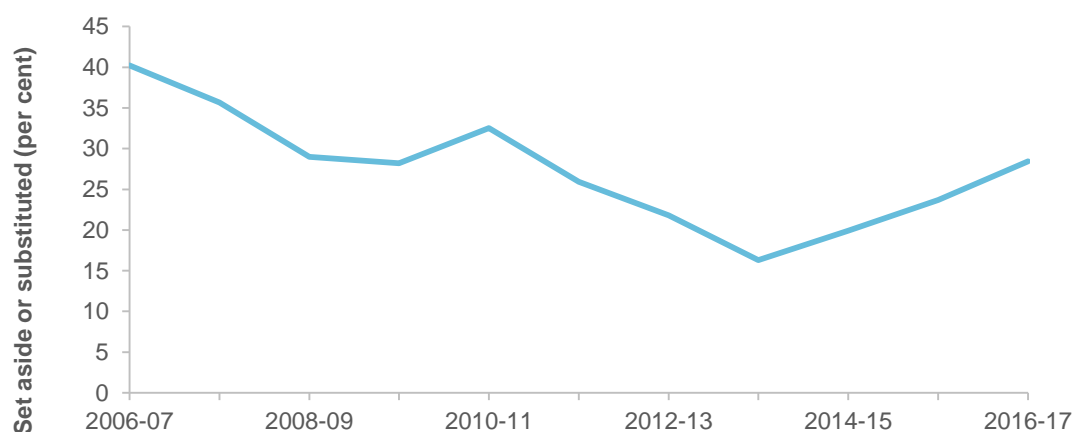
Since 2006-07, the number of complaints to the SCT that made it to the review stage has ranged from around 100 to close to 300 in any given year, and show a rising trend (table 10.1; figure 10.3). Of these, a relatively small proportion of trustee decisions have been set aside or substituted. However, the Commission does not necessarily see this as reflecting that principal-agent issues are not a material concern.

Table 10.1 Complaints to the Superannuation Complaints Tribunal (to review stage), 2006-07 to 2016-17

<i>Year</i>	<i>Number of complaints</i>	<i>Affirmed</i>	<i>Remitted</i>	<i>Varied</i>	<i>Set aside or substituted</i>
2006-07	169	94	6	1	68
2007-08	143	87	4	0	51
2008-09	100	71	0	0	29
2009-10	78	54	1	1	22
2010-11	123	79	3	1	40
2011-12	108	76	0	0	28
2012-13	133	101	2	1	29
2013-14	270	220	4	2	44
2014-15	286	224	1	2	57
2015-16	173	121	10	1	41
2016-17	211	144	6	1	60

Sources: SCT Annual Reports (various years).

Figure 10.3 Only a minority of reviewed SCT complaints involve trustee decisions being set aside or substituted



Source: SCT Annual Reports (various years).

Current regulation of SMSFs appears appropriate

Members of SMSFs are directly responsible for their own strategic superannuation decisions and thus face fewer principal-agent problems than members in the default and choice segments. Regulation of SMSFs — largely the responsibility of the ATO therefore focuses

on SMSF compliance with legislative and regulatory requirements. ATO regulatory activities include:

- providing information to help members set up their fund
- ensuring funds comply with taxation obligations
- checking funds are managed in accordance with the superannuation laws
- taking enforcement action to correct matters when there is a breach of the law
- checking that SMSF auditors perform their duties to the required standard.

Both the 2012 Cooper Review and 2014 Financial System Inquiry considered whether APRA or ASIC should have a role in regulating SMSFs. The Financial System Inquiry concluded:

The Inquiry does not support [prudential regulation of SMSFs by APRA]. The defining characteristic of the SMSF sector is that trustee members are directly responsible for each fund and must take responsibility for their own decisions. (Murray et al. 2014, p. 234)

The Cooper Review reached similar conclusions:

Given that SMSF members are entirely responsible for their own decisions ... the Panel sees the ability to be genuinely self-directed and self-sufficient as an important feature of SMSFs. The Panel believes that trustees should not lightly be exposed to administrative and other burdens that are not directly relevant to building their retirement savings through sound investment practices. (Cooper et al. 2010b, p. 219)

The Commission is of a similar view. One of the major attractions of SMSFs for members is that they have greater control of their investments, and they overwhelmingly do not want regulatory ‘red tape’ constraining them. Moreover, while principal–agent issues might be a factor in the decision to set up an SMSF (that is, financial advisers could potentially be influenced by the prospect of future fee revenue), these issues are not subsequently present in the day-to-day running of an SMSF. The FoFA reforms and forthcoming higher educational and training standards (commencing 2019) that will be required for financial advisers (O’Dwyer 2017a) should also provide greater protection to SMSF investors regarding the quality of advice they are likely to receive.

Given that SMSFs are exempt from prudential regulation, they are also exempt from the statutory compensation that APRA-regulated funds can access in the event of theft or fraud (Treasury 2014), although it is likely many SMSF members are not aware of this. Consequently, financial advice laws and regulations on financial products (administered by ASIC) are the main forms of protection available to SMSF members.

The ATO’s role in the system has been expanding

In addition to their role as SMSF regulator, the ATO has played an increasing role in managing the infrastructure of the superannuation system. This is appropriate because the ATO is uniquely placed to facilitate and monitor transactions between funds, employers and

employees, and recent initiatives such as SuperStream, Single Touch Payroll and SuperTICK have improved the efficiency of the superannuation system.

As discussed elsewhere in this report, the Commission envisages this role will increase (chapter 6; chapter 13). In particular, the ATO would have a role in creating a universal centralised online service for members to virtually eliminate unintended account proliferation. The ATO should also be given a greater role in reuniting members with ‘lost’ accounts and ensuring employer compliance with superannuation guarantee payments.

The Australian Government needs to ensure the ATO is adequately funded to undertake these additional tasks.

10.3 Material systemic risks are not evident

Systemic risk can be defined as the risk that an event at an individual firm or fund-level could threaten stability of the overall system (Caruana 2010). During the Commission’s three stages of work on superannuation, some participants raised concerns about specific systemic risks in the superannuation system, although most did not identify this as a material issue or a major inhibitor to system efficiency.

The Commission’s stage 1 framework proposed two indicators to examine whether there are material systemic risks in the superannuation system:

- risk exposures in the SMSF sector due to limited recourse borrowing
- market concentration and interconnectedness at the upstream service provider level.

SMSF use of limited resource borrowing should be monitored

Since 2007, superannuation funds, including SMSFs, have been permitted to borrow single assets under ‘limited recourse borrowing arrangements’ (LRBAs). LRBAs differ from a typical loan because in the event of borrower default, lender recourse is limited to the assets purchased with the loan. This feature is typically priced into the terms of the loan.

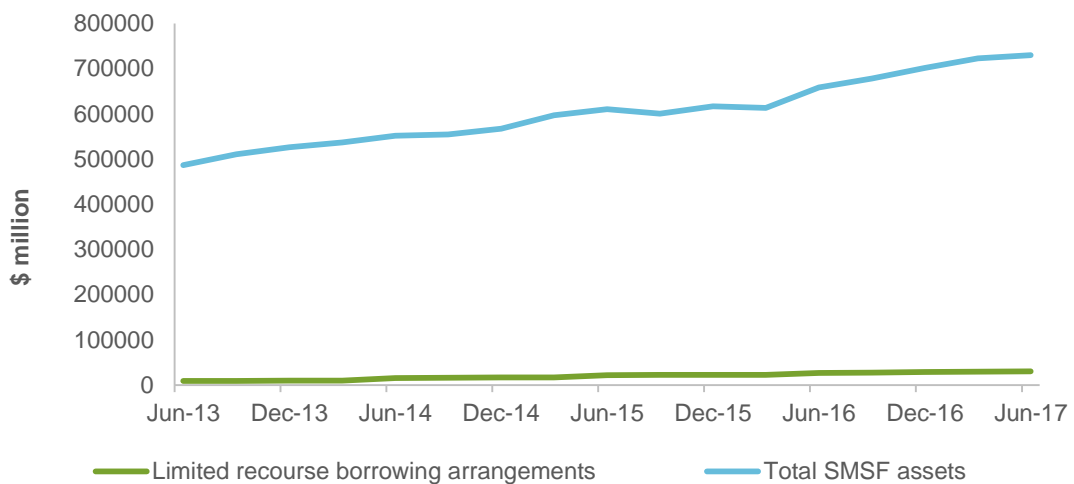
LRBA investments within the SMSF sector more than doubled in the four years to June 2017 off a very low base, up from 1.9 per cent in June 2013 to 4.4 per cent of total SMSF assets (figure 10.4).

Concerns that the increased use of LRBAs could impact SMSF stability — and general concern about the potential for borrowing to drive speculative investments in property — have motivated the Reserve Bank of Australia, APRA and the Financial System Inquiry to propose the removal of the limited recourse borrowing exception to the general prohibition on borrowing by superannuation funds (APRA 2014a; Murray et al. 2014; RBA 2015).

Rather than accepting the Financial System Inquiry’s recommendation, the Australian Government commissioned the Council of Financial Regulators and the Australian Tax Office to monitor leverage and risk in the superannuation system and report back after three years.

As of 30 June 2016 (the most recent period for which data are available), 6.9 per cent of SMSFs had some form of LRBA. This relatively small proportion of SMSFs with some form of LRBA — combined with the relatively small proportion of SMSF assets accounted for by these arrangements — provides the Commission with some confidence that LRBAs are unlikely to pose a material systemic risk. However, given the magnitude of recent increases, coupled with taxpayers ultimately underwriting (in large part) any gross underperformance of SMSF through the Age Pension, ongoing monitoring (along with public reporting and discussion by the Council of Financial Regulators) is clearly warranted to ensure that SMSF borrowing to fund investments does not have the potential to generate systemic risks in the future.

Figure 10.4 Limited recourse borrowing in the SMSF sector has been growing but is still small in the context of SMSF asset growth
June 2013 to June 2017



Source: (ATO 2017b).

DRAFT FINDING 10.4

The relatively small number of SMSFs with some form of limited-recourse borrowing arrangement (about 7 per cent and representing 4 per cent of SMSF assets) means such borrowing is at present unlikely to pose a material systemic risk. However, active monitoring (along with public reporting and discussion by the Council of Financial Regulators) is clearly warranted to ensure that SMSF borrowing does not have the potential to generate systemic risks in the future.

The failure of upstream service providers — a case of disruption not systemic risk

Some participants raised concern that high levels of concentration in wholesale service provider markets — and linkages between many of the entities at the wholesale level within the system — could impact system stability in the event of an upstream service provider unexpectedly failing.

Analysis of concentration levels in wholesale service provider markets in chapter 7 found indications that the markets for administration and actuarial services are highly concentrated (section 7.2). More generally, it is notable that the wholesale level of the system is more concentrated than the retail level. However, high rates of concentration could reflect an efficient market structure based on economies of scale and specialist expertise.

The Commission notes that while the impact of an upstream wholesale service provider unexpectedly closing would vary from case to case, any such closure would cause disruption and short-term losses or inconvenience to members. This could reduce confidence in the system and have flow on effects for other participants. However, based on the information available it is not clear such closures would present a material systemic risk. Moreover, while APRA’s licensee-focused prudential regulation means upstream wholesale service providers are not within their direct purview, funds are required under the relevant prudential standard to demonstrate to APRA that they have developed contingency plans in the event of disruptions to outsourced services.

10.4 Significant issues lie in data reporting

In assessing the efficiency and competitiveness of the superannuation system, the Commission has frequently been frustrated by the limitations of official data collections, and the quality of data provided to, and maintained by, APRA, ASIC and the ATO. Issues that have created hurdles for the assessment include:

- widespread reporting of ‘zero’ investment costs by funds
- poor data on costs attributed to related parties
- inconsistent reporting of costs due to the discretion given to funds
- an absence of product-level data outside of MySuper
- funds reporting zero or an implausibly low level of assets
- non-alignment of data collection and reporting between institutional funds and SMSFs
- the absence of panel data for SMSFs
- inadequate member-level data
- information about the types of insurance cover in individual accounts is inaccessible.

Although the limitations have been frustrating, of greater significance from a future perspective is that they limit the ability of members — or their agents — to ascertain the best performing funds (and products) as well as the products most suitable for their needs (table 10.2). They also limit the ability of regulators to monitor potentially undesirable or illegal practices. The Cooper Review concluded that transparent and accurate data represented ‘one of the most powerful regulatory tools available’ (Cooper et al. 2010b, p. 315).

Product-level data are particularly important to members

Although the Commission is cognisant of the difficulties associated with provision of product-level data, these must be weighed up against the requirements of members to be able to determine how their products are performing relative to other products and the system overall. It is likely a number of members in the choice sector would switch to more suitable products if better information were available to measure relative performance.

Although there is a relative wealth of information available regarding MySuper products for default members, by comparison there is a dearth of information available to ascertain member outcomes in the choice sector. This largely stems from the absence of product-level data. When assessing performance in the choice sector, there is generally reliance on fund-level data which has limitations from a member decision-making perspective, given the factors affecting the actual returns to members are not always determined at the fund level.

The Commission considers APRA should enhance its data reporting framework by providing greater visibility of outcomes at the product level (and therefore over actual member outcomes). Provision of performance data at the product level would achieve:

- increased ability to proactively monitor products across the system
- the provision of higher quality financial advice to members
- improved engagement and decision making by members
- a better informed and, therefore more efficient, superannuation system.

Table 10.2 Data and disclosure: members need to mind the gap

Is my fund the best performer?

Q: Can members readily compare fund performance?

A: No. Dashboards are not readily comparable and do not exist for many products.

Q: Can others make these comparisons (on behalf of members)?

A: Not easily as there is no long-term, consistent and exhaustive data source.

- APRA MySuper data are the best available, but:
 - are only available from 2014 (cannot measure long-term returns)
 - do not capture the whole market (no non-MySuper products)
 - are missing net investment returns and fees by asset class (sources of performance are hidden).
- APRA fund-level data are available from 2004 but:
 - are not representative of a member's experiences
 - only have asset allocation data (needed to measure relative performance) for default investment options.
- Research firm data include product and investment options with a long time series but cover a smaller, biased selection of products.

Am I getting value for money with my insurance?

Q: Can members readily assess the value for money of their insurance?

A: No:

- Funds are not required to report — to members or the regulator — on how insurance erodes member balances
- The ATO knows who has multiple insurance accounts, but funds cannot access these data, and the ATO does not notify members directly.

Q: Do funds appropriately use member data to develop value-for-money default insurance?

A: Many funds do not. Funds use limited data and do not use it well

- At least 10 per cent of funds use no data.

Is my trustee looking after my interests?

Q. Can members determine whether trustees are looking after their best interests?

A: Not easily:

- Data on payments made to related parties provided to APRA are questionable and not reported to members
- The gap between the actual and desired skills of trustee Boards is not disclosed to members or regulators
- Trustees do not always report, to members or regulators, on why some mergers do not go ahead (even though they may be in members' best interests)
- There is no disclosure, to members or regulators, on financial flows between RSEs and RSE licencees.

And reporting to regulators seems to focus on the interests of funds

Ongoing reporting of ‘zero’ investment expenses — a ‘red flag’

The APRA framework for the reporting of investment expenses is currently under review. The framework is clearly not delivering the data it is intended to identify, with many funds reporting zero investment expenses. This stems from the current framework’s heavy reliance on the goodwill of funds to report investment expenses that they do not incur directly (for example, where those expenses are netted out of returns the fund receives from a separate legal entity that undertakes investments on the funds behalf). It is not sufficient to rely on funds to report expenses that reflect the spirit of the reporting framework. The framework itself must, as a matter of priority, be strengthened to ensure all investment expenses are reported, whether incurred directly or not, to ensure full transparency is achieved. It is ultimately the responsibility of regulators — and specifically APRA in most cases — to ensure useful data are provided. If the current review fails to resolve data anomalies, APRA should seek to ensure correct data are provided. The Commission notes the *Financial Sector (Collection of Data) Act 2001* (Cwlth) provides significant penalties (of up to \$10 500 a day) for entities failing to adequately supply data to APRA. Moreover, in many cases, the continued provision of imperfect data would represent a ‘red flag’ that should prompt further regulatory questions and action.

Data quality should be a key focus

Issues of data quality and adequacy in the superannuation system are not new — for example, the 2015 ASIC Capability Review (Chester, Gray and Galbally 2015) highlighted the need for ASIC to better develop its data capabilities — and warrant a comprehensive response. The Commission considers the respective regulators (APRA, ASIC and the ATO) should work with the Commonwealth Treasury and the ABS to establish a superannuation data quality working group. This group should report on its process towards improving data to the Council of Financial Regulators (chapter 13). And all three regulators should ensure they have the right data analytics capability.

10.5 The level and pace of reform are broadly appropriate

Comprehensive regulation of the system is inevitable

A number of industry participants raised concerns about the overall regulatory burden on the system. For example, the Association of Superannuation Funds of Australia (ASFA) expressed concern about the opportunity costs associated with regulation and the cost to members:

There are considerable opportunity costs associated with regulation. Regulation potentially inhibits innovation as participants’ investments are concentrated on implementing changes to comply with regulatory requirements. ... In the case of superannuation, fund members ultimately bear the costs — via a combination of higher fees, lower net returns and a reduction in the quality of products and services provided (particularly where regulation stifles innovation). As such,

ASFA is cautious about any new reforms which add to the regulatory or reporting burden for its members without a clear purpose or benefit first being established. (sub. 47, p. 21)

On the other hand, the Australian Council of Trade Unions (ACTU) was more relaxed about the regulatory environment:

Clearly much of the regulation which has existed for 30 years has been developed with the policy intent of a structured system but one which maximises outcomes to the system participants. Hence the development of a system to regulate superannuation fund selection and default arrangements within the framework of industrial regulation is a cornerstone of policy settings in this area. Much of the regulation around superannuation emanates from this setting. The ACTU does not view this as an impediment to a successful superannuation system: we see it as the foundation of one. (sub. 50, p. 6)

Participants also suggested the burden associated with the ongoing regulatory data collection was unnecessarily high.

As noted throughout this report there are undoubtedly some areas of regulation requiring reform. However, many of the specific examples of unnecessary or outdated regulation provided by industry in submissions, surveys and consultation sessions have represented relatively minor regulatory burdens or have been only peripherally related to superannuation. Many have referred to their concerns about RG97 (chapter 3), which is currently under independent review. In other areas flagged by stakeholders, such as unnecessary impediments to mergers, there have been significant improvements in recent years.

Further, it is inevitable that the superannuation system is comprehensively regulated in view of the:

- dollars at stake
- compulsory nature of superannuation
- prevalence of principal–agent issues
- level of disengagement of many members
- high level of information asymmetry regarding superannuation products.

Arguably, the superannuation industry (collectively) has also shown a tendency to be resistant to change and has struggled to get agreement on self-initiated reforms. This has likely led to a higher level of regulatory intervention than might otherwise have been the case. There is also an (understandable) reluctance within the industry to share information, which has similarly led risk averse regulators to determine the data that are to be collected (albeit typically with varying degrees of industry consultation).

Therefore, although the Commission has recommended a number of areas of reform, including some where a tougher regulatory stance is considered necessary, the Commission’s overall assessment of the regulatory burden is that it is broadly appropriate given the nature of superannuation.

But potential reform impacts are not always adequately assessed

In addition to raising concerns about the level of the regulatory burden, a number of participants raised concern about regulatory uncertainty and the seemingly ‘never ending’ reform process (box 10.3). Further, 34 of 71 CEOs responding to the Commission’s governance survey identified dealing with regulatory changes as the top challenge confronting their Board, and 65 of 71 listed it among the top four challenges.

As highlighted in this chapter, policy and the regulation of superannuation has traditionally struggled to keep up with the sector’s significance and diversity. It is therefore unsurprising that there have been regular changes. While the pace of reform is often seen as a problem (and undoubtedly creates real pressures for superannuation system participants), the Commission’s perspective would be that most of the recent major reforms (for example, Stronger Super, SuperStream, MySuper) have been overwhelmingly beneficial from a public interest perspective.

Box 10.3 Participants’ views on regulatory change

A number of participants suggested constant regulatory changes affecting the superannuation system were a major problem.

Vision Super stated:

The biggest threat to Australians’ confidence in the system is continued unnecessary regulatory change. What the superannuation system needs is a long period of stability with any changes made only to address urgent issues that are putting Australians’ retirement at risk, not further changes that may or may not prove to actually increase competition or engagement with superannuation. (sub. 30, p. 3)

The Association of Superannuation Funds of Australia said:

ASFA firmly believes in the need for a prudent regulatory framework for superannuation. However, excessive regulation – and unduly frequent changes in the regulatory framework and requirements – adversely affects efficiency, productivity and innovation. Changes to superannuation and tax settings necessitate capital expenditure, and the complex and prescriptive nature of the regulatory framework imposes material ongoing compliance costs. (sub. 47, p. 2)

Many highlighted benefits of recent regulatory reforms, while seeing others as ill-conceived. PwC stated:

Many [regulatory changes over the past 25 years] were positive changes for the industry such as the introduction of APRA prudential standards to improve fund governance and the Super Stream reforms to improve the back office functions, efficiency and quality of data. However, many changes were the result of constant tinkering with taxation, SG levels and contribution caps and rules in order to meet budget or other political objectives, all of which were possible as there was no overarching framework and objectives for superannuation. (sub. 62, p. 2)

DRAFT FINDING 10.5

The frequency and pace of policy change undoubtedly create real pressures for participants in the superannuation system. However, most of the recent major reforms (such as MySuper and SuperStream) have been overwhelmingly beneficial from a public interest perspective.

10.6 Overall conclusions on system governance

There have been significant improvements in system governance in recent years, following a number of major reviews. And recent reforms (both proposed and implemented) have the potential to further improve system governance.

There is, however, significant room for improvement. Current weaknesses undoubtedly represent a major contributing factor to the fund governance problems discussed in chapter 9 which have the potential to significantly harm members. Particularly notable issues include that:

- the MySuper scale test has proven inadequate in protecting default members from poorly performing products
- the respective roles of APRA and ASIC overlap and need to be more clearly delineated to ensure strategic conduct regulation is ‘alive and well’ and examples of poor governance are dealt with satisfactorily. APRA should be more clearly focused on ensuring high standards of system and fund performance, and ASIC should focus on the conduct of trustees, advisers and the appropriateness of products (including for particular target markets)
- the complaints body for superannuation has been underfunded to date, with long delays in dealing with complaints
- current data limitations curtail the ability of members — or their agents — to ascertain the most suitable products for their needs.

APRA and ASIC need to become more confident regulators and more focused on member outcomes. Their role is ultimately to protect members’ interests, but the absence of member voice in the system means the interests of funds can sometimes dominate regulator decision making.

11 Overall assessment

Key points

- Competition in a superannuation system pushes funds to become more efficient and work to better serve members' needs. It also 'weeds out' underperformers. An efficient superannuation system maximises net returns for members, ensures members are in the most appropriate products given their needs and finds ways to improve members' outcomes over time.
- Competition and efficiency are not delivering on their potential for members.
- Competition is muted, constraining efficiency and member outcomes. The system lacks the critical mass of engaged and well-informed members who would provide competitive pressure on funds to deliver better products and services. Rivalry between funds in the default segment is superficial and there are signs of unhealthy competition in the choice segment.
- The superannuation system has delivered mixed returns. Overall most institutional funds have delivered solid net returns (and the system exhibits no material systemic risks). But a comparison of returns with benchmarks, and the spread of performance, shows that many members could be doing much better. Too few are in the very best products.
- Fees, the biggest drain on net returns, have been slowly falling at a system level, but primarily because retail segment fees have come down from levels well above those in other segments.
- Structural (policy) flaws have led to a situation where a third of all member accounts are unintended multiples. Members holding these accounts (and attached insurance policies) suffer unnecessary and regressive erosion of their account balances. Recent reforms will improve, but not eradicate, this problem.
- Overall, the system offers products and services that meet most members' needs. However, products are most complex during accumulation and most simple in retirement — when the converse constellation is needed for most members. And many members lack quality, comparable information to support engagement and good decision making.
- Governance within funds has been improving, but falls short of best practice. Board skills and performance assessment, management of related-party transactions, disclosure practices and investment governance remain chief areas of concern. Barriers to mergers have come down, but some substantive obstacles remain.
- Insurance in super provides value for money for some, but not all, members. Insurance contributes to excessive balance erosion and system complexity. Some members have policies that ill-suit them (including 'zombie' policies they cannot use). The Government-prompted industry code of practice, while a step in the right direction, falls short of what is needed.
- The key regulators — APRA and ASIC — are doing reasonably well in their core duties. But conduct regulation arrangements are confusing and opaque, with significant overlap and no clear delineation between the roles of APRA and ASIC. Regulators also need to be more confident and member-focused in the manner in which they regulate — they need to be 'member champions'.

Australians are compelled to save a material part of their wages through superannuation. As the system matures — today representing \$2.6 trillion in members' assets — superannuation is becoming more important to living standards in retirement. Reflecting this, the Government asked the Commission to assess the efficiency and competitiveness of the superannuation system.

In an efficient super system, net returns are maximised, members are in the most appropriate products given their needs and the system finds ways to improve members' outcomes over time. Competition promotes efficiency. In the face of competition, funds seek ways to become more efficient and to better serve members' needs; inefficient (poor-performing) funds are 'weeded out'.

The Commission's assessment has been guided by a framework — comprising five system-level objectives, 22 assessment criteria and 89 corresponding indicators (chapter 1) — which was publicly released after substantive consultation during stage 1 of this inquiry. This chapter presents summary assessments against the criteria. More detailed findings from the Commission's assessment are presented in the overview.

11.1 The assessment was not straightforward

Multiple sources of evidence informed the assessment:

- submissions from participants, conversations with experts and roundtable discussions
- data collections from the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investment Commission (ASIC), the Australian Tax Office and research houses (local and international)
- fund publications, policy documents and official reports, and research papers
- separate surveys of **members**, of all large APRA-regulated super **funds** (covering their operations and market conditions), and of their CEOs (covering **governance** practices).

The evidence base supported novel analysis, and the surveys provided new evidence (box 11.1). But data gaps and inconsistencies dogged the work (chapter 10; appendix B). And, while our surveys were designed to fill some of the gaps, the quality of responses to our **funds** survey was (at best) disappointing (overview).

The broad framework proved to be a reasonably useful guide for the assessment, although data gaps rendered a few indicators unworkable and complicated the analysis of others. Where possible, other information and data sources were drawn on to circumvent these gaps, and to assist with interpretation.

The following summary assessments rest on a collective interpretation of the relevant indicators and criteria and draw on other evidence and judgment, as necessary.

Box 11.1 **What the Commission has done that is new and novel**

To gather evidence for this inquiry, the Commission collected data and undertook several novel analyses. As part of this, the Commission:

- constructed **investment benchmark portfolios** to compare performance across the system (by segments, funds and products) against the relevant benchmark portfolio, adjusted for investment strategy (asset allocation)
- developed a range of **cameos** to illustrate how retirement balances can be eroded by multiple accounts, unpaid super, insurance premiums, high fees and low net returns
- undertook **econometric analysis of products** to look at impacts of product proliferation on costs and fees, combined with **stochastic analysis** of how these fees affect members' retirement balances
- **simulated sequencing risks** that members might face to evaluate how effective life-cycle products are at managing these risks
- **surveyed members:**
 - to support analysis of how members might behave when choosing a superannuation product when assisted by a shortlist of good products
 - to gather new evidence on member behaviour, including how they engage with their super fund and their levels of satisfaction, use of information and experiences with switching funds and investments
- **surveyed super funds** to fill gaps in the evidence base for key metrics such as net returns and fees, market contestability, related-party costs, insurance and regulation
- **surveyed fund CEOs** in relation to governance, and especially in areas where limited evidence is in the public domain, such as Board member selection, Board capability, and conflict and risk management.

We are also currently undertaking two further pieces of analysis, which will be uploaded to our website as technical supplements following release of this draft report. We are:

- undertaking **econometric analysis of economies of scale** to estimate cost savings to date, what remains to be realised, and how much of the benefits of scale have been passed through to members as lower fees
- **modelling the fiscal effects** of insurance in super, including the impact of insurance payouts on social security payments and the impact of balance erosion caused by insurance premiums on Age Pension liabilities.

11.2 Competition is not being fully harnessed

Competition in any market depends on the actions of both consumers and producers. In super, it requires a critical mass of engaged members making informed choices, and rivalry between funds to attract and retain members. Neither member engagement nor fund conduct is fully consistent with healthy (or effective) competition in the Australian system (table 11.1).

Members are not always able to drive competition (chapter 5). Some are highly engaged and create a competitive discipline on funds; but engagement is generally low — many members

simply default into a fund and a product. For many, this is rational. Engaging takes time and effort, and trustees are charged with acting on their behalf and in their best interests. But the system contributes to making it difficult for those who want to engage. While many Australians have a good broad knowledge of superannuation, product complexity, lack of quality information and behavioural biases combine to constrain informed engagement.

On a cursory glance, the market is conducive to rivalry (chapter 7). There is no shortage of funds, nor unnecessary barriers to entry. While there are relatively few firms in some wholesale markets, those few firms are likely capturing the benefits of economies of scale. And insourcing by larger funds adds to competitive pressure.

But a closer look reveals muted competition. Disengagement among members in the default segment means competition is reliant on fund rivalry. But there is neither competition *for* the market (that is, between funds for the right to provide default products), nor *in* the market (that is, from rivalry between funds to become an employers' default provider) (chapter 7). Processes for listing default funds in awards constitute an effective barrier to entry.

Table 11.1 Competition is not being fully harnessed to members' benefit

<i>Assessment criteria</i>	<i>Assessment</i>
System-level objective #5: Competition in the superannuation system should drive efficient outcomes for members	
<i>Market structure</i>	
C1 Is there informed member engagement?	Member engagement is generally low but increases with age and account balance.
C2 Are active members and member intermediaries able to exert material competitive pressure?	Demand side pressure on competition is muted.
C3 Is the market structure conducive to rivalry?	The large number of funds at the retail level, and multiple options at the wholesale level, create market structures conducive to rivalry.
C4 Is the market contestable at the retail level?	Contestability is largely present in the choice segment, but it is precluded by high barriers to entry in the default segment.
C5 Are there material anticompetitive effects of vertical and horizontal integration?	Vertical and horizontal integration do not create material anticompetitive effects but give rise to conflicts of interest that harm members.
<i>Conduct and outcomes</i>	
C6 Do funds compete on costs/price?	Funds compete on costs/prices to a degree, but this delivers limited benefits to members.
C7 Are economies of scale realised and the benefits passed through to members?	Some economies of scale are realised but the extent of pass through is unclear.
C8 Do funds compete on member-relevant non-price dimensions?	Funds compete on things other than fees (prices), but fees are more important for most members.
C9 Is there innovation and quality improvement in the system?	Innovation and quality improvement are evident, but progress is slow.
C10 Are outcomes improving at the system level?	Outcomes are improving at a system level, but many members are being left behind and harmed.

Nor is competition universally delivering for members in the choice segment (chapter 7). While the structure of the choice segment is consistent with competitive pressure between funds (there are many options), and self-managed super funds (SMSFs) add competitive tension, product proliferation and a lack of comparable data point to a lack of healthy competition.

More generally, symptoms of muted competitive pressure and unhealthy competition are apparent across the system. The system exhibits: persistent underperformance by some funds; unrealised economies of scale (well over 100 small APRA-regulated funds, holding over two million member accounts, remain in play); low levels of genuine new entry; a cornucopia of regulation aimed at trying to ensure members' best interests are met; and limited evidence of cost innovation. Vertical and horizontal integration are also problematic, with a lack of effective transparency on related-party arrangements and long-running concerns that some funds pay too much to related providers.

11.3 Long-term net returns are not being maximised

An efficient superannuation system would maximise long-term net returns for members through strong investment performance, competitive fees and prevention of unnecessary balance erosion. On each count, the system could do better.

Overall, the system has delivered mixed investment performance for members (chapter 2). Over the decade to 2016, both APRA-regulated funds and SMSFs delivered net returns of about 5.6 per cent a year (although smaller SMSFs delivered significantly less). And the default segment has generated average returns of over 7 per cent a year over the 12 years to 2016. Top performers were typically (but not always) larger, not-for-profit funds. But returns at many funds stack up poorly against reasonable benchmarks, and material gaps between the top and bottom performers in both the default and choice segments show many members could be doing a lot better.

Fees — the biggest drain on net returns — have been falling slowly, primarily because of falls in the retail segment (chapter 3). Fees remain relatively high in this segment (1.5 per cent on average compared with 0.9 per cent in the industry segment), and a not insignificant share of member accounts is paying fees that are well above average, particularly for choice products, mostly offered by retail funds. The costs of this can be high. Paying an extra 0.5 per cent in fees is projected to reduce a typical member's balance at retirement by 12 per cent (or \$100 000).

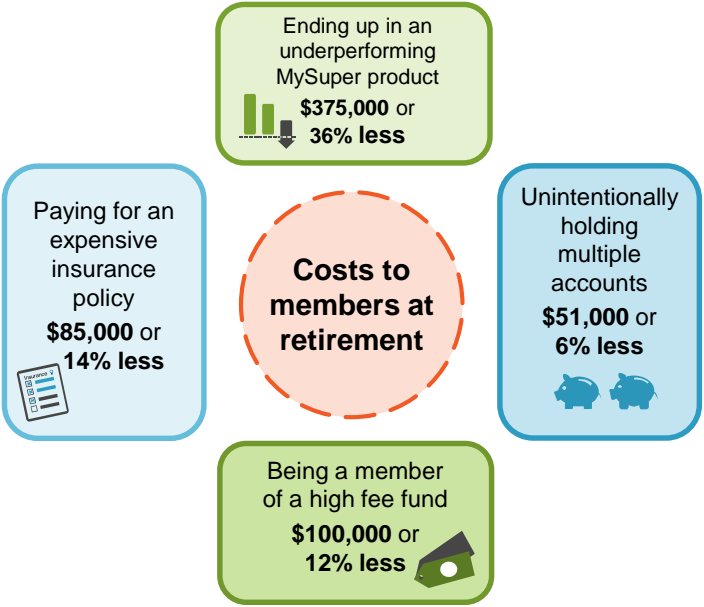
Unnecessary erosion of member balances is not being prevented (chapter 6). Far too many members unintentionally hold multiple accounts, paying multiple sets of fees and insurance premiums — one in every three member accounts is an unintended multiple. These accounts are typically a product of the system that sees people default into a new fund on changing jobs. Potential retirement incomes are also being compromised by employers who fail to pay contributions to funds. Affected members are often young and low paid. Recent policy

initiatives have made inroads, but the stock of unintended multiple accounts remains large, and progress on reducing it has been slow.

Subpar system performance (including via inappropriate insurance, discussed below) can do considerable harm to members’ balances at retirement (figure 11.1). For example, holding multiple accounts can reduce a typical worker’s balance at retirement by about 6 per cent (\$51 000) and an underperforming MySuper product can reduce a typical member’s balance by 36 per cent (\$375 000).

The payoffs from fixing some of the worst problems in the super system would be significant. Commission estimates show that members would have been in the order of \$2.6 billion better off each year if there were no unintended multiple accounts in the system. And members would have collectively gained a further \$1.3 billion each year had all MySuper products delivered returns in line with the top performers. While these figures may appear immaterial across a \$2.6 trillion system, being defaulted into a single top-performing MySuper product would lift the retirement balance of the median 55 year old by up to \$61 000 when they retire, compared to being defaulted into two underperforming products. For a new workforce entrant today, the gain would amount to \$407 000 by the time they retire in 2064.

Figure 11.1 **The character of member harm^{a,b}**
Subpar system performance = much lower member balances



^a Figures reflect the projected impact at retirement for an average wage member of: being in a top performing MySuper product (the median of the top 10) versus the median underperforming MySuper product (MySuper cameo); having one account versus two across their working life (multiple accounts cameo); or paying an extra 0.5 per cent a year in fees (high fee cameo). The fourth cameo reflects the projected impact for a low income member of holding insurance including a light blue collar loading and income protection. ^b The assumptions underpinning these cameos are set out in chapter 1.

Table 11.2 Long-term net returns are not being maximised for members

Assessment criteria	Assessment
System-level objective #1: The superannuation system contributes to retirement incomes by maximising long-term net returns on member contributions and balances over the member's lifetime, taking risk into account	
E1 Are long-term net investment returns being maximised over members' lifetimes, taking account of risk?	Persistent wide variation in investment performance across the system indicates that long-term net returns are not being maximised.
E2 Are costs incurred by funds and fees charged to members being minimised, taking account of service features provided to members?	Fees have fallen gradually at a system level, primarily because of falls in the retail segment, but many high-fee products persist.
E3 Do all types of funds have opportunities to invest efficiently in upstream capital markets?	There are no obvious material barriers to funds investing in upstream capital markets.
E4 Is the system effectively managing tax for members, including in transition?	It is unclear whether funds effectively manage tax for members.
E5 Are other leakages from members' accounts being minimised?	Unintended multiple accounts and unpaid contributions contribute to egregious erosion of member balances and member harm.

DRAFT FINDING 11.1

Fixing some of the worst problems in the current superannuation system would bring substantial benefits. If there were no unintended multiple accounts (and the duplicate insurance that goes with them), members would have been collectively better off by about \$2.6 billion a year. If members in underperforming MySuper products had instead been moved to the median of the top-10 performing MySuper products they would collectively have gained an additional \$1.3 billion a year.

11.4 Members' needs are not being fully met

An efficient system would ensure that members can access a range of products and services suited to their needs (including products that appropriately manage key risks), and that they can readily access good quality information to inform any choices they seek to make. While the system is accommodating some members' needs, others remain unmet. This gap will widen without action.

Members' needs are a product of the economic and social environment. That environment today is very different from the one that gave rise to Australia's super system, and will become more so (chapter 1). Contributions are much higher, people are working longer, women are more likely to work and life expectancies are higher. Much more is at stake today in financial terms than at the system's inception. Furthermore, if rates of home ownership fall, retirement asset portfolios, and people's approaches to lifetime saving, will change. Members' needs for retirement income planning and engagement with funds are likely to grow. Labour market change will also shape people's retirement savings. Some expansion of the gig economy will

occur and digital disruption will likely prompt more job changes between businesses, industries and occupations — inflating the risk of balance erosion that comes with the unintended multiple accounts created when members default on changing jobs.

Members' needs are fundamentally simple during the accumulation phase — high net returns, low fees, good disclosure by funds and transparent product features. These needs can be well served by 'no-frills', low fee products with a balanced or balanced growth asset allocation. Products reasonably close to this benchmark are available in the default segment, although insurance offerings (discussed below) are unnecessarily complicated. The proliferation of little used and complex options in the choice segment (some 40 000 in 2016) complicates members' decision making and increases fees, reducing net returns (chapter 4).

As members approach retirement, there is a rise in the potential costs to their balance at retirement from a year of poor returns. Life-cycle products, which reduce the share of riskier assets in a member's portfolio as they age, target this sequencing risk. But these products typically do not markedly reduce that risk, and forego (many prematurely) the higher returns that come with a larger weighting to riskier products. 'Smarter' MySuper life-cycle options can be designed, but need trialling in the choice market before inclusion in the default segment.

If simple is generally right in accumulation, it is wrong in the retirement phase. The irony of the system is that, if anything, products are most complex during accumulation and most simple in retirement — when the converse constellation is needed for most. The large diversity of household preferences, incomes and other assets means that no single retirement product can meet the needs of all — a default 'MyRetirement' option is not appropriate. The range of retirement products on offer — including account-based pensions, annuities and new hybrid annuity products — appears sufficient to meet members' needs, but the extent to which they meet each member's needs remains problematic. And policy changes in the middle of 2017 reduced tax and regulatory barriers to the development of new products.

A key policy challenge, across all phases, is the availability of quality, comparable information and quality (impartial) financial advice. While there is no shortage of information, many members find it complex, overwhelming and inconsistent with their needs (chapter 5). And many do not know where to turn for financial advice. When they do receive advice, it is likely that many struggle to judge the quality and, for some, it is poor.

Data is key. Businesses in many sectors are mining data to identify customers' needs, offer products and services that better meet them and communicate more meaningfully. But this activity appears nascent in Australian funds (chapters 4 and 5). Most collect little information about their members, and few use the data they do collect to design and price products. This finding applies to insurance too.

DRAFT FINDING 11.2

The superannuation system has not kept pace with the needs of members. Most notably, structural flaws have led to the absurdity of unintended multiple accounts (one in every three accounts is unintended) in a system anchored to the job or the employer, and not the member.

11.5 Governance has improved, but still falls short

High quality governance is integral to the protection of members' interests. Super fund members are heavily reliant on the conduct and actions of others — funds, financial advisers, government and regulators. This is more so than in many other markets. Members are compelled to save a material portion of their wages over their working lives. Government policy directs the savings of those who do not choose a fund into the default segment (chapter 12). And, as noted above, the demand-side pressures that drive healthy competition, and ultimately efficient outcomes, in other industries are muted. Consequently, governance within funds needs to be robust, and regulators need to diligently and confidently supervise fund performance, trustee and financial adviser conduct and the quality of products, services and information provided to members.

While fund governance has improved materially in recent years, and some funds have strong and effective governance regimes, a number of governance practices remain that raise considerable doubts about whether funds *always* act in the best interests of members (chapter 9). Areas of concern include Board skills and performance assessment, management of conflicts of interest (including related-party transactions), disclosure practices, investment governance and evidence that many funds have failed to merge when it appears likely that mergers would have been in members' best interests. Failed mergers are potentially very costly for members of underperforming funds — a typical full-time worker who spends their working life contributing to the median bottom-quartile fund on investment performance, for example, is projected to retire with a balance 53 per cent (or \$635 000) lower than if they were in the median top-quartile fund.

Unfortunately, little is known about mergers that have been broached but not completed. Some barriers to mergers are still evident, despite recent guidance to funds (on successor fund transfers). Trustee self-interest is clearly one. The temporary nature of provisions to provide funds with relief from capital gains tax is another.

The key regulators — APRA and ASIC — are doing reasonably well in their core duties of prudential regulation (APRA) and regulating financial products and advice (ASIC). But there is some confusion around their respective roles, given both have long held powers to police bad behaviour by trustee boards (chapter 10). They also need to be more confident and member-focused in the manner in which they regulate. Their role is ultimately to protect members' interests, although the absence of members' voices means the interests of funds can sometimes dominate.

Table 11.3 Members' needs, including for best practice governance, are not being fully met

<i>Assessment criteria</i>		<i>Assessment</i>
System-level objective #2: The superannuation system meets member needs, in relation to information, products and risk management, over the member's lifetime		
E6	Is the system providing high-quality information and intrafund financial advice to help members make decisions?	Members face a plethora of information, but many find it hard to access and interpret. There is little information available that is genuinely comparable; intrafund advice provides limited guidance.
E7	Is the system providing products to help members manage risks over their life cycles and optimally consume their retirement incomes?	A wide range of products is available (especially in accumulation) but not all members land in products that suit their needs.
E8	Are principal-agent problems being minimised?	Conflicts of interest are often not well managed.

11.6 Not all members receive value for money insurance

Around 12 million members hold insurance through super, with benefits to many, but entrenched problems mean it is of little or no value (and not worth the premiums) for others (chapter 8).

On the positive side, group insurance offers substantial cost savings over individually written cover, resulting in more favourable pay-out ratios. And the opt-out nature of most group policies means that the pool of insured members includes a larger share of lower risk members than would otherwise be the case. The inherent cross subsidisation reduces costs for all. Furthermore, provision of group insurance without an individual risk assessment means that members who might otherwise struggle to find affordable insurance are covered.

Against these benefits, balance erosion heads the list of problems. Higher than average premiums; unintended multiple policies; premiums that do not vary with income (particularly costly for the balances of lower income workers); contributions on inactive accounts (particularly deleterious for people with interrupted work history); and relatively expensive income protection insurance contribute to excessive balance erosion for some members. Many of these factors are correlated, making erosion highly regressive. Members with low income, intermittent labour force attachment and multiple accounts are hit especially hard.

Other problems range from complex and incomparable policies, through difficulties for members in opting out, inappropriate application of risk premiums (for example, for occupation or smoking status) and inadequate tailoring of policies to members' needs. A general lack of member awareness about the insurance in their super (around a quarter do not know if it is attached to their account) exacerbates the problems.

Inappropriate insurance can impose a high cost on members. A ‘typical’ low income worker, for example, who attracts a light blue collar loading and is paying for income protection insurance could be 14 per cent (or \$85 000) worse off at retirement than if they had no insurance.

The Government prompted industry code of practice, while a step in the right direction, falls short of what is needed. Its ultimate success will depend on it being universally adopted by funds, its provisions being much bolstered and it being effectively enforced.

Table 11.4 Not all members receive value for money insurance

<i>Assessment criteria</i>	<i>Assessment</i>
System-level objective #4: The superannuation system provides value for money insurance cover without unduly eroding member balances	
E11 Do funds offer value for money insurance products to members?	Insurance within super provides value for money for some members, but the cover is inappropriate for others.
E12 Are the costs of insurance being minimised for the level and quality of cover?	Group insurance reduces premiums for some members; others pay too much. Undue balance erosion is an egregious problem.

11.7 System performance and member outcomes have improved, but have a way to go

The preceding discussion acknowledges improvements in various aspects of the system, but the many problems identified indicate that the system is not overcoming all impediments to improving long-term outcomes for members.

Table 11.5 System efficiency and member outcomes have improved, but have a way to go

<i>Assessment criteria</i>	<i>Assessment</i>
System-level objective #3: The efficiency of the superannuation system improves over time	
E9 Does the system overcome impediments to improving long-term outcomes for members?	The superannuation system could do better in improving long-term outcomes for members.
E10 Are there material systemic risks in the superannuation system?	There are no obvious material systemic risks in the system.

While the superannuation system exhibits no material systemic risks (chapter 10), characteristics of the current system are constraining, and will continue to limit, healthy competition and improvements in efficiency — arguments for modernising the system are strong. A package of recommendations supporting this outcome is presented in chapter 13.

12 Competing for default members

Key points

- In a world of compulsion the onus is on Government to ensure that default super is the system exemplar, eliminating the costly (and highly regressive) twin risks for a default member — defaulting more than once, or into an underperforming fund.
- A degree of longstanding underperformance is manifest in all segments of the superannuation system. While the default segment has on average outperformed the system as a whole, and worked well for the majority of default members, it fails to ensure members are placed in the very best funds and places a sizable minority in underperforming products, and at a pernicious cost to these members (a reduction in their retirement balance of 36 per cent or \$375 000 for a typical new job entrant today). Current arrangements also deny some members any ability to choose their own fund. Default arrangements should be recrafted to harness the benefits of competition for default members.
- The key problem with current default arrangements is linking the choice of default fund to the employer, rather than the member. This inevitably contributes to unnecessary account proliferation. These arrangements are ill-suited to today's workforce where employees are increasingly likely to move between industries and occupations, and technology is breaking down traditional industry and occupational boundaries. Current arrangements also may expose members to poor quality decisions made by third parties, including employers.
- Of the default models considered by the Commission (including the current system), the assisted employee choice model is likely to provide the best outcomes for members. It would best harness healthy competition and 'nudge' members into the very best products. Its design is inspired and informed by behavioural economics — how people actually behave, not how they 'should' behave — to ensure simple and safe choice for members from a shortlist of best in show products, and a longer list of good products for more engaged members to consider. It fosters direct member engagement, in contrast to current arrangements that stifle it.
- By comparison, assisting an employer to make the choice performs less well in ensuring employees are placed in the very best funds, due to the inconsistent incentives with leaving the decision to the employer. Many employers are not well equipped to choose default funds. Moreover, once there is a shortlist of superior funds, there is no rationale for employers to be involved in the decision — employees are capable of making that choice themselves.
- The assisted employee choice model would apply to all new workforce entrants (around 474 000 members each year with about \$1 billion in annual contributions initially). Importantly, it also offers immediate benefits to many existing default members through extending to them any lower fee offers made in the course of best in show selection; and signalling via the shortlist whether a fund is really best for members. Over time, this should benefit members in the choice and SMSF segments (including by lifting the quality of financial advice).
- A government monopoly default fund, suggested by some experts, could realise economies of scale within the system and simplify the whole process — but at the cost of abandoning any attempt to both improve engagement and simplify choice. And it would run counter to the (desirable) absence of an actual or implied government guarantee in the Australian superannuation system and would fail to harness the benefits of a competitive process.

Although most employees have been able to choose their own fund since July 2005, many (possibly up to two thirds of new job entrants) do not do so. Where employees do not make a choice, employers are required to make Superannuation Guarantee (SG) contributions into a default product on their behalf. All default contributions must be made into a MySuper product. Around half of all superannuation accounts are in these MySuper products which have been designed to be particularly suitable for default members. Default arrangements are therefore important for a large proportion of the workforce. This importance is reinforced because many of the employees who default are disengaged from superannuation and (on average) have much lower balances. In view of the compulsory and complex nature of superannuation, default arrangements reflect the duty of government to ensure the interests of these employees are protected.

Improvements to default arrangements, therefore, have the potential to benefit the many Australians holding default products and, by making default the exemplar, further benefit members across the entire superannuation system. They could also facilitate greater member engagement.

This chapter assesses the current default settings (including whether reforms to the current system would adequately solve problems), and considers whether an alternative default product allocation mechanism would deliver net benefits. The chapter builds on the Commission's stage 2 draft report, and assesses the current system and various alternatives against a baseline where employees choose their own super product without any assistance and against each other. Given the significant analysis in the stage 2 draft report, and subsequent extensive consultation (through submissions and hearings), discussion in this report is brief. The presented assessment is based on the criteria established in the stage 2 draft report (member benefits, competition, stability, integrity and system-wide costs).

12.1 How does the current default system perform?

Background

Current arrangements sit within the workplace relations system. Many employers are required to choose a default fund from those listed in the relevant modern award or enterprise bargaining agreement. Funds have been included in modern awards on the basis of consensus between employer and employee representatives (and typically reflect those listed in earlier award-based instruments). In making decisions, the Fair Work Commission (FWC) (until it was rendered unable to do so) had drawn heavily on precedent, and viewed itself as a dispute solving body — not as an arbiter of the quality or merit of funds put up for inclusion. Individual members' interests are a secondary consideration to questions of standing and history.

With the commencement of modern awards, persons or organisations generally had to have standing before the FWC in order to apply to have a default fund listed in an award. Standing has generally been restricted to industrial parties such as employer groups and unions. Retail

funds, or industry funds without the backing of industrial parties, often had difficulty putting their case for inclusion (PC 2012).

In 2012, the Australian Government legislated a number of changes to the system for listing default funds in awards, based on recommendations in the Commission's 2012 report *Default Superannuation Funds in Modern Awards* (PC 2012). The FWC full bench was empowered to make decisions for each award every four years based on an advisory Default Superannuation List chosen (on the basis of merit) by an Expert Panel within the FWC. And all funds were enabled to appear before the Panel to make a case for inclusion, although not to appear before the final decision maker (the FWC full bench) (Shorten 2012).

An Expert Panel was set up in January 2014. However, following a number of changes due to concerns about conflicts of interest, the Federal Court in June 2014 declared the panel was not correctly constituted under the *Fair Work Act 2009* (Cwlth) (Fair Work Act). The Panel stopped dealing with default listings (Ross 2014), and the system put in place by the new legislation effectively stalled. No new appointments have been made to the panel; the revised system is dormant.

The introduction of MySuper (also in 2012) was intended to ensure the suitability of default products and to reduce some of the variation in member outcomes in default by requiring all funds to obtain MySuper authorisation to be allowed to offer a default product (and thus be eligible to be chosen by employers). But this has been far less effective than envisaged (chapter 2).

The assessment of the current system considers both the manner in which the system is operating in practice (*as implemented*), and how the Commission considers it would be operating were the post-2012 reforms in force (*as legislated*).

Assessment of the current system

Participants expressed a diverse range of views on the system's performance, a small sample of which is contained in box 12.1.

In terms of **member benefits**, the Commission's analysis finds that the current system (as implemented) has delivered most default members into products that have performed relatively well. The segment has generated average net returns of 5.1 per cent per year over the ten years to 2017. It has not, however, always delivered members into the *very best* products available. In the ten years to 2017, the top 10 default products analysed by the Commission (representing 6 million member accounts and over \$225 billion in assets) generated a median return of 5.7 per cent. Over the same period, 26 MySuper products (representing 1.7 million members and \$62 billion in assets) returned a median return of 3.9 per cent a year to their members (chapter 2).

Differences in performance matter a lot to member outcomes. The Commission's cameo model suggests a typical full-time worker who is in a median underperforming product is

projected to retire with a balance 36 per cent (or \$375 000) lower than if they were in a top-performing MySuper product (the median of the top 10 performers) (cameo 12.1).

Box 12.1 Participants expressed a variety of views about the current system

Some participants viewed the default system favourably

The existing industrially based system is highly efficient in selecting a universe of default funds, which reduces the search costs for employers and members, and reduces the administrative cost to employers. ... The current system has proved efficient for government in that it has selected, on average, high-performing funds and reduced the cost of the Aged Pension. (First State Super, sub. 37, p. 13)

The cumulative evidence from two decades of performance data demonstrates current default arrangements have delivered the most efficient component of the system, charging lower fees and delivering better net returns than other sectors. (AustralianSuper, sub. 43, p. 19)

The ACTU maintains the view that the system provides widespread coverage for the workforce (and any deficiencies in this coverage are easily overcome), the system has proved highly efficient in delivering cost effective superannuation arrangements to Australian workers ... and is world class in providing investment returns as part of an internationally highly rated retirement policy ... (ACTU, sub. 50, p. 4)

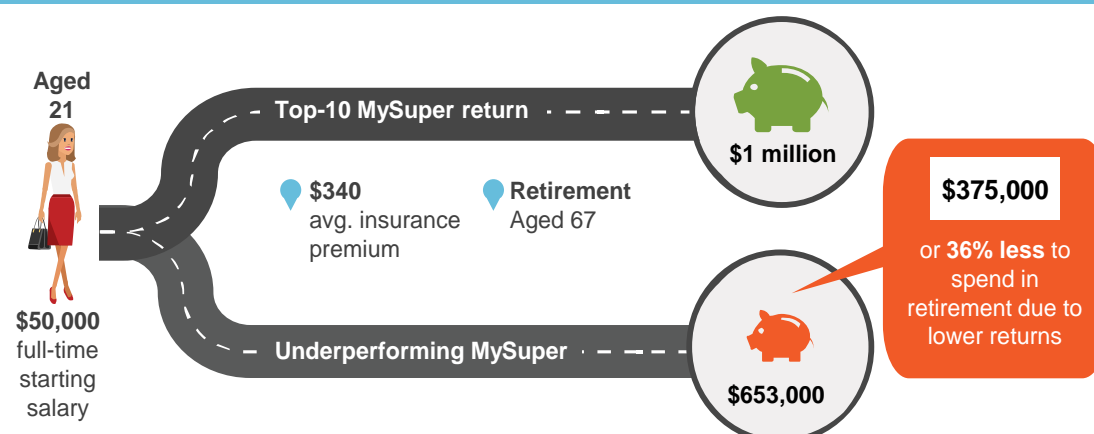
While others saw it as deeply flawed

The current FWC model for allocating default contributions results in demonstrably poor outcomes for consumers. (FSC, sub. 69, p. 4)

Australia's current mandatory and default superannuation system risks perpetuating issues around member apathy and disengagement, in addition to missing out on opportunities from fostering more choice and competition. (ANZ, sub. 73, p. 6)

Cameo 12.1 MySuper returns can be a lottery for default members^a

Super problem: Underperforming MySuper = 7.5 years' lost pay



^a The assumptions underpinning this cameo are set out in chapter 1.

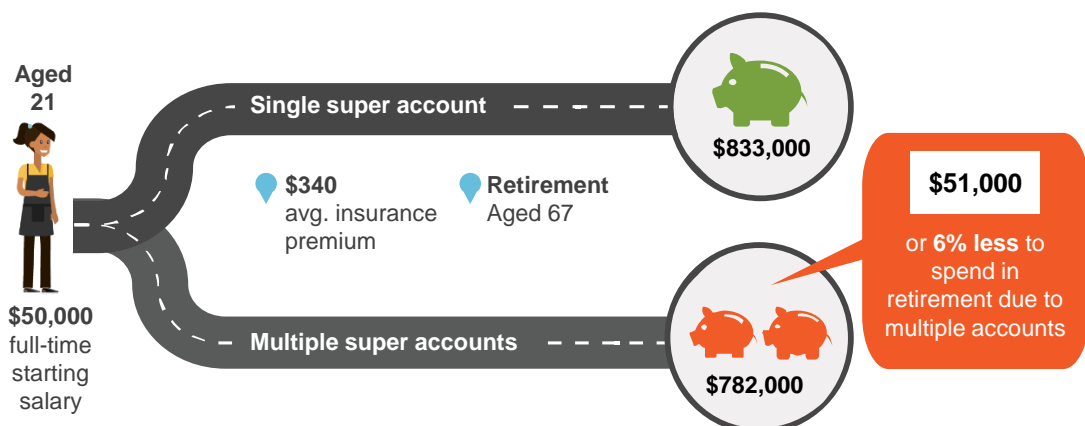
The absence of emphasis on merit in the process used to determine which products receive award listing, and a structure that restricts contestability between funds to obtain default members, have been key factors in some members being placed in products that have not performed well. Poorly performing products have not been weeded out of the system. And the system has ‘propped up’ some sub-scale funds at a large cost to those members through lower net investment returns (chapter 2). The system can be viewed as something of a ‘lottery’, with outcomes for employees dependent, at least to some extent, on the financial acumen of their employer — which will be highly variable. And many employers feel ill-equipped to make these decisions on behalf of their employees, as noted by ACCI:

... many, if not most, employers feel inadequate to select the best default for their employees, don’t have the time or capacity to do so or are influenced by non-relevant criteria. It is not a job which they want, nor one they are equipped for. ... There is no systemic reason why employers should choose their employee’s default fund. (ACCI, stage 2, sub. DR79, p. 6)

Another problem is that the linking of default products to employers and thereby jobs means workers often change products when they change jobs, contributing to unintended account proliferation (chapter 6). This comes at a high cost. Under the Commission’s cameo model, an average earner with two accounts rather than one between the ages of 22 and 41 would be 3.5 per cent (or \$29 000) worse off in retirement. This would worsen to 6 per cent (or \$51 000) if the two accounts were held over the entire accumulation phase (cameo 12.2). And the costs of multiple accounts are even higher for low income workers or those with intermittent work histories (chapter 8). Further, restrictive clauses in some enterprise bargaining agreements prohibit employees from choosing their own fund.

Cameo 12.2 Multiple accounts reduce retirement balances^a

Super problem: Multiple accounts = 1 years’ lost pay



^a The assumptions underpinning this cameo are set out in chapter 1.

The current system (as implemented) does not rate highly from a **competition** perspective. The fact that funds have had to rely on industrial parties with standing before the FWC for inclusion in awards creates an anticompetitive barrier to entry (chapter 7). And the fact that

an employer's choice of fund is limited to those listed within the relevant award or enterprise bargaining agreement (including, in some cases, to only one fund), further reduces competitive pressure on funds. This would not be a major concern if the list of eligible funds were determined through a genuinely competitive process focused on merit. But this is manifestly not the case.

From an **integrity** viewpoint, the current system (as implemented) has a range of third party involvement that can result in decisions which are not necessarily in a member's best interests. The fact that employers choose default funds on behalf of employees creates an incentive for funds to offer benefits to employers to influence this choice. And some funds do (chapter 9). The FWC acts as an agent of employees in determining eligible default funds. But its methods are not those of an entity interested in the best performing funds being preferred, as a member is likely to want. And industrial parties play a key role in determining the eligible funds into which defaulting employees are placed. But these industrial parties have themselves sponsored the joint development of funds, and so are not unhindered by conflict when reviewing other funds' requests to be registered.

The current system (as implemented) rates highly from a **stability** viewpoint. Yet a desire for stability also promotes inertia and props up some poorly performing funds. There is no active FWC process for reviewing and delisting funds (although APRA is now pressuring some poorly performing funds to justify their MySuper authorisation).

The **costs** associated with *operating* the current system (as distinct from any costs that might potentially stem from underperformance) are reasonably modest. There is no real cost for defaulting employees as they are not required to do anything. Employers face costs associated with choosing funds, although these costs vary depending on the approach taken to selection (a tender process, for example, will be more costly). There are costs for funds associated with participation in the FWC process.

Had the reforms legislated in 2012 been fully implemented, member benefits and competition might have improved. A quality filter would have been applied, a potential mechanism to remove underperforming funds from awards would have existed and all funds would have been able to apply directly to the FWC Expert Panel for inclusion in awards. The quality filter would have likely mitigated *somewhat* against concerns about employers choosing defaults, by providing greater guidance to employers about the quality of funds.

Overall conclusions

In summary, while the default segment has *on average* performed relatively well in terms of returns to members, it also structurally supports some poorly performing funds by directing a share of default members to them. These members are not well treated by the system.

Moreover, the current default system prevents healthy (or effective) competition between funds, leads to unnecessary erosion of member balances by encouraging account proliferation and relies too heavily on third party decision makers, thereby ingraining

member disengagement. These flaws are regressive in impact. Those least likely to engage with super, and so most likely to rely on the default system, are the young, people with lower education and those on lower incomes (chapter 5).

Tying default fund choice to the employer is anachronistic, and — given its role in unintended account proliferation (which is not typically a feature of default systems internationally) — is particularly ill-suited to a workforce where employees often change jobs or hold multiple jobs (chapter 1). In addition, many employers feel ill-equipped to make a choice. Moreover, employer choice is hard to justify when it reduces engagement — pushing back on your employer’s choice is hard — and yet maximising member returns relies on (informed) member engagement. The problems associated with employer involvement in the choice of default funds represented a major consideration in the Commission’s preference for the employee choice model (section 12.5).

DRAFT FINDING 12.1

While the default segment has *on average* outperformed the system as a whole, it fails to ensure members are placed in the very best products and places a sizable minority in underperforming products. For example, the top 10 MySuper products generated a median return of 5.7 per cent a year in the decade to 2017, whereas the bottom 26 generated a median return of 3.9 per cent a year (and represent about 1.7 million member accounts and \$62 billion in assets).

Current arrangements also deny some members any ability to choose their own products. Default arrangements need to be modernised and recrafted to harness the benefits of competition *for* default members.

The good member results seen in parts of the current default system are owed to a combination of trustee and management good will and endeavour. But over time (and given the total number of funds), variation in performance by both funds and regulators is inevitable. Sustaining a high level of performance, and spreading it to more members, is only achievable by providing incentives to adapt to better ideas or new needs.

Arguments for reform to the current system are therefore strong, and the Commission put forward four alternative models in its stage 2 draft report. Features common to each of these models are described below before an assessment of them is presented.

12.2 Foundations for a modern default allocation system

A focus on new workforce entrants

From the work undertaken in earlier chapters, any preferred model for allocating default members requires both simplification, and a focus on the best interests of *all* such members. But no existing member of any fund should be made to change their fund.

A system with these characteristics would first and foremost ensure that an employee should only be placed in a default product if they fail to exercise choice *and* do not have an existing superannuation account.

These members would typically be new entrants to the workforce (the **first-timer pool**) (chapter 6). They would then retain that account (including after a change in employer) unless they actively switch. This is a critical circuit-breaker to the current system's propensity for costly account proliferation.

Second, other employees who commence a new job would see their superannuation guarantee contributions retained by one of their existing superannuation accounts, or a new account should they exercise choice (figure 12.1). This would be implemented through the universal use by employers of an ATO centralised online information service (discussed in chapter 6). The service would enable employers to identify which employees do not already have an existing account, and the standard employee choice form, combined with the Tax File Number process, would facilitate members consolidating their accounts.

Third, while all new workforce entrants would benefit (around 474 000 members each year with about \$1 billion in annual contributions initially⁷⁸), the process for selecting a shortlist of default funds for these members will also lead to benefit for existing members. Funds selected for the shortlist would be required to extend any benefits obtained in the course of competing for and securing this right to all their *existing* MySuper fund members. And choice members who join that fund would also benefit.⁷⁹

In considering the case for reform, the Commission has also been cognisant of the capacity for instability in the system to negatively impact on members. Reform that significantly increased member churn could have adverse consequences for system stability. The pool for total MySuper contributions in 2017 was \$55 billion (APRA 2018a), compared to an estimated first-timer contributions pool of \$1 billion. Therefore, while there would be a clear equity rationale in ensuring that existing members benefit from any new default models, the Commission considers that any new default allocation mechanism should be restricted to new workforce entrants to underpin system stability.

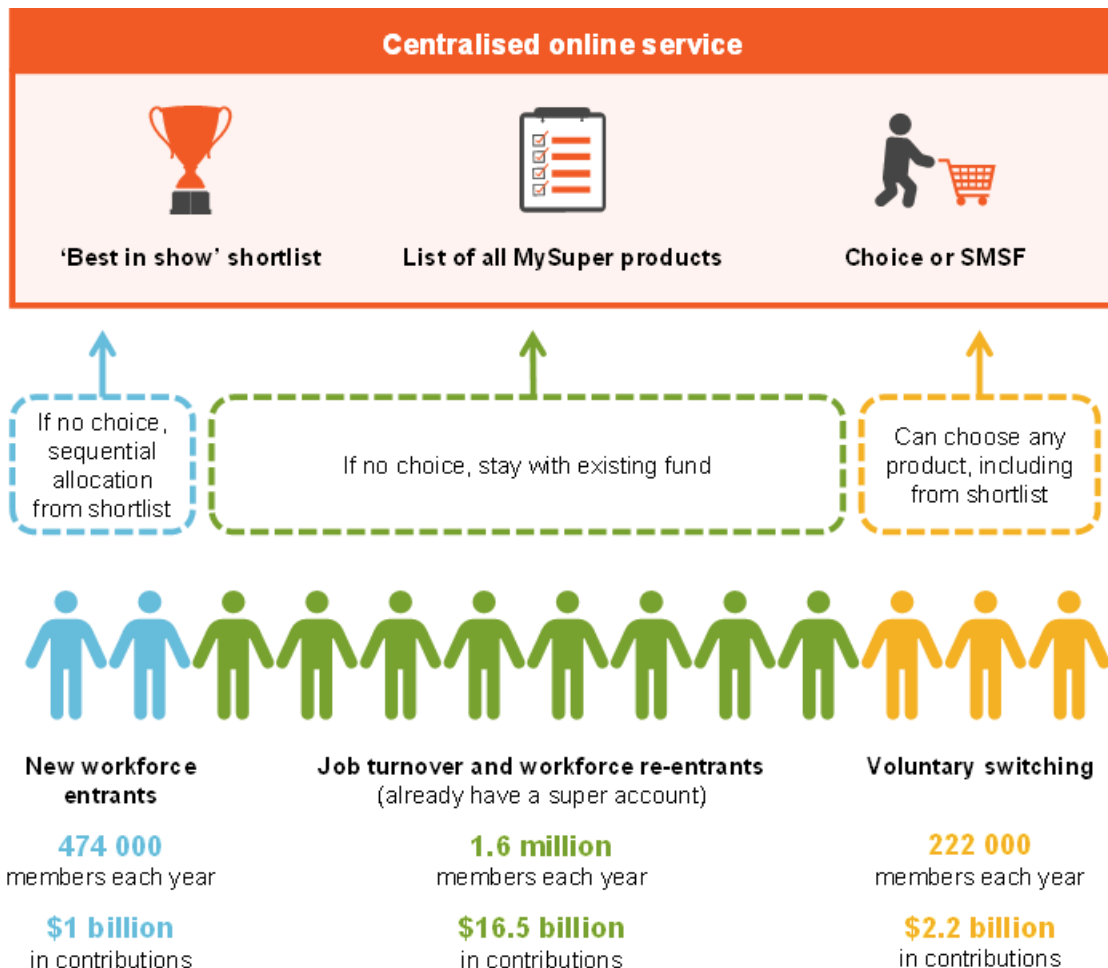
The initial size of the first-timer pool potentially understates the significance for funds of being shortlisted. The pool is initially relatively low in dollar terms because of the relatively low level of average incomes for people first joining the workforce. However, as the incomes of each year's first-timer cohort increased over time, so would their significance for funds. Attracting these new starters would be more attractive for funds otherwise facing net outflows in the face of an ageing membership base. Attaining default status would also be

⁷⁸ These numbers are approximate and should be seen only as providing an order of magnitude regarding the impact of the policy changes considered.

⁷⁹ Commission calculations based on the Commission's members survey, ABS *Participation, Job Search and Mobility, Australia, February 2017* (Cat. no. 6226.0), (ATO 2017e), ATO (pers. comm., 24 January 2017, 15 February 2017).

more attractive to funds given the potential for signalling effects for shortlisted funds enabling them to sign additional members outside the ‘first timer’ context.

Figure 12.1 Eliminating unintended account proliferation^a



^a Illustration for assisted employee choice model. The estimates of the number of members in each category are not a precise assessment and are only intended to provide an order of magnitude of the effects.

Sources: Commission calculations based on the Commission's members survey, ABS *Participation, Job Search and Mobility, Australia, February 2017* (Cat. no. 6226.0), (ATO 2017e); ATO (pers. comm., 24 January 2017, 15 February 2017).

A focus on harnessing the benefits of competition and improving the focus on members

Any modern default allocation system would be required to ensure members end up in the very best funds, and would include mechanisms to improve the quality of default funds over time. Competition *in* the market is problematic given many employees are disengaged, and many would struggle to make good decisions even if they were to become engaged (box 12.2).

But competition *for* the market (that is, competition through a formal process to earn the right to access default members) would be expected to generate significant competitive pressures and drive improvements. All of the models proposed by the Commission in stage 2 involved the use of a competitive process to drive competition for the market.

Box 12.2 The Commission's thinking — inspired and informed by behavioural economics

The Commission's conclusions regarding the best default model are guided by the reality that many employees are disengaged from decisions about their retirement, and many would struggle to make good decisions even if they were to become engaged (chapter 5).

There are a number of reasons for this, including poor incentives to become engaged (especially for young people), cognitive constraints and behavioural biases, and the perceived and actual cost of engaging.

Several studies have found that presenting too many options can overwhelm people and lead them to make poor choices, especially in a financial context (Abaluck and Gruber 2011; Iyengar, Huberman and Jiang 2004; Keim and Mitchell 2016; Morrin et al. 2012; Samuelson and Zeckhauser 1988). Restrictions on the number of options presented have been put forward as one way to reduce choice overload and help people to make better choices (Abaluck and Gruber 2011, p. 22; Ketcham, Kuminoff and Powers 2016, p. 2).

The degree of choice overload people experience depends on the complexity of the decision and choice set, how certain people are in their preferences, and how much effort they are willing to put into the decision (Chernev, Böckenholt and Goodman 2015). Providing too much information risks confusing people or deterring them from reading it. People can be overwhelmed when presented with too many different attributes (Johnson et al. 2012, p. 495). People are typically guided by a few considerations in decision-making, rather than the myriad of components considered too minor and firms need to compete for consumer attention in a world where 'less is more' (Gabaix 2017)

The order in which choices are presented to people matters. In a well-known experiment, Benartzi and Thaler (2002, p. 1610) found that people were averse to picking extreme options when selecting from a set of investment portfolios ordered from low to high risk, to the extent that their preferred option among two alternatives changed when a third option was presented either to the left or right side of the pair.

As noted by the Cooper Review, the superannuation system should facilitate, but not impose choice (Cooper et al. 2010b, p. 6). Therefore, as submitted by Barr and Diamond (sub. 74, p. 1), while people who want to make their own decisions about superannuation should generally have room to do so, it should be recognised that some people will not make choices, and some people will make bad choices. If forced to make choices, many employees would have bad outcomes. The normal forces of supply and demand (competition *in* the market) can therefore not be relied on — and the high level of disengagement means that demand-side competitive pressures are suppressed.

However, the use of a competitive process to enable funds access to default members (competition *for* the market) harnesses the benefits of those competitive pressures to benefit members. Arrangements that then make for simple and safer choice should increase member engagement and lead to better member outcomes.

What criteria should determine shortlisting?

The current Fair Work Act criteria, with some modifications, represent a suitable basis for determining the best in show list. The criteria should include:

- the match between the product's long-term investment return target and risk profile for the types of members who typically default
- the expected ability of the fund to deliver on the product's return target, given its history and risk profile
- fees and costs, given the product's stated long-term investment return target and risk profile
- the fund's governance practices, including mechanisms to deal with conflicts of interest
- compliance with the *Insurance in Superannuation Voluntary Code* (chapter 8) (that is, it would not be enough to simply be a signatory to the Code). The merits of a product's insurance offering would not be a selection criterion, but funds should justify why the insurance offering was demonstrably in members' best interests
- the administrative efficiency of the fund.

The panel should also give heed to the fund's intrafund advice offering and track record on innovation and identifying and meeting member needs (including design of superannuation products. To ensure flexibility, the selection panel determining the shortlist would be able to consider any other factors they considered relevant. But, given the primacy of net returns to retirement balances (chapter 2), the key focus of the selection process should be on a fund's **likelihood of producing high net returns for members**. Ancillary services should not be a decisive factor (subject to meeting a threshold level). The relative weightings attached to each criterion should be published to inform funds' applications for shortlisting.

The Commission considers it is important to ensure that any worthy entity can compete for the default market, and that arrangements not represent a barrier to entry. To ensure arrangements enable the inclusion of new entrants, the panel should consider past performance in similar investment products or offshore markets for new entrants.

The optimal length of the shortlist

If a list is too long, the competitive dynamic will be muted (because the reward of making the list is low), the number of options can overwhelm and make choice difficult, and there is a risk mediocrity might be tolerated, with lower quality products making the list. However, if a list is too short, many worthwhile products might be left off, competition might be unnecessarily restricted as funds do not apply because the probability of making the list is relatively low, and the lack of options might drive a relatively unsuitable employee choice.

Given any new default process would not be starting from a 'clean slate', transition issues are relevant to the appropriate length of the shortlist. A longer list would promote stability,

but reduce the competitiveness of the process. On the other hand, a shorter list would provoke stronger competition, thereby promoting greater benefits for members.

Experience in New Zealand with KiwiSaver is instructive regarding these trade-offs. A New Zealand cabinet paper discussing the most recent KiwiSaver tender process suggested the shortlist of default providers should be ‘sufficiently high to avoid a tight oligopoly but not so high as to cause loss of economies of scale, excessive ... administration and ... monitoring costs’ (NZCO 2013, p. 12). However, critics of the New Zealand process have suggested selection processes seem to be a ‘tick the box’ affair in which large institutions are invariably chosen and too many funds are therefore chosen for the size of the New Zealand market (Littlewood 2012).

A strategy for dealing with the risk of upselling

A number of participants raised concerns that shortlisted funds might encourage their MySuper members to switch to higher cost, less suitable choice products. Industry Super Australia (ISA) stated:

The Draft Report envisions a system where private sector, for-profit financial institutions can bid for and win pools of default superannuation members. Such an outcome will deliver to the for-profit part of the super system a ready-made, government sanctioned, customer base at a very low acquisition cost. Once this customer base is acquired, these institutions will up-sell and cross-sell other products. (stage 2, sub. DR78, p. 20)

The Commission acknowledges that upselling represents a risk that should be mitigated. Funds should be required to annually inform ASIC and APRA about the number of cases of intra-fund movements from MySuper to choice products, and this information could be considered in future MySuper authorisation processes. To improve transparency, where a fund encourages members to move from MySuper to choice products, it should be required to disclose comparative information (costs, fees, net returns, future return targets and risk) to them (chapter 13).

These processes would also be guided by the requirements of the proposed product design and distribution requirements, assuming these pass into law (chapter 10). These include a requirement for offerors of financial products to make a target market determination for most products. These determinations would presumably provide guidance about the appropriateness of switching people between products.

Fund mergers to obtain ‘best in show’ status likely to be a positive

To obtain (or maintain) a significant presence in the default market, some funds that miss out on having products included on the best in show list could seek to merge with funds that are on the list. Such mergers should be allowed provided that the same conditions continue to be offered to all members of the shortlisted product offered by the merged fund.

Given the desirability of fund mergers, the potential for a best in show list to promote fund mergers is likely to be positive for fund members.

Decoupling of MySuper products and industrial instruments

The stage 2 draft report argued that default eligibility should be decoupled from awards.

- To the extent that there are benefits from tailoring products to groups across the workforce, they appear limited to relatively few segments of the workforce (and generally relate to insurance rather than the default superannuation product *per se*).
- The link is likely to have promoted the proliferation of low scale industry-based funds that would not have otherwise emerged or remained operating, imposing a significant cost on members (section 12.1).

The Commission remains of this view. One single list of MySuper products and one single shortlist of best in show products across the workforce would lead to better outcomes for members. Products maintaining an element of specialisation could still be developed and selected by employees making an active choice.

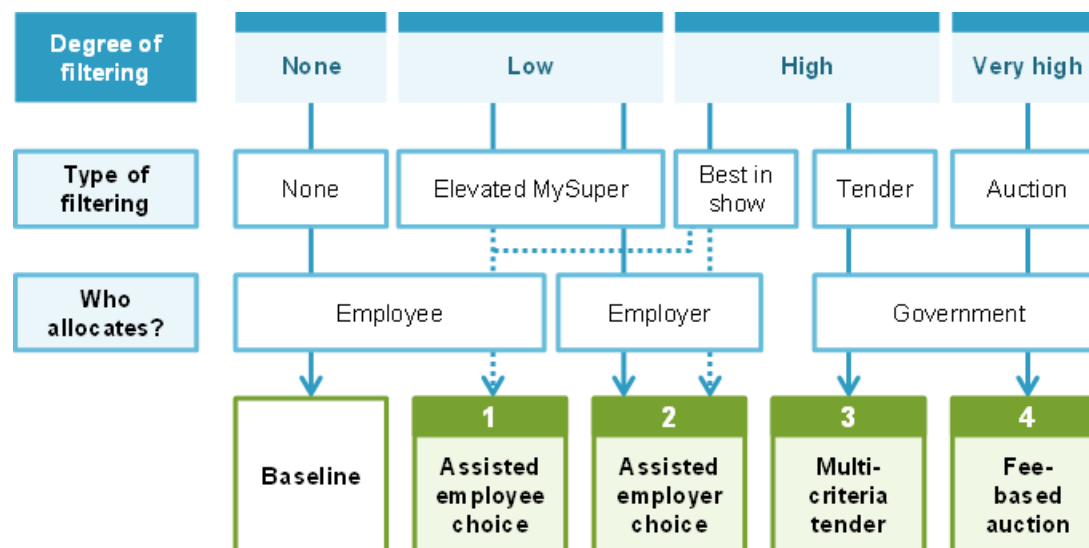
12.3 How do alternative default approaches perform?

The Commission proposed four alternative models in its stage 2 draft report (figure 12.2). The four models had many common foundations (discussed in section 12.2) and all aimed in some way to address the information problems in superannuation by limiting or nudging choice to a smaller set of better products. Where they differed was on the degree of filtering, and where decision making sat. For reasons outlined below, assisted employee choice is likely to provide the best outcomes for default members and is therefore the Commission's preferred model.

Detailed discussion of the models is not repeated here except where necessary for model comparisons, or where the proposed models have been refined since the stage 2 draft report.

Little support was received from participants for the fee-based auction and multi-criteria tender models (box 12.3). Although considered workable, and preferable to the unassisted employee choice baseline from stage 2, these models contain risks that could not be fully ameliorated. Funds participating in a fee-based auction might pursue low cost investment strategies (to minimise fees) at the expense of maximising net returns to members. Reliance on contractual arrangements with the capacity to 'lock in' asset allocations or investment strategies in a multi-criteria tender is problematic in an uncertain world where funds need a reasonable degree of flexibility to protect member interests.

Figure 12.2 The building blocks of the Commission's proposed stage 2 allocation models



The beneficial competitive aspects of the multi-criteria tender are present in other models without this inherent inflexibility. The assisted employer choice model is superior to both the fee-based auction and multi-criteria tender models, but has some critical shortcomings. The Commission's assessment here focuses on the assisted employer choice (with employee protections) (hereafter assisted employer choice) and assisted employee choice models.

Box 12.3 The multi-criteria tender and fee-based auction models had little support from participants

[The fee-based auction model] represents extraordinary market intervention which risks the stability and strong performance of the superannuation system and should not be considered further. It would result in a 'race to the bottom', a poor service offering and sub-optimal returns. It would preclude investment in historically strong performing illiquid assets. (Sunsuper, stage 2, sub. DR89, p. 18)

We have two in-principle concerns with a fee based auction model. Firstly, a focus on fees is likely to distort the market away from the more important focus on net long-term returns. This would be detrimental to the retirement savings of Australians. Secondly, it removes consumers completely from the decision-making process ... While this model is likely to be very effective as driving down costs it will struggle to keep pace with other demands consumers are likely to place on their superannuation fund, such as better customer service and engagement. (CHOICE, stage 2, sub. DR93, p. 12)

A tender or auction based on administrative and investment costs will fail to capture many of the current ways in which value is extracted from members and would see default products by for-profit providers shift the way in which they extract value from members into other arrangements. (ISA, stage 2, sub. DR78, p. 32)

... a fee-based auction would be a major disincentive for funds to invest in assets classes such as private equity and alternative assets, as well as active management, due to their higher costs. However these classes can provide important diversification benefits (as well as illiquidity premiums in some instances) that can contribute to higher risk-adjusted net returns. (Mercer, stage 2, sub. DR73, p. 11)

Assisted employer choice

Employers retain a central role in selecting default products in the assisted employer choice model (table 12.1), and must choose an authorised MySuper product.

The *mandatory* MySuper list would provide well-resourced employers flexibility to negotiate good deals for their workforces, while still providing a safeguard against very poor products. The *optional* best in show list would assist all employers with choosing a high performing product for their employees. Participant feedback on this model was diverse (box 12.4).

Evaluation of the assisted employer choice model

From a **member benefits** perspective, assisted employer choice would increase the number of members in higher performing funds relative to the status quo. The best in show list would guide some employers to the best funds; current members of shortlisted products would benefit from any improvement in the product offering; strengthened MySuper authorisation would eliminate poor performers; and funds that were not shortlisted would have an incentive to lift their performance to retain members (including in the choice segment).

Competition would be stronger. Competition to make the best in show list (which would be expected to provide a significant competitive advantage) would be particularly robust. And the potential for switching by employers and engaged members in response to the signalling provided by the shortlist would increase competitive pressure on funds.

Third party decision making would remain an **integrity** risk, with employers and the expert panel making decisions on behalf of employees. While risks around the expert panel can be in part mitigated with selection, accountability and transparency processes, it is not possible to impose a regulatory obligation upon employers to act in their employees' best interests.

Risks to system **stability** would be very low. Many employers would remain with their existing default fund — whether due to inertia or satisfaction with the offering. Similar factors would influence members' switching behaviour. Sizeable switching to shortlisted products would be unlikely given current switching rates are low (chapter 5). If a product was removed from the best in show list (and retained MySuper authorisation), it would continue to receive default contributions. Products that lost authorisation with a strengthening of MySuper would become ineligible to receive default contributions, leading to some industry consolidation, which would be readily managed by APRA.

Search **costs** would remain low for defaulting employees. Employers' costs would depend, as they do now, on how they determined their default fund (but would likely be lower for employers relying on the shortlist), and funds' costs would be slightly higher than currently for those that apply for shortlisting, but similar for those that do not.

Table 12.1 Key features of the assisted employer and employee choice models

<i>Features common to both models (and applying to existing members regardless of whether members change their arrangements)</i>	<i>Assisted employer choice</i>	<i>Assisted employee choice</i>
'Best in show' shortlist		
A list of up to 10 superior products selected by an independent expert panel every four years following a rigorous competitive process. Existing members of shortlisted products would benefit from product enhancements induced by the selection process. Shortlisted funds would need to offer the same conditions to new and existing members.	Employers provided with the shortlist in random order.	New workforce entrants presented with the shortlist in random order.
MySuper authorisation list		
APRA administers MySuper authorisation to ensure only suitable products are offered. Standards for MySuper authorisation are strengthened.	Employers can choose any product meeting the elevated MySuper authorisation threshold. MySuper authorisation provides protection for employees where employers choose beyond the shortlist.	Employees can choose any product, regardless of whether it is authorised. MySuper authorisation provides protection and comparability for employees choosing beyond the shortlist. Funds require MySuper authorisation to be eligible for the shortlist or maintain existing default members.
Information on shortlisted products		
The information is simple and covers investment performance, risks and fees (with the specific metrics to be based on detailed consumer piloting).	Provided in a consistent format by ASIC to help employers choose the product that best meets their employees' needs.	Provided in a consistent format by ASIC to help employees choose the product that best suits them.
Transparency and accountability		
Funds apply to have products on best in show list. Submissions are publicly available. Panel decisions are clearly articulated and transparent.		
Allocation where no choice made		
Existing workers (or people re-entering the workforce) who do not nominate a product on changing jobs are allocated to their most recently active account.	New workforce entrants who do not nominate their own superannuation product are allocated to their employer's shortlisted product.	New workforce entrants who do not nominate their own superannuation product are sequentially allocated to a shortlisted product.
Ongoing monitoring, enforcement and reassessment		
Annual self-reporting by fund trustees backed up by independent auditing by, or on behalf of, APRA. Periodic review of the criteria to assess default status (every 10 years).		

Box 12.4 Participant views on the assisted employer choice model

Some participants supported assisted employer choice

We support [assisted employer choice]. [It] maintains strong consumer protections (after applying the high quality filter) while boosting competition. It should be adopted along with complementary reforms to drive market efficiency. (Sunsuper, stage 2, sub. DR89, p. 17)

We believe that the employer is the most qualified party to select a default fund on their behalf. Employers are aware of the demographics of their workforce and can select a default which best suits this demographic. Many employers also use superannuation and insurance as a tool to distinguish themselves from other employers; often providing increased benefits to their workforce. (Workplace Super Specialists Australia, stage 2, sub. DR81, p. 1)

We support ... Assisted Employer Choice, as enabling the preservation of the best aspects of the current system, and avoiding a move to presentation of lowest common denominator choices, which result in poor outcomes for those intended to benefit from the arrangements. (Corporate Super Association, stage 2, sub. DR59, p. 2)

Others were strongly opposed

The prism of 'employer choice' is dangerous. It creates an administrative burden for employers and has the potential to cause huge conflicts of interest. (United Voice, stage 2, sub. DR97, p. 4)

The employer choice model has the potential to divert fund selection away from member interests and overall is least likely to achieve the goals set out by the Commission. ... Employer involvement in decision-making processes is antiquated and unlikely to lead to the consumers' best interests being taken in to account. (CHOICE, stage 2, sub. DR93, p. 14)

... many employers do not have adequate incentive, skill or desire to select appropriate products on behalf of their employees and historic engagement by small and medium employers with superannuation funds has been low in some instances. (Mine Wealth and Wellbeing, stage 2, sub. DR64, p. 5)

HESTA strongly opposes this model as it is missing the most important element – the requirement to pursue member's best interest. It echoes some of the historical strengths of the sector, like a link to the industry. But it is retrograde in many other ways. (HESTA, stage 2, sub. DR70, p. 12)

In summary, relative to the current system, the assisted employer choice model would improve member benefits and competition, involve roughly similar costs and entail low stability risks. However, third party decision making on employees' behalf would remain and, in the absence of other reforms (chapter 6), risks of account proliferation would not fall. And unlike the baseline or assisted employee choice, this model would do little to promote better member engagement.

Assisted employee choice

There are three key features to this model:

- choice of product rests with employees who are assisted via information of higher quality and accessibility than is currently available
- the shortlist to guide members to better quality products and reduce the risk to those who do not make a choice (backed up by the elevated standards for all MySuper products)

-
- a shortlisting process that, on the supply side, steers competition to more beneficial aspects (table 12.1).

The model design is influenced by behavioural economics and the concept of ‘nudges’ (Thaler and Sunstein 2009). The shortlist ensures that new workforce entrants (or first timers) are asked to choose from only the very best funds, while addressing the problem that ‘having more options can impede choice’ (Barr and Diamond sub. 74, p. 12). Participants expressed a varying range of views about the model (box 12.5).

Box 12.5 Participant feedback on the assisted employee choice model

In principle CHOICE sees merit to this model, although we acknowledge significant consumer protections would need to be built in to this framework to ensure it delivered substantial benefits above the current model. (CHOICE, stage 2, sub. DR93, p. 11)

BTFG considers that the assisted employee choice model, with some modifications, could potentially achieve the Committee’s desired objectives of improving scale and efficiency within the industry, enhancing competition and delivering better outcomes for fund members ... we do not support the need for the creation of a shortlist. (BT Financial Group, stage 2, sub. DR67, p. 3)

Assisted employee choice is not a default arrangement and does not address any of the issues related to default. The imperfect knowledge and information asymmetry of a large number of consumers underpin the need for a robust default system. The assisted employee choice model fails to provide a robust system, fails to protect and enhance consumer outcomes and there is no evidence that it would result in an improved net investment performance over the long term. (AustralianSuper, stage 2, sub. DR60, p. 6)

The application of the ‘assisted employee choice’ model would involve abandoning the position taken by successive Australian governments and superannuation policy reviews over the past 25 years that if disengaged and low-information workers are compelled by law to participate in markets for products they do not understand, then government has an obligation to act to minimize the risk that they are exploited by the private organizations that manage their contributions. (ISA, stage 2, sub. DR78, p. 49)

How would the assisted employee choice model work

Some members would choose from a second list of good performers

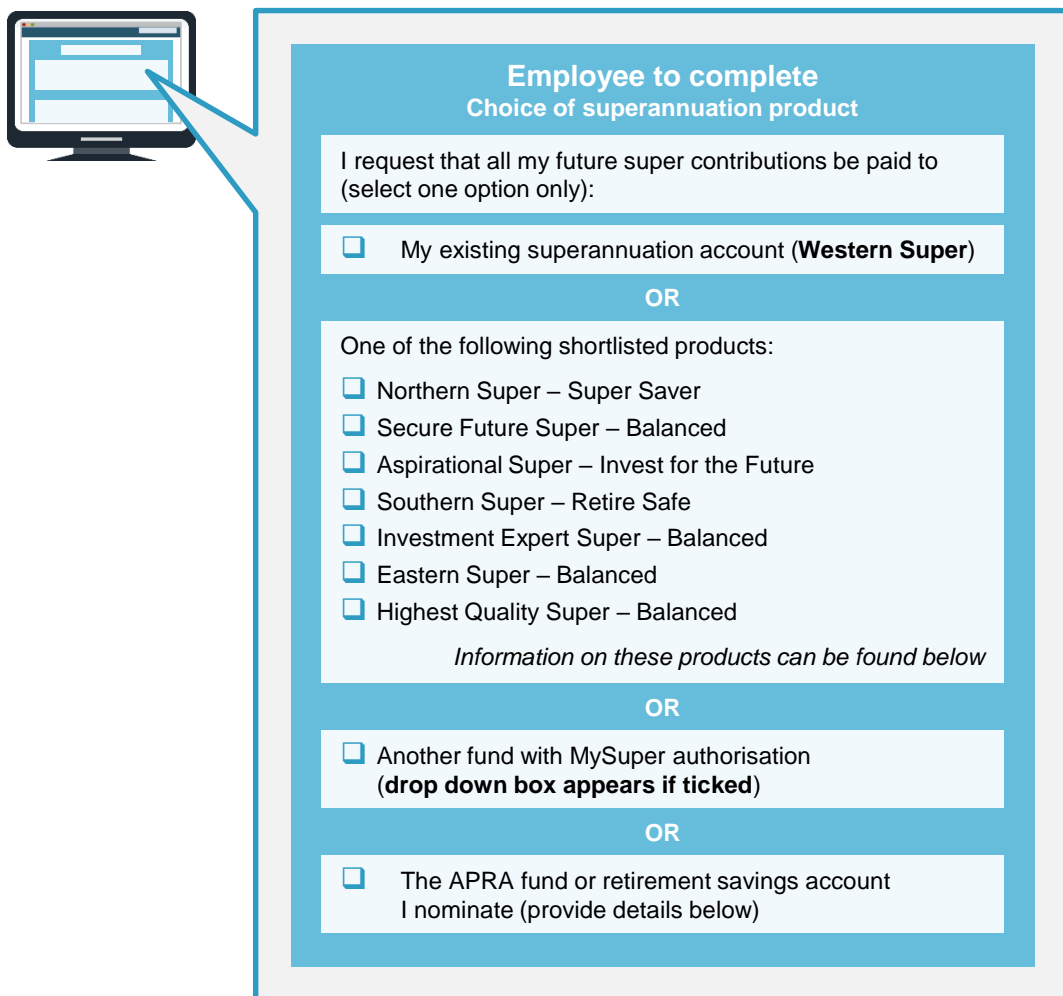
Some more engaged new workforce entrants would choose products from beyond the shortlist, with the likelihood that a range of good products would be maintained or developed to cater for particular member circumstances. Strengthened MySuper authorisation would mitigate against the risk of poor product choices, and see existing default members removed from underperforming products. And funds would require MySuper authorisation to continue receiving super guarantee contributions for existing default members.

The mechanics of assisted employee choice

On starting their first job, new workforce entrants would be presented with the shortlist via an online standard choice form (figure 12.3; chapter 6). The ordering of products on the shortlist should be randomised for each employee to remove ordering biases. Clear, easily understood metrics on the key features of each product would be provided by ASIC

(chapter 5) to support choice. New workforce entrants could choose any other product in the market, or self-manage their super, but the presentation of information would steer them towards the shortlist. The adoption of the model would not preclude employers or unions from providing information to their employees if they choose to do so, or employers from maintaining corporate funds. (A mechanism for taking care of employees who do not choose is discussed below.)

Figure 12.3 Sample: online choice form for an employee with an existing fund



Employee to complete
Choice of superannuation product

I request that all my future super contributions be paid to
(select one option only):

☐ My existing superannuation account (**Western Super**)

OR

One of the following shortlisted products:

- ☐ Northern Super – Super Saver
- ☐ Secure Future Super – Balanced
- ☐ Aspirational Super – Invest for the Future
- ☐ Southern Super – Retire Safe
- ☐ Investment Expert Super – Balanced
- ☐ Eastern Super – Balanced
- ☐ Highest Quality Super – Balanced

Information on these products can be found below

OR

☐ Another fund with MySuper authorisation
(drop down box appears if ticked)

OR

☐ The APRA fund or retirement savings account
I nominate (provide details below)

Existing (and previous) workers would remain with their current fund unless they chose to switch. On changing jobs (or re-entering the workforce), their existing fund/s would be preselected in the online standard choice form (chapter 6), and presented alongside the shortlist and the option of choosing any other product.

The Commission considers the ideal length of the shortlist would be up to 10 products, at least in a context where members are making the choice (a longer list may be acceptable in models where employers or government pick). However, there is merit in allowing the

selection panel to determine the length of the list (not deviating far from the 10 fund parameter) based on the merits of products. The panel should ensure the list contains only the highest quality funds, but also ensure there remains a competitive dynamic for inclusion to ensure the process produces benefits for members.

In the (unlikely) event that a product lost MySuper authorisation while on the best in show list, APRA would need to ensure an orderly transfer of their default members' balances to other best in show listed products.

Taking care of employees who fail to choose

Regardless of how straightforward the process is for choosing a fund, some new workforce entrants will inevitably not make a choice. The Commission's experimental survey work undertaken during stage 2 (appendix C) suggests relatively few people will fall into this category — with over 95 per cent of respondents who received a recommended shortlist of 4 to 8 funds making a choice; and over 80 per cent of respondents selecting a fund from the shortlist (PC 2017a).⁸⁰

In the stage 2 draft report, it was suggested that superannuation guarantee contributions for new workforce entrants who did not choose could be placed in a temporary holding account for safeguarding until the employee exercised a choice, with ultimate transfer of the balance to a new provider. The fund was to be given a remit to encourage members to choose another provider.

In feedback on the stage 2 draft report, some participants suggested sequential allocation of members (sometimes known as 'cab rank' allocation) to the products on the shortlist would result in better outcomes than a last resort fund. For example, Dixon Advisory said:

Dixon Advisory suggests a more efficient solution ... is to allocate members sequentially into the shortlisted default fund if they do not exercise a choice from the default shortlist within a designated period (i.e. 60 days). The sequential allocation of members across a wide but well filtered and appropriately considered shortlist, may also help reduce some of the issues with the ordering of the shortlist and concentration risk amongst certain funds. (stage 2, sub. DR76, p. 2)

The Commission has adopted this suggestion as it guarantees that employees who do not make a choice within 60 days are placed in one of the superior funds. Under the holding account arrangements, some members would have been likely to remain in the holding account for an extended period, which potentially would have been to their financial detriment. Allocating people to the superior shortlisting funds is also consistent with the Commission's view that a good default model should seek to ensure defaulting employees are placed in the very best funds.

⁸⁰ Indeed, the members choice survey results (PC 2017a) suggested a high proportion of people would choose from a longer list, which is why the design of the online standard choice form ensures attention is drawn to the shortlist of superior funds in the first instance.

Evaluation of the assisted employee choice model

Member benefits would be higher under assisted employee choice than current arrangements. Most new workforce entrants would choose from the shortlist. And those who did not make a choice would be defaulted to a shortlisted product. This highlights a key strength of the model: new members are encouraged to make good choices, but are protected whether they make a choice or not. Some existing default and choice members would switch to the shortlisted products due to its signalling effect.

Further, as for assisted employer choice, existing members of shortlisted products would benefit from any improvement in the product offering (as funds on the shortlist would need to offer the same conditions to new and existing members); strengthened MySuper authorisation would eliminate poor performers; and funds that were not shortlisted would have an incentive to lift their performance to retain members (including in the choice segment). In addition, by removing the link between employers and default fund selection, the model would reduce account proliferation and its associated costs to members (chapter 6).

Stronger **competition** would contribute to member benefits for similar reasons to those laid out for assisted employer choice. In addition, the ‘loss’ of new workforce entrants from non-shortlisted funds to shortlisted funds would create a stronger incentive for other funds to work to retain existing members. By encouraging employees to interact with their superannuation and make an active choice, it could potentially drive member engagement and encourage some competition *in* the market. In summary, there would be more vigorous competition both *for* the market and *in* the market.

The assisted employee choice model performs well from an **integrity** perspective by removing employer decision making on behalf of employees. However, there would be potential for marketing and advertising that was not in the interests of employees. The risk of upselling would need to be mitigated (and can be, as discussed above). The expert panel’s role in choosing the shortlist creates an integrity risk that would need to be mitigated through the panel selection and accountability process, although this process should *enhance* the integrity of decisions about default funds.

The assisted employee choice model is not expected to pose system **stability** risks. Only new workforce entrants (around 474 000 members accounting for about \$1 billion in annual contributions, in contrast with existing members who start a new job and account for about 1.6 million member accounts and \$16.5 billion in contributions) will be nudged to select a shortlisted product. Sudden large-scale movements in fund balances would not be expected, with (as in the employer choice model) the exception of funds that lose MySuper authorisation, where APRA would need to ensure an orderly transfer of balances to other products. Any switching to shortlisted products by existing members of non-shortlisted products would likely occur slowly and over time. Modelling by the Commission suggests that even if existing members switched at much higher levels than currently apply (chapter 5), investment returns on remaining balances and continuing contribution inflows from remaining members would support liquidity for the large majority of funds; and

therefore not impact or discourage long-term investment strategies.⁸¹ The modelling estimated the potential impact on funds' MySuper member accounts and assets of varying shares of new workforce entrants and existing members (whether at job change or workforce re-entry or unrelated to these events) choosing a shortlisted product versus alternative MySuper offerings. Details about the modelling approach and assumptions adopted are presented in technical supplement 7.

Costs associated with the operation of this model would be low for employers relative to current arrangements and the assisted employer choice model, as employers would not have a role in default selection. Costs for new entrants who chose a fund from the shortlist or who did not exercise choice would be similar to those under the current model, while costs for those choosing from a broader product range would likely be lower than those incurred by choice members currently, given the provision of additional straightforward information.

There would be costs to government in administering the shortlist, MySuper authorisation and online choice, the ongoing monitoring of fund behaviour, the (presumably small) costs of setting up a sequential allocation mechanism for members not making a choice, and the costs of information provision. Funds would also incur costs associated with these processes, and might engage in higher levels of marketing activity. However, the costs to government and funds would not be expected to be significantly different to those currently incurred — or that would be incurred as a result of adopting the system improvements recommended elsewhere in this report, regardless of default changes.

Overall conclusions

In summary, assisted employee choice has a number of desirable features. Over time, it should ensure a high proportion of members are in superior products and encourage better performance by funds through increased competitive pressure relative to the status quo. The model makes space, by encouraging member engagement, for competition in the market. This form of competition is valuable in the long term, because it is better able to encourage innovation and anticipate, and accommodate, shifts in member needs.

Assisted employee choice also removes many of the third party decision making issues present in current arrangements (and the assisted employer choice model). By encouraging new workforce entrants to make a choice, it would better promote member engagement, and by contributing to a reduction in account proliferation, it would increase returns to members.

⁸¹ The Commission asked APRA to review its approach to modelling the potential impacts of alternative default models and APRA confirmed that the methodology and underlying assumptions were reasonable and consistent with APRA's understanding of the industry. However the views and conclusions in the report based on the modelling undertaken are solely those of the Productivity Commission.

12.4 Preferred approach to the expert panel

Ensuring an objective and accountable shortlisting process would be critical to ensuring good outcomes. Feedback on the stage 2 draft report (box 12.6) highlighted stakeholder concerns about the potential for capture or politicisation of any entity formed to develop a shortlist of the most suitable products for default members, particularly in view of the polarised and highly partisan nature of the superannuation industry.

Box 12.6 Participant views on an expert panel

For example, the Financial Services Council (FSC) stated:

... it would be poor public policy for the Commission to recommend the creation of a new Government body that, in our view, would inevitably become politicised through potential conflicted appointments. The power to appoint individuals, be they domestic or international experts, inevitably rests with the Commonwealth Government. (stage 2, sub. DR88, p. 13)

And the ACTU observed:

It is ... true to say we live in a partisan political world where many senior political figures have avowed prejudices against one sector or another. ... In such an environment, how could any objective observer believe that the selection process – its terms of reference and its appointees – won't be corrupted. (stage 2, sub. DR71, p. 6)

On the other hand, other participants saw ministerial appointment of panel members as appropriate. For example, Sunsuper stated:

Given we entrust Ministers to appoint the Governors of Reserve Bank and High Court Justices, the superannuation panel should also have Ministerial appointees. We believe there exists a deep reservoir of superannuation fund selection expertise within the industry which would be drawn upon for this purpose such as professional services firms, ratings agencies and/or tender consultants. (stage 2, sub. DR89, p. 17)

Many stakeholders, particularly from the industry fund sector, argued the FWC represents the most likely forum for achieving a 'fair' outcome for employees, while others (mainly from retail funds) argued it was necessary to remove them from the process.

Cbus stated:

... the FWC architecture is ideally placed to perform the role. The FWC is a quasi-judicial body accustomed to applying the rules of natural justice, and making its decisions having regards to the substantial merits of the matter before it. Its processes are open, low cost and all the evidence before it is in the public domain. Its reasons for decision are made public, and its decisions are subject to judicial review. (stage 2, sub. DR74, p. 8)

The FSC saw the FWC process as giving too much power to trade unions:

The FSC is concerned, however, that the FWC process and enterprise agreement model discourages consumer engagement by delegating decision-making responsibility to trade unions. This is particularly a concern considering only 15% of all employees are members of a trade union, resulting in unions making decisions on behalf of consumers who are not their members, and with no legal obligation to act in the interest of those consumers. (stage 2, sub. 38, p. 21)

Appointment procedures need to ensure the body is seen as sufficiently credible and non-partisan. The Commission developed principles in the stage 2 draft report to achieve this aim. The decision-making body must:

-
- have a strong focus on member interests
 - have sufficient expertise to evaluate products
 - be independent and free of real or perceived conflicts of interest
 - have processes that are transparent and afford procedural fairness
 - be accountable for its decisions.

APRA would be unsuitable for the role — particularly in the context of a highly competitive process — due to a clash with its role as a prudential regulator. It is important APRA not be seen to be ‘backing’ products that represent a subset of those they regulate.

The FWC is also ill-suited to the role, as this process would give no weight to its area of expertise — in workplace relations and industrial precedent. And the appointment process it is subject to is clearly of a partisan nature — a criticism which good design of this panel can avoid. Accountability to government is also essential in a world of compulsion and where independent appointees potentially have a high degree of influence. The FWC’s independence is a strength as an arbitrator but the appointment of experts whose accountability is to this process rather than the objectives of the industrial relations system is essential.

Selection for a shortlisting panel should follow a fully transparent process reflecting contemporary best practice. This would include:

- public advertising of panel positions
- candidate interviews to prepare a candidate list to submit to the relevant Minister, conducted by a high level selection panel (including a member capable of representing member interests) for Cabinet approval
- appointment for a fixed term.

Adherence to best practice recruitment is essential to ensure appointment of the most suitable candidates to the shortlisting panel and provide the public with confidence in the default product selection process.

The shortlisting panel would meet only for the period it was required and then suspend operations. To ensure the panel approached each selection process with an open mind, no more than one third of the panel should ever carry over from one selection period to the next, and this should be a legislated constraint.

As its decisions about listing could provide significant commercial advantages to funds with products included on the shortlist, the panel should be established as a statutory decision-making body. Conflicts of interest (or perception of that) would all need to be publicly exposed prior to decision-making. Decisions about inclusion on the shortlist should be made public. The Minister should not have powers to change the decision of the shortlisting panel once it is made.

Decisions of the panel would be subject to judicial review (available under general administrative law provisions), but not merits review. Members of the panel would have a Commonwealth indemnity against litigation by aggrieved parties.

It would be important to ensure the panel had a highly skilled Secretariat to assist them in their task. Given the irregular nature of the assessment task, this Secretariat would not be standalone in nature. The Commission considers the Australian Government Actuary (AGA) would be best placed to fulfil this role given its expertise and independence. The AGA is located within Treasury with a high degree of independence and provides actuarial and related policy advice to the Australian Government and its departments and agencies. It typically advises government agencies on a Memorandum of Understanding basis (independent of Treasury) with funding for individual assignments provided by the commissioning agency. Its Secretariat role working for the expert panel should be specified in the legislation establishing the panel, and the AGA should be given an explicit budget by the Australian Government to ensure it is adequately resourced for the task. The AGA would be likely to draw on input and support from consultants.

12.5 The best option for future default arrangements

The assisted employee choice model would likely provide the best outcomes for default members and over time all superannuation members. The logic behind the model is simple and driven by behavioural economics — it is based on how people actually behave, not according to how they ‘should’ behave. Many people have difficulty making decisions regarding complex financial products and are disengaged from superannuation (chapter 5). Moreover, for many members in the accumulation phase, low engagement is a rational decision. This model is designed to ensure this disengagement would not adversely affect members: new workforce entrants would be guided to high quality products chosen by independent experts, or placed in these products should they not make a choice. Default superannuation accounts should only be created for members who are new to the workforce or do not already have a superannuation account.

Assisted employee choice would better promote competition and member engagement, would involve fewer third party decision-making issues than the status quo or the assisted employer choice model and would contribute to reducing account proliferation. Member benefits would be higher.

Moreover, once there is a shortlist of best in show products, there is no rationale for employers to be involved in the decision-making process. Further, the introduction with SuperStream of electronic data and money transfers to a common standard, and the widespread adoption of clearing house arrangements in recent years, means employers no longer need to fear the administrative complexities associated with dealing with multiple funds.

The Commission has considered whether any reforms to the current system (such as moving to a panel outside the industrial relations system, or breaking the link between default

eligibility and awards) would be sufficient to rectify identified deficiencies and concluded that they would not. A modernised superannuation system also needs to break the link with employer choice. Introduction of the assisted employee choice model would be the best way forward for members.

DRAFT FINDING 12.2

Current default arrangements do not promote member engagement. Recent survey evidence reveals that when members are provided with a simple and accessible list of superannuation products, only a small minority would not choose their own product. This evidence aligns with the lessons of behavioural economics.

12.6 Some propose a government monopoly provider

Barr and Diamond (sub. 74) recommended that all default contributions should be allocated to a government-owned entity that could then take advantage of the economies of scale stemming from its status as a monopoly default provider. A similar idea has been suggested by the Chairman of the Future Fund (and former Commonwealth Treasurer) Peter Costello (box 12.7).

This inquiry is tasked to look at how to make competition work better for members, so contemplating this model is inconsistent with that desirable goal. One suggestion — that a sovereign fund could compete to join the proposed shortlist — is more compatible with this inquiry’s task and would allow this idea to be better assessed. The Commission has therefore included it for completeness, and to obtain participant feedback on the costs and benefits of such an approach.

Such an arrangement would be broadly comparable to arrangements in Sweden and the United Kingdom, which potentially provide some operational insights. The UK Government in 2008 created a default pension scheme — the National Employment Savings Trust (NEST) due to concerns that some small businesses may be unable to secure the services of a private pension provider. Employers are not required to use NEST to meet their superannuation obligations, and competition with the private sector is intended to ensure NEST provides value for money (UK DWP 2016).

When the Swedish Government launched their premium pension scheme in 1999, it established a government-owned default fund for individuals who did not choose a fund. Initially, more than two-thirds of new savers chose a fund. However, by 2011 almost all new savers were joining the default, and many likely did so by making a deliberate passive choice (Barr 2013). Reasons offered for the decline in new savers making an active choice include an excessive amount of fund choice, the dot-com bubble immediately after the launch of the premium pension, and the strong performance of the default fund compared with other premium pensions (Hagen 2013).

For the reasons outlined in box 12.7, the Commission is not supportive of all default contributions being allocated to a government-owned fund. If allocated all default contributions, such a fund would fail to harness the benefits of competition for better member outcomes (as identified by the Murray Report, and implied in the terms of reference for this inquiry). While having a government-owned fund competing to make the best in show list would enable benefits of competition, such an arrangement would still raise concerns about the potential risk to current and future taxpayers stemming from a government-owned default fund in the event of poor performance (potentially encouraging a more conservative investment strategy). It would also raise competitive neutrality concerns and possibly constitutional issues.

Box 12.7 A few propose a government monopoly default provider

Barr and Diamond (sub. 74) recommended that the optimal arrangement for default contributions would be for all default contributions to be allocated to a government-owned entity. Their conclusions were influenced by the more member-oriented default systems in Sweden with the AP7 Safa default fund, and in the United Kingdom with the National Employment Savings Trust. The Chairman of the Future Fund (and former Commonwealth Treasurer) Peter Costello has suggested a similar idea based on arrangements for the Canadian Pension Plan (Costello 2017).

Proponents highlight the potential for the realisation of significant economies of scale under this approach, particularly with regard to investment. Other advantages Barr and Diamond highlighted included:

- avoidance of diverse returns within the system (viewed as unfair, and generating dissatisfaction and political hostility)
- a simpler picture for employees of the consequences (negative or positive) of not actively choosing a fund
- avoidance of account proliferation and regular moving of assets between different funds when employees switch jobs.

Similar considerations have been factored into the Commission's assisted employee choice model, and into other recommended policy changes in the report (including the use of an online standard choice form (chapter 6)). The assisted employee choice model would make fund choice straightforward — and protect members who did not choose — while promoting the creation of relatively generic products and dealing with account proliferation and the potential movement of assets with job change.

(continued next page)

Box 12.7 (continued)

The assisted employee choice model side-steps some of the material risks associated with government-ownership of pension schemes. The OECD has previously highlighted the many conflicts at the heart of governance of government-owned pension schemes:

These funds are exposed to particular risks related to the multiple roles played by the state in the regulatory, supervisory and operational fields. The state is, at the same time, sponsor, regulator, supervisor, service provider, fiduciary agent and recipient of pension fund investments. Specific government-related agency problems can arise with respect to these funds which differ from those frequently analysed in the private sector. Given the state's responsibilities as plan sponsor, fiscal accounts are also quite vulnerable to their performance and results and eventual funding or investment problems in some of the largest pension funds might provoke financial and fiscal turmoil. Frequently, taxpayers are invited to share the sponsor's responsibilities through increases in taxes, issuance of public debt or reduction in public expenditures in other areas, from which resources are reallocated to finance eventual unfunded liabilities. (Pinheiro 2004, p. 1)

The biggest risk associated with a government-owned monopoly default fund in the Commission's view is political (and associated fiscal) risk. In the event of poor performance by a *government owned* defined contribution fund there could be significant political pressure to 'top up' returns. The risks associated with losses or poor performance could potentially be shifted from members to taxpayers creating an implied guarantee, even if only perceived. This political risk could also manifest via a more conservative investment strategy (in order to avoid negative returns), ultimately harming members by locking them into lower investment returns.

Similar implicit risks apply to the government pension funds in countries such as Belgium, Canada, France, Spain, Sweden, Japan, and Norway. Such government-owned fund models come with either an explicit or implicit government guarantee, something that has (desirably) never been a feature of the Australian superannuation system. Potentially placing taxpayers at risk for underperformance of a superannuation fund would run counter to the global policy trend in recent years of shifting from defined benefit funds to defined contribution funds to reduce the risk to the taxpayer associated with unfunded liabilities. Over the past twenty years, global defined contribution assets have grown by 7.9 per cent, while defined benefit assets have grown by 4.5 per cent (Willis Towers Watson 2018). The Future Fund is itself an example of an attempt to reduce the risk to taxpayers associated with these schemes.

The adoption of a government monopoly default model would also run counter to the global policy direction of recent decades towards privatisation of government assets (including in the financial services sector, such as various Australian state government-owned banks, many following prudential mishaps).

Government-owned funds are also vulnerable to political interference in their investment strategies. For example, a government could seek to influence a fund to invest in government preferred infrastructure projects even when this was not in the best interests of fund members.

A government-owned default fund could also come up against constitutional issues and potentially create significant competitive neutrality issues given the advantages that a government-owned fund would have over private sector competitors. These advantages are important because although ostensibly a 'default fund', the fund would effectively be competing with the choice sector even if employees were not free to actively choose it. Many would be conscious that it was the default offering and they could effectively 'choose' it by not choosing another fund when they changed jobs.

DRAFT FINDING 12.3

Although a sovereign monopoly default fund would be well placed to realise economies of scale for default members, such a model would run counter to the (desirable) absence of an actual or implied government guarantee in the Australian superannuation system and would fail to harness the benefits stemming from a competitive process. It would also supplant member engagement.

INFORMATION REQUEST 12.1

Are there any material impediments to high-performing non-incumbent funds participating in a 'best in show' selection process? The Commission is particularly thinking about possible claims for participation by funds with no prior local track record but in-principle claims, such as foreign funds or a government-owned fund.

13 Modernising the super system to work better for all members

Key points

- The super system has delivered mixed investment performance for members, and current arrangements only chip away at entrenched problems of unnecessary balance erosion and poor-performing funds — at great expense to members in retirement. Changes are needed to better meet the needs of the modern workforce and retirees.
- The Commission is proposing a package of improvements that simplify choice, boost investment performance for members and better match products to members' needs — all by making way for healthier, safer competition that will also maintain system stability.
- Many members are disengaged and are especially vulnerable to the risk of poor outcomes. Government needs to ensure default is the exemplar — for all members.
 - Members should only be defaulted once, upon entering the workforce for the first time (or if they do not have an account), so they do not end up with unintended multiple accounts.
 - Default products should not be selected by employers or listed in modern awards. Instead, new members should be supported and empowered to choose from a simple, easy to use online list of 'best in show' products. This list should be short (to work for members) and set via a competitive and independent process (to drive the best outcomes).
 - The benefits will be immediate for new workforce entrants. Benefits will also spill over to existing default members, and over time to choice and SMSF members.
- All members — whether they default or not — can and should be better protected.
 - An outcomes test for MySuper products should be legislated and the authorisation criteria tightened. This will give all members a larger set of simple, safe products to choose from.
 - Governance standards should be brought up to contemporary best practice, including more robust appointment of board members based on skills and experience, stronger vetting and disclosure of outsourcing arrangements, and removing impediments to fund mergers.
- The ATO should be empowered to clean up unintended multiple accounts in the system.
- It should be easier for members and advisers to evaluate and compare products in the market (via simple and comparable product dashboards that are easy to compare with 'best in show' products). And funds can do more to harness data and technology to meet member needs.
- Super funds and Government need to do more to ensure that members, particularly young and lower-income Australians, get value from insurance attached to their super. The recent voluntary code of practice is a small first step, but needs to be strengthened and made enforceable (with concerted regulator endeavour and oversight).
- Regulators need to become confident member champions. There is scope to clarify the roles of APRA and ASIC for regulating trustee conduct. And all regulators should work together to collect more comprehensive, accurate and member-relevant data from the super system.

The workforce is evolving. Australians are increasingly moving between industries and occupations, women are participating in the labour force in greater numbers than ever before, and the number of people holding multiple jobs has been rising (chapter 1). The gig economy and technologies such as automation are starting to break down industry and occupational boundaries. Incomes will be higher for many workers — meaning that they will be contributing more to their superannuation — but, for some, potentially more volatile.

Retirement is evolving too. The average retirement age is on the rise, and future cohorts of retirees will be wealthier than those of today. By the time the super system reaches maturity in the 2040s, most Australians reaching retirement will have contributed a substantial portion of their income to super for their entire working lives. Many will also continue to work — and contribute to super — past the age at which they could access their super or the Age Pension. How well the system caters to their financial needs in retirement will be the ultimate test of its efficiency and competitiveness.

Yet our super system remains stuck in the past. It is a creature of the workplace relations system that provides a new super account to workers whenever they change jobs or industries (unless they actively choose otherwise — and most do not). In most respects it is opaque, with members finding it difficult to understand how their super fund stacks up against others.

It is time to modernise the super system. The investment performance of the system has been mixed and, as the Commission has found in this inquiry, policy change is needed to make the system work better for *all* members — especially those who are clearly not well served by the current system (chapter 11).

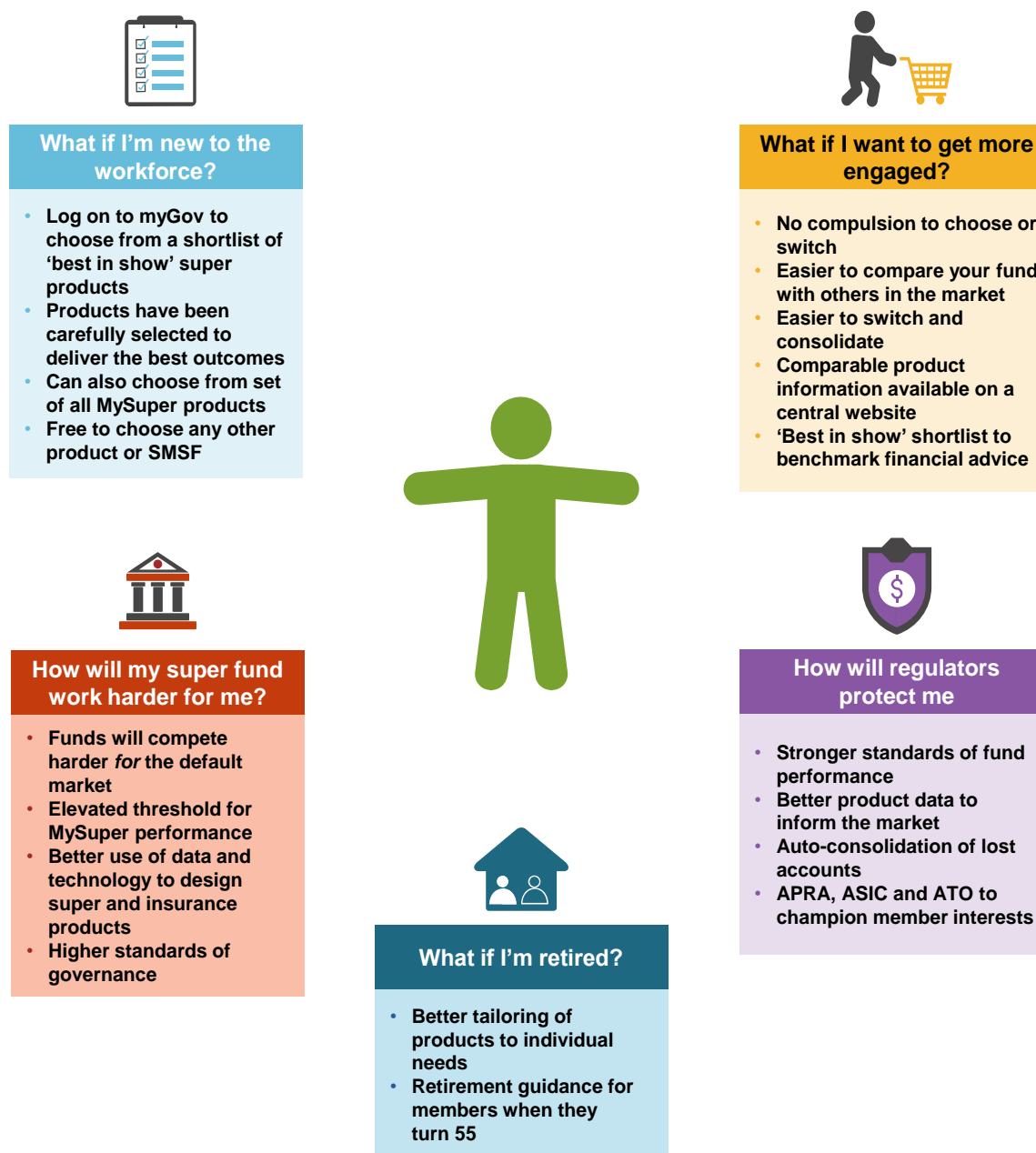
This chapter sets out a package of draft recommendations to do this (figure 13.1). Defaults are at the centre because, in a compulsory system, government has a duty to protect members from ending up with poor outcomes. Government also has a duty to help people make good decisions about their super, and to get the policy and legislative settings right so that the super system works for members first, not for the interests of funds and their suppliers.

13.1 Healthy competition for new default members

Default arrangements are a necessity in a compulsory super system. They act to protect members who do not or cannot make their own investment decisions and, in practice, have led to good outcomes for many members (chapter 12). But defaults can also encourage members to disengage from making decisions about their super and thus stifle the competition and innovation that would otherwise occur when members make active decisions.

Government's duty to protect members is of heightened importance in a defined contribution system where most financial risks lie with the individual: in relation to investment performance, fees and ultimately the benefit in retirement.

Figure 13.1 How will a modern super system work for me?



Indeed, other countries are increasingly recognising that they need to do more to meet their stewardship obligations to private pension systems. In recent years, the United Kingdom and Sweden, for example, have sought to make their systems simpler and easier for members to navigate, while providing safeguards against poor or uninformed choices (chapter 12).

The Commission is thus recommending a new mechanism for allocating default members to products. It has some features that are similar to the current mechanism, but is built in a way that will make funds compete harder for the default market, and to deliver the best outcomes for members. It will also facilitate greater involvement by members in their super and drive

better outcomes across the super system by making default the exemplar that other funds, including in the choice segment, will be driven to follow.

Remove employers from default selection

One of the biggest failings of the current default allocation is the proliferation of accounts and insurance policies that it generates (chapter 12). To better serve the needs of members, they should not be defaulted into a new super fund whenever they change jobs or industries. Instead, defaulting should only be an option for members who do not have an existing account — a solution to the multiple-accounts problem that was recommended by the Financial System Inquiry, but has not been taken up (Murray et al. 2014).

Existing members would remain with their existing account when they change jobs, rather than being re-defaulted into their new employer's fund. All members — existing and new — will still have the option to choose a different fund (or their own self-managed super fund (SMSF)), or to actively switch at any point.

This process should draw on the online 'standard choice' form being developed by the Australian Taxation Office (ATO) for use by new job starters in choosing where their super contributions will go — and by achieving universal participation by employers and employees in using the online system. As explained below, employees who are new to the workforce would use this centralised online service to choose a super product for themselves. This service should also make it easy for existing employees to consolidate multiple existing accounts when they move to a new employer. And the ATO should configure the service in a way that gives a clear nudge to support and encourage member engagement.

While embedding the choice of default super products in the workplace relations system may have made sense in the past, the existence of different lists of funds in different awards is fuelling the creation of unintended accounts (by having different funds for different industries), and poses barriers to new funds entering the default market (chapter 7). Moreover, enterprise and workplace agreements that restrict an estimated 1 million individuals from exercising their own choice of fund serve no purpose in a modern super system, and should be prohibited by legislation (chapter 12).

The current system fails to mitigate the risk of defaulting a member into a poor performing product (chapters 2 and 12). In a modern super system, members should not be at the mercy of their employer to choose a default product. While some employers are capable and well-intentioned when it comes to choosing a default, many struggle or do not have sufficient incentive to find the best product for their employees. It is an historical oddity that employers can select financial products for their workers without needing to hold an Australian Financial Services Licence or indeed any financial advice qualifications at all.

DRAFT RECOMMENDATION 1 **DEFAULTING ONLY ONCE FOR NEW WORKFORCE ENTRANTS**

Default superannuation accounts should only be created for members who are new to the workforce or do not already have a superannuation account (and do not nominate a fund of their own).

To facilitate this, the Australian Government and the ATO should continue work towards establishing a centralised online service for members, employers and the Government that builds on the existing functionality of myGov and Single Touch Payroll. The service should:

- allow members to register online their choice to open, close or consolidate accounts when they are submitting their Tax File Number when starting a new job
- facilitate the carryover of existing member accounts when members change jobs
- collect information about member choices (including on whether they are electing to open a default account) for the Government.

There should be universal participation in this process by employees and employers.

Introduce a ‘best in show’ shortlist

Members should be both supported and empowered to choose their own super product when they enter the workforce. To assist them — and reduce the risk of poor choices — a shortlist of ‘best in show’ products should be developed using a competitive process. There should also be a larger set of simple and safe products available to members, in the form of an elevated threshold for MySuper authorisation. This is the assisted employee choice model evaluated in chapter 12.

The best in show shortlist is at the heart of this model. It will ‘nudge’ members towards good products while still allowing them to choose something different. In this way, it offers members much greater opportunity to engage with and make decisions about their super — and thus increases member engagement — without members being overloaded with choices or information that is too difficult to navigate.

The design of this model is inspired and informed by evidence from behavioural economics on how people actually behave, not how they ‘should’ behave. This evidence strongly suggests that the shortlist should be short — with no more than 10 products — and be accompanied by simple and comparable metrics on each product’s features in a way that captures members’ attention. The Commission’s model is also informed by the substantial body of work of several international pension experts that supports a simple choice environment, where members who do not choose end up in good defaults, and those that do exercise choice are able to do so simply and safely.

The shortlist should be incorporated into the centralised online service. Members should also be able to choose from the larger set of MySuper products, which should be subject to elevated MySuper authorisation standards to better protect members (section 13.2). This

would mean more flexibility for members wanting to get more engaged in their choice of product, but materially reduce the risks of making a bad choice. And members can still choose to have their super paid into a choice product or SMSF.

Members will be assisted to choose, but not forced to choose. Any employee that does not make any choice within 60 days — and our survey evidence suggest this would likely be fewer than 5 per cent under the proposed arrangements — would be sequentially allocated to a fund from the best in show shortlist, and thus become a member of that fund. This will eliminate the risk that completely disengaged members are defaulted into a poorly performing product.

DRAFT RECOMMENDATION 2 ‘BEST IN SHOW’ SHORTLIST FOR NEW MEMBERS

A single shortlist of up to 10 superannuation products should be presented to all members who are new to the workforce (or do not have a superannuation account), from which they can choose a product. Clear and comparable information on the key features of each shortlisted product should also be presented. Members should not be prevented from choosing any other fund (including an SMSF).

Any member who fails to make a choice within 60 days should be defaulted to one of the products on the shortlist, selected via sequential allocation.

The ATO should embed the shortlist and accompanying information into the centralised online service.

Existing default members — who are already in the system — will not be compelled to switch funds or to use the shortlist. However, those who change jobs or re-enter the workforce will be provided with the shortlist — and the opportunity to switch funds (and consolidate accounts), if they so choose. Those who do not will simply remain with their current fund (most recently active account). Members will also be provided with information on how their current fund compares whenever they log in to the myGov website, in a format that makes for easy comparisons with the products on the shortlist (section 13.3). Existing members will also benefit from the Commission’s other draft recommendations, including elevated standards for MySuper authorisation and governance (section 13.2).

How will products be shortlisted?

A competitive process is essential to compile the shortlist. Funds seeking to have their products shortlisted will need to vigorously compete *for* the default market by applying to an independent expert panel (which is accountable to Government). This panel will evaluate applications based on clear criteria that are focused on member outcomes, with a high weight placed on investment strategy and performance (box 13.1). The result will be that the panel will only shortlist funds judged to deliver the best outcomes for members.

Box 13.1 **The best in show shortlisting process**

Selection criteria

To be eligible to apply to the panel, funds must offer a product that has obtained MySuper authorisation from APRA (under the elevated standards set out in section 13.2) and is open to all new members.

In choosing between products, the expert panel should determine and publish the range of criteria that it will consider, and should have the flexibility to determine how the criteria are weighted, contingent on doing so in a transparent manner and publishing the weights prior to funds submitting their applications. In general, the fund's investment strategy, fees and the likelihood of producing long-term net returns for members should be given high weights, to ward off any risk of a 'race to the bottom'. The panel should also give heed to the fund's intrafund advice offering, governance, and track record on innovation and identifying and meeting member needs (including design of superannuation products).

As well as criteria relating to superannuation, the panel should evaluate how well the fund complies with the insurance code of practice, and the trade-off the fund has articulated between insurance premiums for current and prospective members and their future retirement balances (section 13.4). The quality or range of ancillary services relating to superannuation or insurance should not be a deciding factor (subject to meeting a threshold level).

The panel

The most suitable body to determine the best in show list of funds would be an expert panel, collectively possessing super system and financial expertise and acumen, with insights into consumer behaviour and the skills required to undertake such an evaluation task.

Appointed panellists should be free of direct conflicts of interest, and seen to be so by the general public. To strike the right balance between expertise and independence, not all members would need to have a high degree of expertise in super: some could be accomplished individuals that have experience in collecting and evaluating evidence and advice, but who are also able to see beyond it (such as academics).

As compulsory super is a creation of the Australian Government — and it is the Government, and ultimately taxpayers, that bear some of the financial cost of a poor default allocation by way of increased Age Pension outlays — the panel should be accountable to it, and specifically to the relevant Minister. It is imperative, however, that the panel be independent. The relevant Minister should not have powers to change the decision of the panel. The panel's decisions would be subject to judicial review (available under general administrative law provisions), but not merits review.

The Government would appoint panellists through a robust selection process, and have in place a clear process for terminating and replacing appointments. There would also need to be adequate reporting and oversight to the Minister of the processes and decisions of the panel.

Source: Chapter 12.

The shortlist would contain up to 10 products, with the selection panel determining the precise number based on the merits of products. The panel should also consider what is most tractable for members while maintaining a competitive dynamic between funds for inclusion.

The panel should be comprised of experts and be independent of — but accountable to — Government. It should not sit within the Fair Work Commission. While that body’s independence is a strength as an industrial arbitrator, appointment of experts whose accountability is to the shortlisting process rather than the objectives of the industrial relations system is essential.

The shortlisting process should be conducted every four years. Each fund selected for the shortlist would be required to extend any benefits offered to new default members in the course of competing for and securing the right to act as a default fund to all its existing MySuper members. And choice members who join that fund should also receive the same benefits as existing members.

Funds that fall off the shortlist will be able to retain their existing default members provided they maintain their MySuper authorisation. The Australian Prudential Regulation Authority (APRA) should not be involved in shortlisting or appointing the panel, but any fund that materially underperforms would be at risk of losing its MySuper authorisation, and if this occurs the fund would naturally also lose its place on the shortlist.

DRAFT RECOMMENDATION 3 **INDEPENDENT EXPERT PANEL FOR ‘BEST IN SHOW’ SELECTION**

The Australian Government should establish an independent expert panel to run a competitive process for listing superannuation products on the online shortlist. This panel should select from products submitted by funds that meet a clear set of criteria (established beforehand by the panel) and are judged to deliver the best outcomes for members, with a high weighting placed on investment strategy and performance.

The panel should have flexibility to select up to 10 products, with the exact number at the discretion of the panel based on the merit of each product and what is most tractable for members, while maintaining a competitive dynamic between funds for inclusion.

The panel should be comprised of independent experts who are appointed through a robust selection process and held accountable to Government through adequate reporting and oversight.

The process should be repeated, and the panel reconstituted, every four years.

How will members benefit?

The best in show shortlist is about putting members first — regardless of their employer or industry of employment. The evidence from behavioural economics shows that nudging people to make a decision from a small set of choices is an effective way to engage them in making an active decision.

At the same time, the thorough process for shortlisting products will act as a safety net. Where members pick from the shortlist (or do not make a choice and are sequentially allocated to a product on the list), they are likely to end up in high-performing products. The

competitive dynamics generated by wanting to get onto, or remain on, the shortlist, will drive funds to deliver strong outcomes to members and innovate to better meet their needs. Funds that miss out the first time will have a clear incentive to beat their competitors the next time around.

Moving to a system where employees select their super product from a pool of highly performing funds will extricate superannuation from workplace relations, and focus it on value and worker agency. The absurdity of accidental multiple accounts becomes undeniable once super is conceived as anchored to the member, not to a job or an employer.

And removing employers from the process will sidestep the potential conflicts of interest that go hand in hand with the current system. But this would not preclude employers or unions from playing a role. Though they will no longer be directly involved in selecting default products at a workplace or industry level, employers will still have scope to bargain with super funds on behalf of their employees to secure group discounts on fees or to develop tailored products or insurance. Corporate funds will remain in the system. And employers and unions could still provide information (as distinct from advice) to their employees if they wish. The difference is that members would need to actively choose the product (without obligation) rather than having it imposed upon them by default.

The immediate benefits will extend beyond new job entrants, as the successful funds are required to extend the same product to their existing default members, and other funds face competitive pressure to increase their performance. There will also be broader spillover benefits to members across the whole super system, in terms of greater competitive pressure in the choice segment and on financial advisers (discussed in section 13.3).

How should these improvements be introduced?

A move to this new default allocation mechanism will have implications for the inflow and outflow of members (and their balances) to existing funds. Those that are on the shortlist will likely see greater inflows of new members, while those that miss out may see some of their members voluntarily switch funds.

This is unlikely to destabilise the super system. The available data and evidence suggest that even if many members chose to switch to a shortlisted fund, and other funds needed to exit or merge in the first few years, this should be manageable for APRA and would advance (not compromise) members' interests (chapter 12).

Should there be a government-owned default fund?

A radically different approach to default allocation would be the creation of a government-owned monopoly fund to hold the contributions of all members who do not actively choose a super product for themselves. Some inquiry participants (such as Barr and

Diamond, sub. 74) put this idea forward as a solution to low member engagement and a way to reduce costs by achieving greater economies of scale, especially in administration.

But a government-owned fund would come at the cost of abandoning any attempt to achieve beneficial member engagement. It could also give the government implied responsibility for the fund's performance, putting at risk a unique virtue of Australia's self-reliant super system (chapter 12).

It would also bypass competition in and for the default segment, and with it the benefits that come from providers competing with one another, including higher net returns over time and innovation. Ultimately, strong default options and safe member choice are better delivered via a best in show process. Top-performing non-incumbents, including government-owned entities, need not be precluded from competing in the process.

13.2 A higher standard of performance

The draft recommendations above relate to the flow of new default members into products. But the number of new members entering the super system each year (about 470 000) is vastly smaller than the stock of existing members (14.8 million). A sizable proportion of these are default members — over half of all accounts in the system are in MySuper products (APRA 2018c) — though a statistic of how many unique members this constitutes does not exist (chapter 1).

Super funds should be held to a high standard for all their members. The Commission is therefore recommending an elevated threshold for MySuper products and a higher standard of fund governance. These are incremental changes designed to make super funds work harder in their members' interests. As noted above, the Commission is *not* proposing that existing default members be forcibly moved to a product on the best in show list (or any other product), provided their fund maintains its MySuper authorisation.

Elevate the threshold for MySuper

MySuper authorisation plays an essential safety role in the super system by setting strong protections for MySuper members and requiring funds to meet a high standard of disclosure. It functions to make products more comparable, which helps members to make decisions about their super and to exert competitive pressure on funds to meet their needs. At the same time, it acts to reduce some of the material risks to members who want to become engaged and choose their own product.

MySuper will continue to perform these roles under the Commission's draft recommendations. It will also serve to protect *existing* default members (since funds must hold MySuper authorisation in order to accept default contributions).

However, MySuper standards need to be strengthened (table 13.1). Under current MySuper rules, there is wide dispersion in member outcomes — members of some products achieve returns well above the average, while at least 15 per cent of accounts are in products that performed well under a benchmark portfolio over a 10-year period (chapter 2). Since the implementation of MySuper in 2013, a number of deficiencies have become apparent, such as serial underperformance by more than a handful of funds and limited scope for APRA to remove authorisation once it has been granted.

The Government has already presented legislation to Parliament to strengthen MySuper. This entails the introduction of an ‘outcomes test’ whereby trustees must annually determine whether their MySuper product is meeting the best interests of their members, and must annually compare their MySuper product against others in the market based on fees, returns, risk and other metrics. APRA will have increased powers to require underperforming funds to transfer their MySuper members to another fund. These reforms are a clear step in the right direction and should be legislated.

To complement and bolster the outcomes test, funds should be required to obtain independent verification — to an audit-level standard — of their outcomes test assessment, comparison against other products in the market, and determination of whether members’ financial interests are being promoted, at least every three years.

In addition, funds should be required to report to APRA annually on how many of their MySuper members switched to a higher-fee choice product within the same fund each year. This would give APRA greater visibility over upselling and cross-selling practices by funds. Further, funds should be required to immediately adopt the insurance code of conduct to obtain (or retain) MySuper authorisation, with the code to be strengthened and made enforceable within the next few years (section 13.4).

And funds that fail to meet these elevated standards — or persistently underperform (for five or more years) an investment benchmark tailored to their asset allocation by a material margin (as determined by APRA) — should have their MySuper authorisation revoked.

These changes — along with the new ‘outcomes test’ — will inevitably put pressure on some funds to merge or to withdraw from providing a MySuper product. Indeed, that is the very point of the changes: to lift performance for default members and, where funds cannot achieve this, to encourage mergers or exits. Where a fund loses MySuper authorisation, members in this product will then need to either actively choose to remain, or otherwise be transferred to a better fund (which must hold MySuper authorisation). APRA will need to oversee this process to ensure remaining members’ interests are protected.

Following implementation of this enhanced outcomes test, there should be an independent review of the MySuper authorisation rules every five years to ensure they are meeting the intended objectives and are being suitably applied by APRA to remove underperforming MySuper products.

Table 13.1 Elevated MySuper authorisation

Common characteristics

Product features	Administration, investment, intrafund advice
Investment strategy	Single diversified strategy or set of life-cycle strategies
Fee structure	Single fee structure that applies to all members
Other fees	Exit fees, switching fees, and buy–sell spreads levied on cost recovery basis; commissions and any other direct fees prohibited

<i>Differences</i>	<i>Current MySuper</i>	<i>+ Outcomes test (yet to be legislated)</i>	<i>+ Proposed additional elements = elevated MySuper</i>
Performance and member outcomes	<p>Trustees must:</p> <ul style="list-style-type: none"> • make an annual determination on whether their MySuper members are disadvantaged relative to members of other MySuper products • report return and risk targets, but are not required to meet any specific investment performance standard 	<p>Trustees must make an annual determination of whether the financial interests of members are being protected, involving:</p> <ul style="list-style-type: none"> • an assessment of their MySuper product on various matters including the appropriateness for members of the investment strategy, options and insurance offering, and whether scale presents problems • a comparison of their MySuper product against other MySuper products based on fees, costs, return targets, actual returns and the level of investment risk <p>The determination and a summary of the assessment and comparison must be made publicly available on the fund's website within 28 days</p>	<p>Trustees are required to obtain independent verification (to an audit-level standard), at least every three years, of their:</p> <ul style="list-style-type: none"> • outcomes test assessment • comparison against other products in the market • determination of whether members' financial interests are being promoted <p>Products that persistently underperform an investment benchmark tailored to their asset allocation by a material margin (as determined by APRA) for five or more years lose authorisation</p>
Member switching	No specific requirements	No specific requirements	Trustees must annually report to APRA how many members switch to a higher-fee choice product
Insurance	Trustees must provide life cover and total and permanent disability cover on an opt-out basis	Trustees must assess the appropriateness of the insurance strategy for members and whether insurance premiums inappropriately erode the retirement income of those beneficiaries	Trustees must have adopted the insurance code of conduct

Sources: Australian Government (2011, 2017); PC (2016a).

DRAFT RECOMMENDATION 4 **MYSUPER AUTHORISATION**

The Australian Government should legislate to allow APRA to apply the MySuper outcomes test.

Authorisation rules for MySuper should be further strengthened to require funds to:

- obtain independent verification — to an audit-level standard — of their outcomes test assessment, comparison against other products in the market, and determination of whether members' best interests are being promoted, at least every three years
- report to APRA annually on how many of their MySuper members switched to a higher-fee choice product within the same fund.

Funds that fail to meet these conditions — or persistently underperform (for five or more years) an investment benchmark tailored to their asset allocation by a material margin, as determined by APRA — should have their MySuper authorisation revoked.

After implementation, the Australian Government should commission an independent review, every five years, of the effectiveness of the MySuper authorisation rules (including the outcomes test) at meeting their objectives.

Make governance best practice

Super funds have some similarities with listed companies, but unlike listed companies, super fund members have no voting rights and little if any influence over board appointments. Members also tend to be much more disengaged. Individual members are unable to put much discipline on funds (short of exercising their right to switch — which few do) so the regulator must act on their behalf.

Over the past 30 years the governance of super funds has improved greatly (chapter 9). Yet in some ways, governance practices lag behind contemporary best practice. The Commission is thus recommending three groups of amendments to governance rules to lift the performance of boards and make trustees more accountable to their members. Chapter 9 sets out the case for these changes in more detail.

Better trustee board members

Best practice governance would require that the trustee boards of *all* super funds have a good mix of knowledge, skills and experience, and are free from potential conflicts of interest. And best practice would also include the presence of a 'critical mass' (to use the Cooper Review's term) of independent directors — which, in practice, would mean at least one-third of directors. More genuinely independent directors on boards may help in this regard — the Government's proposed tightening of the definition of 'independence' is helpful.

Trustees of all super funds should be required to have, use and disclose a process to assess, at least annually, their board's performance relative to its objectives and the performance of

individual directors (as required by APRA's Superannuation Prudential Standard 510 (APRA 2016c)). Alongside this, boards should be required to maintain a skills matrix that identifies the skills and experience of each trustee director (and publish a consolidated summary each year), such that new appointments can be selected on the basis of filling identified gaps in expertise. This would better align super funds with best practice for companies listed on the stock exchange.

Trustees should also be required to engage an external third party to evaluate the performance of the board (including its committees and individual trustee directors) and capability against the skills matrix at least every three years. APRA should be provided with the outcomes of such evaluations as soon as they have been completed.

DRAFT RECOMMENDATION 5 REGULATION OF TRUSTEE BOARD DIRECTORS

The Australian Government should legislate to:

- require trustees of all superannuation funds to use and disclose a process to assess, at least annually, their board's performance relative to its objectives and the performance of individual directors
- require all trustee boards to maintain a skills matrix and annually publish a consolidated summary of it, along with the skills of each trustee director
- require trustees to have and disclose a process to seek external third party evaluation of the performance of the board (including its committees and individual trustee directors) and capability (against the skills matrix) at least every three years. The evaluation should consider whether the matrix sufficiently captures the skills that the board needs (and will need in the future) to meet its objectives, and highlight any capability gaps. APRA should be provided with the outcomes of such evaluations as soon as they have been completed
- remove legislative restrictions on the ability of superannuation funds to appoint independent directors to trustee boards (with or without explicit approval from APRA).

Stronger disclosure on outsourcing

Disclosure of fund practices and decisions is an essential prerequisite for good governance and for making trustees accountable to their members. While transparency has benefits and costs — and there are valid reasons for not disclosing all information funds hold (for example, where disclosure could harm members or third parties) — there are some clear weaknesses in current requirements of what funds must report to APRA. Prime among these is a lack of transparency on outsourcing arrangements, especially where a related party has been used.

APRA should require funds to conduct formal due diligence of their outsourcing arrangements at least every three years, to determine whether their arrangements are

achieving value for money. A copy of the assessment should be provided to APRA (including the fees paid to each provider and a comparator based on other fees charged in the market). Funds should also publicly disclose to current and prospective members the proportion of costs paid to service providers that are associated with related-party outsourcing arrangements. Broader improvements to disclosure, including through better data collection, are discussed in sections 13.3 and 13.5.

Fewer impediments to mergers

The super system is populated by a large number of funds, some of which have achieved significant scale, and others that are very small — for example, about half of all APRA-regulated funds (112 funds) have less than \$1 billion in assets (chapter 7). Size is not the sole determinant of performance, but both underperformance and economies of scale point to scope for more fund mergers in the interest of members. A member on an average wage in the median fund in the bottom quartile on investment performance is projected to retire with a balance 53 per cent (or \$635 000) lower than if they were in the median top-quartile fund (chapter 9).

The regulators can do more to facilitate mergers between underperforming or subscale funds. Trustees on both sides of a merger attempt should be required to disclose all such attempts (that reach the memorandum of understanding stage) to APRA, as well as the reasons why a failed merger did not proceed and the assessment of members' best interests that informed the decision. This will likely assist APRA in applying the outcomes test under elevated MySuper authorisation standards (as discussed above), especially where action needs to be taken to facilitate or compel a merger.

The Australian Securities and Investments Commission (ASIC) has a role to play too. It should proactively investigate questionable cases where mergers between super funds stalled or did not proceed — which would dovetail with a greater focus on strategic conduct regulation (section 13.5).

DRAFT RECOMMENDATION 6 REPORTING ON MERGER ACTIVITY

The Australian Government should require trustee boards of all APRA-regulated superannuation funds to disclose to APRA when they enter a memorandum of understanding with another fund in relation to a merger attempt. For mergers that ultimately do not proceed, the board should be required to disclose to APRA (at the time) the reasons why the merger did not proceed, and the members' best interests assessment that informed the decision.

Government can also do more to directly facilitate fund mergers. The Australian Government should make capital gains tax relief permanent for funds that merge, and require APRA to report annually to the Council of Financial Regulators on the extent to which the MySuper outcomes test is bringing about fund mergers (section 13.5).

DRAFT RECOMMENDATION 7 **CAPITAL GAINS TAX RELIEF FOR MERGERS**

The Australian Government should legislate to make permanent the temporary loss relief and asset rollover provisions that provide relief from capital gains tax liabilities to superannuation funds in the event of fund mergers and transfer events.

13.3 Products that meet member needs

A well-performing super system requires funds to strive to meet the needs of individual members. Robust competition between funds is essential, because competition is a driver of innovation. With ongoing advancements in technology, funds need to be continually improving their products and services to meet the needs of existing and prospective members. Indeed, many are already doing this.

Yet many members struggle to find the right products, and the system — and Government — has made engagement harder than it ought to be. And even where members do get engaged this has not always led them to better outcomes.

Making it easier for members to get engaged and to compare products should thus be a priority. There is scope for much improvement in how funds disclose information on their products. Regulators will need to take the lead on some of this, though there is also scope for funds to lift their game on disclosure.

That said, not all members are well placed to ‘vote with their feet’ and drive competition between funds. For many members, low engagement is rational — and is to be expected in a compulsory and complex system that covers the bulk of the population (chapter 5). The needs of less-engaged members can be better met by harnessing data and technology to design products and insurance. And stronger action can and should be taken by regulators to clean up unintended multiple accounts in the system, regulate exit fees and alert members to any trailing commissions they are still paying.

Clean up unintended multiple accounts

The proliferation of unintended multiple accounts and insurance policies is a perverse side-effect of the current way default members are allocated to products, and imposes large and regressive costs on many members (chapter 6). As noted above, the recommendation to default people only once (when they enter the super system for the first time) will effectively stop the creation of unintended accounts in future.

However, a large legacy stock of multiple accounts will remain. On average, members hold 1.9 accounts each — much more than can reasonably be expected to result from deliberate and informed choice. The number of unintended multiple accounts has been coming down, but not fast enough. These still represent 10 million member accounts, over a third of the total.

To speed things up, super funds should be required to transfer all lost and unclaimed accounts to the ATO, with the ATO empowered to reunite balances with a member's active account (unless the member actively rejects consolidation). Any insurance on the lost accounts should automatically cease. This will reduce the administrative costs of funds holding lost accounts and stem the erosion of these balances from fees and insurance premiums. (The Commission is also recommending that insurance be ceased on all accounts that have not received contributions for the past 13 months, as discussed in section 13.4.)

In addition, the ATO should operate the sole 'holding account' for lost super. This would mean replacing the role of Eligible Rollover Funds (ERFs), which have questionable fee structures and do not appear to be achieving much success at reuniting members with their lost super (chapter 6). All accounts in ERFs should be transferred to the ATO and no further accounts should be sent to ERFs. In all likelihood, this would mean the exit of ERFs from the super system, a process that would require close supervision by APRA.

DRAFT RECOMMENDATION 8 **CLEANING UP LOST ACCOUNTS**

The Australian Government should legislate to:

- ensure that accounts are sent to the ATO once they meet a definition of 'lost'
- empower the ATO to auto-consolidate 'lost' accounts into a member's active account, unless a member actively rejects consolidation
- allow a fund to exempt a 'lost' account from this process only where the member has provided an explicit signal that they want to remain in that fund (prior to the account meeting the definition of 'lost')
- reduce the 'lost inactive' activity threshold from five to two years
- require that all accounts held by Eligible Rollover Funds, regardless of their lost status, are sent to the ATO
- prohibit further accounts being sent to Eligible Rollover Funds.

Make super easier to navigate

Many members find information on super to be too complex and overwhelming. In the choice segment, there has been a proliferation of little used and complex accumulation products — over 40 000 in total (chapter 4). And the irony of the system is that, if anything, products are most complex during accumulation and most simple in retirement — when the converse constellation is needed for most members.

While some complexity is inherent to all financial products, much of that around super is unnecessary. All too often key data are missing or difficult to compare across funds. The Commission's survey evidence suggests that members want more transparency in the information their fund provides them, especially in relation to the returns they get, the fees they pay and the coverage and cost of their insurance (chapter 5). Behavioural economics

research points to the importance of ‘less is more’ in funds competing for the meaningful attention of members.

The super system needs to be easier for people to navigate when they want to get engaged — and they should be able to choose their degree of engagement. Information needs to be accurate, easily understood and readily comparable across funds. When products are easy to compare, members are more likely to exercise informed engagement by switching to better providers. Even where just a subset of members — a critical mass — is thus engaged, they can drive stronger competition that leads to improved outcomes for everyone.

Above all else, engagement needs to be safer for members — in a modern super system, engaged members should be getting better outcomes, not worse.

Dashboards for all products

The spirit of product disclosure needs to be re-oriented from risk aversion to helpfulness, with regulators taking the lead to make disclosure meaningful and digestible. Foremost, clearer, simpler and more widely applied product dashboards are needed to help members compare the returns, fees and risk associated with all super products.

Steps have been taken to improve product comparability with the mandating of product dashboards for MySuper products (from 2014). Similar dashboards were originally scheduled to be mandatory for choice products from July 2015, but industry resistance has led to ASIC pushing back the implementation deadline to July 2019. The Government has also presented legislation to parliament to narrow the scope of these dashboards to just the 10 largest choice products within each fund.

The slippage of timelines and narrowed scope of dashboards will hurt members. Legislation to narrow the scope of dashboards should not be pursued: funds should be required to publish a dashboard for *all* superannuation products. ASIC should prioritise achieving full compliance by July 2019. While providing dashboards will impose some costs on funds, these are likely to be modest and more than outweighed by the long-term benefit to members of more comparable product information across the super system. (Regulators can also do more to collect member-relevant data, as discussed in section 13.5.)

Perfection should not be a barrier to the possible, nor an excuse for perpetual delay. ASIC should seek to revise the content and format of dashboards to simplify them and provide more easily comprehensible metrics (by the end of 2019). In doing so, it should consult with independent experts and consumer organisations. There is also scope to make much greater use of behavioural testing and evidence to inform this process, such that the focus of any changes is squarely from a member’s perspective.

In addition, ASIC should make all product dashboards available on a central website (such as its MoneySmart website). This will make it easier for members to access dashboards for a range of products, while also offering a degree of validation that would bolster trust by

members in the dashboards. Links to this information should be made clearly available to members from the area of myGov that allows for account consolidation, to proactively ‘nudge’ members towards the dashboards.

DRAFT RECOMMENDATION 9 A MEMBER-FRIENDLY DASHBOARD FOR ALL PRODUCTS

The Australian Government should require funds to publish simple, single-page product dashboards for all superannuation products.

ASIC should:

- prioritise the implementation of choice product dashboards to achieve full compliance by 1 July 2019
- revise the dashboards to simplify the content and provide more easily comprehensible metrics (drawing on robust consumer testing) by end 2019
- immediately publish all available MySuper and choice product dashboards on a single website, with the information clearly and readily accessible from the area of myGov that allows for consolidation of accounts.

Dashboards should also be incorporated into the centralised online service (draft recommendation 1) in a way that allows for salient comparisons of a member’s current super product to those on the best in show shortlist. This would make it easier for members to see how their fund is performing and, if desired, switch to a new fund. This will act to drive greater member-side competition in the market.

Further, funds should be required to actively provide their dashboards to members who have requested to switch from a MySuper product to a choice product (within the same fund). This will assist members to make informed decisions (by comparing the dashboard for each product) and provide an opportunity to better understand the implications of switching.

DRAFT RECOMMENDATION 10 DELIVERING DASHBOARDS TO MEMBERS

The Australian Government should require the ATO to present the relevant (single page) product dashboard on a member’s existing account(s) on its centralised online service.

The Government should also require all superannuation funds to actively provide their members with superannuation product dashboards when a member requests to switch from a MySuper product to a choice product within the fund. This should include:

- the dashboard for the MySuper product
- the dashboard for the choice product the member wants to switch to.

More effective product disclosure

More generally, the performance of super funds in disclosing key product information to their members are mixed. Some funds provide information in clear and accessible formats, whereas others tend to ‘bury’ material (including product dashboards) or use terminology that most members find confusing. Product Disclosure Statements seem more focused on protecting the fund than helping the member. Recent attempts to improve disclosure of hidden investment costs have proved protracted and convoluted (chapter 3).

There is much scope for ASIC, as the primary regulator in this area, to more proactively set and enforce disclosure requirements for super funds (section 13.5). The overarching objective should be meaningful and digestible disclosure — information should be simple, comparable and easy for members to understand. This should encompass all member-relevant information that funds must disclose, including the full extent of fees and funds’ related-party arrangements (section 13.5). Members should be able to access basic information without being overwhelmed by its volume or technicalities.

The need for greater standardisation is most obvious when it comes to insurance. Insurance — which is currently absent from product dashboards — is especially difficult for members to compare across products, in terms of the level of cover, key terms and conditions, and the cost. This will likely be a key focus area for regulators as the insurance code of practice is implemented and improved (section 13.4).

Accessible financial advice

There is an unmet need for impartial and affordable financial advice — especially as members approach retirement and have to make significant (and often difficult to reverse) financial decisions (chapter 5).

The best in show shortlist for default members (section 13.1) will help members by serving as a benchmark against which other products in the market can be compared (using the product dashboards). This shortlist can be a useful tool for helping members to question the quality of financial advice they receive and put pressure on advisers to explain why any product advice (including advice to establish an SMSF) diverges from the list. Combined with product dashboards, it will likely also assist advisers to compare products, and assist regulators to hold advisers to account. The benefits of this will span more than just default members and stimulate healthier competition across the whole system.

In addition, more can be done to improve the financial advice delivered to members. While there is promise in digital advice (also known as ‘robo’ advice) as an alternative source of impartial and affordable advice, government action is also needed. A clear starting point is to rename the term ‘general advice’ defined under the Future of Financial Advice legislation, as the Commission has recommended in the draft report for its parallel inquiry into *Competition in the Australian Financial System* (PC 2018). This term has led many consumers into thinking they are receiving advice relevant to their personal situation when

they are only being provided with product information or marketing material. In the Commission's view, all financial advice in relation to super is arguably personal, and needs to take into account members' individual circumstances.

More can also be done to help Australians as they approach retirement. Many members exhibit low levels of engagement with super early in their lives, but become increasingly engaged as they approach retirement and need to make big financial decisions (some of which may be irreversible) — and many seek out financial advice. To help them, the ATO should guide pre-retirees (when they reach age 55) to online information on dedicated websites run by ASIC and the Department of Human Services.

DRAFT RECOMMENDATION 11 GUIDANCE FOR PRE-RETIREEES

The Australian Government should require the ATO to guide all superannuation members when they reach age 55 to:

- the 'Retirement and Superannuation' section of ASIC's MoneySmart website
- the Department of Human Services' Financial Information Service website.

Harness data and technology

Data and technology are opening up new opportunities to make super work better for members — across domains as diverse as product design (such as tailoring products to individual members), member engagement (such as greater use of smartphone apps and websites) and providing advice (such as digital advice).

There is scope for funds to make greater use of data to design products, especially in the transition and retirement phases. This could comprise data on their own members, as well as data from external sources or datasets, such as those published by the Australian Bureau of Statistics (ABS). Combined with tax neutrality and higher quality financial advice, this would likely see greater take-up by members of products that meet their individual and household needs — especially in the transition and retirement phases (chapter 4). There are also opportunities for funds to make smarter use of data to inform insurance design and pricing for specific member cohorts (chapter 8).

Technology also offers ways to streamline the super system by reducing administrative burdens — as the ATO and industry participants have demonstrated through the implementation of Single Touch Payroll and related reforms. Employer contributions are now processed electronically, facilitated by a number of clearing house operators. Current processing arrangements are unlikely to be a material barrier to new funds entering the market, and act to disperse systemic risks. As such, the benefits of introducing a single centralised clearing house are unlikely to exceed the costs at this stage (chapter 7).

The Commission is not making specific recommendations on how funds should use data and technology. Rather, the suite of policy proposals in this draft report will work together to drive stronger competition in the super system. That should be a spur to innovation in how funds deliver products and interact with their members. Crucially, getting the policy settings right will also help to channel competition towards the outcomes that matter for members — not product proliferation for its own sake, or new services that few members need or even use.

However, regulators will need to remain alert to technological developments by making sure that regulation does not impose unnecessary constraints on innovation. Often this will mean getting out of the way. However, there is also a need to protect members, especially where greater use of data collection and matching run up against privacy considerations.

Take stronger action on exit fees and trailing commissions

More than half of members are in products that charge exit or switching fees to members who want to move their super elsewhere (chapter 3). The MySuper regulations already limit these fees on MySuper products to cost-recovery levels, but similar regulations do not apply to the choice segment. To avoid exit and switching fees creating a barrier to member switching — whether in the accumulation or retirement phase — regulations should be extended to limit these fees to cost-recovery levels for new members and new products. And ASIC should review the exit and switching fees faced by existing members, with a focus on whether they unreasonably impeded members moving to products that better meet their needs (section 13.5).

DRAFT RECOMMENDATION 12 EXIT FEES AT COST-RECOVERY LEVELS

The Australian Government should legislate to extend MySuper regulations limiting exit and switching fees to cost-recovery levels to all new members and new accumulation and retirement products.

Some members are still paying trailing commissions to financial advisers through their super (either for the super product or insurance). Responses to our funds survey suggest that at least 2 per cent of accounts are subject to these commissions, though they are present in about a quarter of super funds (chapter 6). Trailing commissions have been banned by the Future of Financial Advice laws since July 2013, but the ban only applies prospectively. Existing members subject to trailing commissions should be clearly informed by their fund, on an annual basis, of the amount of commissions they are paying and that this practice has been made illegal for new members. The extent of trailing commissions and number of affected members should also be publicly disclosed by funds in their annual reports and notified to ASIC.

DRAFT RECOMMENDATION 13 **DISCLOSURE OF TRAILING COMMISSIONS**

The Australian Government should require superannuation funds to clearly inform, on an annual basis, all members who are subject to trailing financial adviser commissions. This information should include the amount of commissions paid and a notice that trailing commissions are now illegal for new members.

All funds should publicly disclose the extent of trailing commissions and number of affected members in their annual reports and provide this information to ASIC.

13.4 Insurance that works for members

About 12 million Australians have insurance (life, total and permanent disability and/or income protection cover) through their super. In 2016-17, they paid a total of \$9 billion in premiums (up 35 per cent in three years). Group insurance arrangements — where funds obtain an insurance contract on behalf of multiple members — deliver many members much more affordable insurance than they would be able to get through individually written cover outside of super (not least because the latter has often been subject to large adviser commissions). There are also tax advantages to holding insurance through super, since the premiums can be paid out of super contributions (taxed at 15 per cent) rather than after-tax income (taxed at an individual's marginal rate).

But insurance provided through super is not working for members as well as it could (chapter 8). About a quarter of members do not know if they have (and are paying for) a policy. There are widespread cases of excessive balance erosion (from insurance premiums eating away at members' account balances) and members being defaulted into inappropriate policies.

The Commission's recommendations for default super will help reduce these problems by stopping the creation of unintended multiple super accounts, and thus the insurance that goes with them (section 13.1). However, more needs to be done to protect members, including those already in the system.

The current opt-out arrangements for insurance do not suit all members. Many young members work in casual or part-time jobs, and have relatively low financial commitments and/or no dependents to support, meaning life insurance is simply not of value to them. The rules should be changed so that young members (aged under 25) need to actively opt in to receive insurance through their super (regardless of whether they are in a default or choice product).

DRAFT RECOMMENDATION 14 **OPT-IN INSURANCE FOR MEMBERS UNDER 25**

Insurance through superannuation should only be provided to members under the age of 25 on an opt-in basis. The Australian Government should legislate to require trustees to obtain the express permission of younger members before deducting insurance premiums from these members' accounts.

Another area for improvement is making sure that insurance cover ceases on accounts that have had no contributions for the past 13 months, unless the member explicitly informs the fund that they wish to retain their cover. This would assist in addressing the problems around unintended multiple policies and reduce the risk of members holding 'zombie' insurance policies that they are unable to claim on.

DRAFT RECOMMENDATION 15 **CEASE INSURANCE ON ACCOUNTS WITHOUT CONTRIBUTIONS**

The Australian Government should legislate to require trustees to cease all insurance cover on accounts where no contributions have been obtained for the past 13 months, unless they have obtained the express permission of the member to continue providing the insurance cover.

More broadly, super fund trustees need to more clearly explain the trade-offs they are making when entering and designing group insurance arrangements. Trustees should immediately be required to articulate and quantify the balance erosion trade-off they have made for their members and make it available on their website annually, along with a simple calculator that members can use to estimate how insurance premiums would impact their balances at retirement. Funds seeking inclusion on the best in show shortlist should also articulate this trade-off for prospective members.

DRAFT RECOMMENDATION 16 **INSURANCE BALANCE EROSION TRADE-OFFS**

APRA should immediately require the trustees of all APRA-regulated superannuation funds to articulate and quantify the balance erosion trade-off determination they have made for their members in relation to group insurance, and make it available on their website annually.

As part of this, trustees should clearly articulate in their annual report why the level of default insurance premiums and cover chosen are in members' best interests. Trustees should also be required to provide on their websites a simple calculator that members can use to estimate how insurance premiums impact their balances at retirement.

Other improvements are coming about from the industry's own volition, albeit upon the prompting of Government. The *Insurance in Superannuation Voluntary Code of Practice* was released in December 2017 and is intended to apply to all super funds from 1 July 2018.

Among other things, the code contains provisions for premium limits (based on a member's estimated income), obliges funds to publish a simple 'key facts sheet' on their insurance offering, and sets out processes for handling insurance claims and complaints.

This code offers many benefits to members. For example, the premium caps in the code will limit balance erosion for some members, as will the requirement to stop deducting insurance premiums from inactive accounts (under certain conditions). As such, adoption of the code should immediately become a requirement for all funds to obtain or retain MySuper authorisation (section 13.2). The code requirements are sufficiently flexible such that there is no apparent reason for funds not to adopt it straight away.

DRAFT RECOMMENDATION 17 INSURANCE CODE TO BE A MYSUPER CONDITION

Adoption of the *Insurance in Superannuation Voluntary Code of Practice* should be a mandatory requirement of funds to obtain or retain MySuper authorisation.

But the code is unenforceable and falls well short of what is needed, and of best practice for an industry code of conduct. Its effectiveness will depend on the extent of voluntary take-up and the strength of its provisions (which are yet to include implementation of standard definitions and a short-form annual insurance statement for members). In its current state, it will only herald modest improvements in member outcomes.

The code owners — the Australian Institute of Superannuation Trustees, the Association of Superannuation Funds of Australia and the Financial Services Council — need to do more work to enhance the code provisions in future iterations. This should include the prompt development of standard definitions for total and permanent disability insurance, moving to a short-form annual insurance statement for members, and development of more robust compliance provisions — and ensuring broad industry adoption.

The regulators should also get involved with monitoring code adoption and compliance by funds. APRA and ASIC should establish a joint taskforce to monitor and report on adoption and implementation of the code — with ASIC taking the lead — and to advise the industry of the further steps that need to be taken for the code to be strengthened and meet ASIC's definition of an enforceable code of conduct. In doing so, the taskforce should consult with consumer representatives and insurance experts.

The industry should be given two years to make the code binding and enforceable on signatories before further regulatory intervention is considered.

DRAFT RECOMMENDATION 18 **INSURANCE CODE TASKFORCE**

The Australian Government should immediately establish a joint regulator taskforce to advance the *Insurance in Superannuation Voluntary Code of Practice* and maximise the benefits of the code in improving member outcomes. The taskforce should:

- monitor and report on adoption and implementation of the code by funds
- provide guidance on and monitor enhancements to strengthen the code, particularly implementation of standard definitions and moving to a short-form annual insurance statement for members
- advise the industry what further steps need to be taken for the code to meet ASIC's definition of an enforceable code of conduct.

The code owners should be given two years to strengthen the code and make it binding and enforceable on signatories before further regulatory intervention is considered.

The taskforce should annually report findings on industry progress on the code.

Both ASIC and APRA should be members of the taskforce, with ASIC taking the lead.

There are many changes underway to insurance in super, and the Commission's draft recommendations will add to these. Ultimately, what matters is that members get good outcomes: insurance that meets their needs, and does not unnecessarily erode their super balances. It is not clear whether initiatives currently underway will achieve this goal.

There thus should be a formal independent review of insurance in super within four years of completion of this inquiry (or earlier if the strengthened code of practice is not made enforceable within two years). The review should evaluate the effectiveness of initiatives to date, examine the costs and benefits of retaining current insurance arrangements on an opt-out (as opposed to an opt-in) basis, and consider if further regulatory intervention or policy change is required. It should also look at the broader question of whether insurance *should* be funded through super, which is beyond the scope of this current inquiry.

DRAFT RECOMMENDATION 19 **INDEPENDENT REVIEW OF INSURANCE IN SUPER**

The Australian Government should commission a formal independent review of insurance in superannuation. This review should evaluate the effectiveness of initiatives to date, examine the costs and benefits of retaining current insurance arrangements on an opt-out (as opposed to an opt-in) basis, and consider if further regulatory intervention or policy change is required. The review should be initiated within four years from the completion of this inquiry report, or earlier if the strengthened code of practice is not made enforceable within two years.

13.5 Regulators that are member champions

Confident regulators that champion the member are essential in a modern super system.

The key regulators — APRA and ASIC — are doing well in their core duties of prudential regulation (APRA) and financial product and advice regulation (ASIC), but there is some confusion around the two regulators' respective roles, given both have long held powers to prevent and police bad behaviour by trustee boards (chapter 10).

For example, ASIC has traditionally been responsible for regulating conflicts of interest, but APRA has increasingly encroached on this role through its prudential standard setting. While much of APRA's work is pre-emptive and out of public view, ASIC has traditionally been reactive (responding to misconduct only after the fact) and public. It has become increasingly unclear which regulator has primary responsibility for trustee conduct — with the risk of misconduct falling between the cracks and a lack of clear regulator accountability.

Strategic conduct regulation appears at times to be missing in action. Ideally, this would involve a regulator proactively identifying actual or potential instances of material member harm, investigating the underlying conduct and taking enforcement action in a way that provides a valuable public deterrent to future poor conduct. To date, there has been a deficit of public exposure of poor conduct (and associated penalties) to demonstrably discourage similar behaviour by others — now and in the future.

Clarify regulator roles

A clearer articulation of which regulator is responsible for strategic conduct regulation is needed — and in a way that allows for much of this activity to be public and provide a strong demonstration effect to all trustee directors. This would also help to improve the accountability of each regulator.

This inquiry has uncovered several prospective areas for more strategic regulatory action on trustee conduct. As noted, failed mergers (especially where questionable) should be investigated more proactively, as should the impacts on members of exit and switching fees (and other indirect costs of switching). And there is scope to review fund advertising that is not directly focused on gaining or retaining members. ASIC is well suited to take on these activities.

Clarifying regulator roles will in large part require changes in regulator practices and culture, with the regulators assuming a more confident regulatory practice and being more member focused. It may also require the Government to change legislation and update Statements of Expectation for each regulator. And whatever the specific delineation, it will always be important for APRA and ASIC to work in parallel to share information (including on trustee conduct), as envisaged by the Cooper Review, and to ensure member interests are protected. A revamped memorandum of understanding between them would be needed.

The Commission is seeking input on whether (and how) a clearer division of responsibilities between APRA and ASIC would lead to better strategic conduct regulation and regulator accountabilities, and intends to revisit this in greater detail for the final report.

The Commission has also identified a number of other tasks that APRA and ASIC should pursue. As noted, APRA will play the central role in enforcing the MySuper outcomes test. And it should require trustees to quantify balance erosion trade-offs from insurance, require funds to conduct formal due diligence of their outsourcing arrangements, and report to the Council of Financial Regulators on fund mergers.

In addition, APRA should systematically assess the costs of legacy products in the super system and, if these represent a significant cost to funds, refine trustees' obligations for member transfers to allow legacy products to be rationalised. APRA should also enhance its data collection, as outlined below.

In conjunction with revamping and extending product dashboards (as noted earlier), ASIC should, more broadly, proactively set and enforce disclosure requirements for super funds. It should also require funds to disclose to members the proportion of costs associated with related-party outsourcing arrangements, proactively investigate cases where mergers did not proceed, and review exit and switching fees faced by existing members.

Finally, the Government should reflect the ATO's growing importance in the super system by setting clear expectations that the ATO will serve members' best interests in the provision of a centralised online service, cleaning up lost and unintended accounts, policing unpaid contributions, and regulating SMSFs.

Clarifying the role of each regulator should assist them in becoming more confident, member-focused regulators. The Government will need to ensure each has adequate expertise and resourcing to fulfil their duties.

Improve data collection and transparency

To say this inquiry has been hampered by data problems is an understatement (chapter 10). There are some major gaps and inconsistencies in the datasets held by regulators — such as the returns and fees (by product) experienced by choice members, funds' outsourcing arrangements and details of the insurance members hold through super. The Commission's funds survey was designed to plug some of these gaps, but many responses fell well short of 'best endeavours' — which of itself proved revealing.

Regulators have done much to improve the breadth and depth of their data holdings in recent years, but this has been off a low base. Major differences in definitions persist across regulators, and poor quality disclosure by funds appears to go unpunished. Progress has been slow in some areas because of industry opposition (largely on the basis of short-term compliance costs) and the lack of a strong member voice to give impetus to change.

DRAFT RECOMMENDATION 20 **AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY**

APRA should (in addition to draft recommendations 4 and 16):

- require all APRA-regulated superannuation funds to conduct formal due diligence of their **outsourcing arrangements**, at least every three years, to ensure the arrangements provide value for money. Each fund should provide a copy of the assessment to APRA (including the fees paid and the comparator fees)
- report annually to the Council of Financial Regulators on the progress stemming from the application of the MySuper scale test (and then the outcomes test, once legislated) in bringing about **fund mergers**
- undertake a systematic assessment of the costs to funds of the thousands of **legacy products** in the superannuation system. If the evidence demonstrates that they represent a significant cost in accumulation, APRA should further refine trustees' obligations for member transfers so these products can be rationalised
- embed **product-level reporting** within its reporting framework as soon as practicable (no later than 18 months) to enhance visibility of actual member outcomes across all APRA-regulated funds and to bring reporting for the choice segment into line with the MySuper segment. APRA should also expedite efforts to address inconsistencies in reporting practices.

DRAFT RECOMMENDATION 21 **AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION**

ASIC should (in addition to draft recommendation 9):

- proactively set and enforce standards for the meaningful disclosure of information to members on superannuation products and insurance policies (in addition to product dashboards). Information should be simple, comparable and easy for members to understand
- require all superannuation funds to publicly disclose to current and prospective members the proportion of costs paid to service providers that are associated with related-party outsourcing arrangements
- proactively investigate (questionable) cases where mergers between superannuation funds stalled or did not proceed
- review exit and switching fees faced by existing members, with a focus on whether these fees are related to the underlying performance of the product, and whether they unreasonably impede members moving to products that better meet their needs.

The regulators need to confidently collect more data that are relevant for assessing member outcomes — and to make these data public. Better data would benefit:

- members — by helping them to gauge how their fund is performing and compare it to others in the market, either directly or via financial advisers

-
- funds — by assisting performance benchmarking against competitors and shining a light on the best performers, thereby making competition ‘fairer’
 - regulators — by giving regulators better insight into fund practices and the ability to more proactively monitor the system, and by improving public confidence in the system by way of greater regulator accountability
 - Government — by enabling a more accurate and granular understanding of the costs and benefits of policy change over time (both existing and prospective).

Draft recommendation 9, to require funds to publish a product dashboard for all their products, will help, as will draft recommendation 21, to require public disclosure of the costs associated with related-party outsourcing. But these are not enough on their own. Regulators need to make a more systematic effort to collect member-relevant data — and the Government needs to give them a clear remit to do so.

APRA, as the system’s prudential guardian and main data custodian, should enhance its data reporting framework to collect more data on actual member outcomes on an ongoing basis. This should include collecting and publishing data at the product level (rather than the fund level), similar to what is collected for MySuper products. Work is also overdue on dealing with inconsistencies between funds in how they report data to the regulator — most importantly for outsourcing arrangements (where related-parties are involved or investment costs are being netted off member returns) and the costs of administering insurance.

Funds should already have all of this information, meaning that improved reporting need not come at an onerous compliance cost. APRA should ensure that these enhancements are made within 18 months, to expedite the benefits to members. The Government should make sure that APRA has the resources and skills to do this.

The centralised online service (draft recommendation 1) will also help address some of the glaring data gaps in the super system by giving the ATO greater insight on the choices people make. The ATO, as custodian of data on taxation and taxpayers, can also do more to inform public policy. There could be value in greater linking of data on members’ superannuation outcomes to other data on their income, wealth and household characteristics — which the ATO has already started doing through its aLife project (ATO 2016a). Such data linking could also be made available to researchers outside of government, provided rigorous confidentiality protections are in place (PC 2017b).

More broadly, the regulators can do more to improve their data analytics capabilities and to coordinate their efforts on data collection and reporting. There should be a joint exercise by APRA, ASIC, the ATO, the ABS and the Commonwealth Treasury to improve data collection and analysis across the whole super system, with a strong focus on collecting and publishing consistent data. This could include better aligning data on fund assets and net returns collected by the ATO (for SMSFs) and APRA (for the institutional funds it regulates), and reporting on outcomes for individual members (who may hold more than one account). It could also usefully draw on consumer testing and evidence from behavioural economics in deciding how best to present data. Treasury should take the lead on this working group.

DRAFT RECOMMENDATION 22 **SUPERANNUATION DATA WORKING GROUP**

The Australian Government should establish a superannuation data working group, comprised of APRA, ASIC, the ATO, the ABS and the Commonwealth Treasury (with Treasury taking the lead). This group should:

- identify ways to improve the consistency and scope of data collection and release across the system, with a focus on member outcomes
- evaluate the costs and benefits of reporting changes, including strategies for implementation
- identify areas where legislative or regulatory change may be necessary to support better data collection
- report annually to the Council of Financial Regulators on its progress, and on the data analytics capabilities of each regulator.

13.6 How these improvements will benefit members

The package of policy improvements in this draft report is designed to lift the overall performance (efficiency and competitiveness) of Australia's super system. A new way to allocate defaults will put the focus squarely on members, and the other components will work with this to address the structural flaws in the current system and put it in good stead to perform strongly in the years to come. Collectively, the improvements will harness healthy competition in the super system and make it work better for all members, bringing it into line with the needs of the modern workforce and diverse retirees.

The draft recommendations do this by simplifying choice, boosting investment performance for members and better matching products to members' needs. They put the member in the driver's seat by making it easy to choose a super product for the first time, to see how their fund is performing against others, and to switch or consolidate accounts. And the recommendations will foster healthier competition in the system that sees funds innovating as they strive to better meet member needs, including by harnessing data and technology.

While the system should work foremost for members, not funds or suppliers, achieving this will have implications for the funds and their service providers. The draft recommendations will see greater competition *for* the default market (via the best in show shortlist) as well as healthier competition *in* the broader market (via greater transparency, better governance and more member-focused regulators). The changes are incremental and should be manageable for the industry, but will likely result in greater levels of exits and mergers as underperforming funds come under pressure. This process should be manageable for APRA. In the long term, however, healthier competition will make the system more stable and better equipped to serve the needs of all Australians into the future.

The Commission invites feedback on the proposals set out in this chapter, and will examine the timing and sequencing of recommendations in more detail in its final report.

A Inquiry conduct and participants

The Commission is undertaking this inquiry under the twin (stage 2 and stage 3) terms of reference. Stage 2 entailed developing alternative models for allocating default members to products (with a draft report in March 2017) (PC 2017c). Stage 3 brings both streams of work together to provide an overall assessment of the efficiency and competitiveness of super system (including an assessment of default allocation) and recommend policy changes.

The Commission received the terms of reference for stage 3 on 30 June 2017. It subsequently released an issues paper on 7 July 2017 inviting public submissions and highlighting particular matters on which it sought information.

- The Commission received 101 submissions associated with stage 2. These submissions are listed in table A.1 and are available on the inquiry website. As part of stage 2, the Commission met with a wide range of stakeholders including in Chile, New Zealand and the United Kingdom (table A.2). Two days of public hearings were held for this inquiry. Hearings participants are listed in table A.3 and transcripts are available on the inquiry website.
- The Commission received 100 submissions associated with stage 3. These submissions are listed in table A.4 and are available on the inquiry website. As part of stage 3, the Commission held meetings with a wide range of stakeholders (table A.5). The Commission also held two roundtables and the list of participants is contained in table A6.

Over the course of stages 2 and 3, the Commission received 201 submissions and met with more than 70 stakeholders spanning governments, regulatory bodies and peak bodies, as well as superannuation funds, organisations and individuals.

The Commission would like to thank all those who contributed to this inquiry, including through participation in its surveys — two of members, one of funds and one of Chief Executive Officers (appendix C) — and it now seeks additional input for its final report. The Commission welcomes submissions in response to the information requests and draft findings and recommendations outlined in this report.

Table A.1 Submissions^a
Stage 2

<i>Participants</i>	<i>Submission number(s)</i>	
Accommodation Association of Australia (AAA)	16	
Ai Group	21	
AMP	42, DR94	
Association of Financial Advisers Limited (AFA)	DR91	
Association of Superannuation Funds of Australia (ASFA)	24, DR96	
Australian Chamber of Commerce and Industry (ACCI)	27, DR79	
Australian Council of Trade Unions (ACTU)	34, DR71	#
Australian Hotels Association (AHA)	6	
Australian Institute of Superannuation Trustees (AIST)	28, DR90	
Australian Prudential Regulation Authority (APRA)	33, 50, DR101	*
Australian Securities and Investments Commission (ASIC)	41	
Australian Super	19, 48, DR60	*
Bell, David	DR83	
BT Financial Group (BTFG)	DR67	
Cbus	DR74	
Centre for International Finance and Regulation (CIFR)	7	
Centre for Market Design	18	
CHOICE	31, DR93	
Club Plus Super	32	*
Colonial First State	25	
Committee for Sustainable Retirement Incomes (CSRI)	DR75	#
Community Clubs Victoria	9	
Corporate Super Association	35, DR59	
Council of Small Business Australia (COSBOA)	DR86	
Cranford, Alexander	DR54	
Deloitte Touche Tohmatsu (Deloitte)	DR61	
Dixon Advisory	DR76	
Fair Work Commission	51	#
Financial Planning Association of Australia (FPA)	29, DR98	
Financial Services Council (FSC)	38, 49, DR88	#
Financial Services Institute of Australia (FINSIA)	DR95	
First State Super	26, DR84	
Gateway Network Governance Body (GNGB)	DR72	
Grattan Institute	DR82	
HESTA	37, DR70	*
Independent Fund Administrators and Advisers (IFAA), QIEC Super and Club Super	13, DR65	
Industry Super Australia (ISA)	40, DR78	
Institute of Public Affairs (IPA)	17	
Kinetic Superannuation	45	#

(continued next page).

Table A.1 (continued)

<i>Participants</i>	<i>Submission number(s)</i>
Land, Richard	22
Law Council	DR80
Limmings, Timothy	DR53
Linacre, Andrew	52
Link Group	DR92
LUCRF Super	30
MacDonald, Michelle	DR77
Mair, Peter	1
Mercer	15, DR73
MetLife Insurance	DR66
Mine Wealth + Wellbeing	46, DR64
Murphy, Sean	DR99
NAB Wealth	DR69
NESS Super	47
Police Federation of Australia (PFA)	14
PricewaterhouseCoopers (PwC)	12, DR85
Queensland Nurses and Midwives' Union (QNMU)	DR57
REST Industry Super	23, DR68
Restaurant and Catering Australia	10
Rice Warner	43, DR87
Simplicity	DR58
SMSF Association (SMSFA)	DR100
Sunsuper	36, DR89 *
Sweeney, Phillip	2, 3, 5, 8 #
Sy, Wilson	DR63
TAL	44 *
Telford, John	DR55
UniSuper	20, DR62
United Voice	DR97
Vision Super	4
Vanguard	39 *
Whan, Steven	DR56
Workplace Super Specialists Australia (WSSA)	11, DR81

^a An asterisk (*) indicates that the submission contains confidential material NOT available to the public. A hash (#) indicates that the submission includes attachments. DR before a number denotes that the submission was lodged subsequent to the release of the stage 2 draft report.

Table A.2 Consultations
Stage 2

Participants

Australia

Ai Group
 AMP
 Association of Superannuation Funds of Australia (ASFA)
 Australian Chamber of Commerce and Industry (ACCI)
 Australian Communications and Media Authority (ACMA)
 Australian Council of Trade Unions (ACTU)
 Australian Institute of Superannuation Trustees (AIST)
 Australian Prudential Regulation Authority (APRA)
 Australian Securities and Investments Commission (ASIC)
 Australian Taxation Office (ATO)
 AustralianSuper
 Chant West
 Clark, Professor Gordon (University of Oxford)
 ClearView
 Department of Employment
 Department of Finance
 Department of Prime Minister and Cabinet
 Fair Work Commission (FWC)
 Financial Services Council (FSC)
 First State Super and StatePlus
 Grattan Institute
 Industry Super Australia (ISA)
 Mercer Australia
 Northern Territory Department of Treasury and Finance
 Rice Warner
 Superannuation Industry Stewardship Group
 The Treasury
 UniSuper
 Vamos, Pauline
 Women in Super

Chile

Bravo, Professor David (Pontificia Universidad Católica de Chile)
 Superintendent of Pensions
 Villatoro, Assistant Professor Felix (Universidad Adolfo Ibáñez)

(continued next page)

Table A.2 (continued)

Participants

New Zealand

ANZ

Booster Investment Management

Commission for Financial Capability

Financial Markets Authority

Financial Services Council

Inland Revenue Department

Kiwibank

Ministry of Business, Innovation and Employment

New Zealand Treasury

Retirement Policy and Research Centre (Auckland University)

Simplicity

United Kingdom

Barr, Professor Nicholas (London School of Economics)

Table A.3 Public Hearings
Stage 2

Participants

Melbourne – 3 May 2017

Australian Council of Trade Unions (ACTU)

HESTA Superannuation fund

Industry Super Australia (ISA)

Minifie, Jim

Simplicity NZ

Council of Small Business of Australia (COSBOA)

Sydney – 8 May 2017

Rice Warner

Financial Services Council (FSC)

CHOICE

Australian Institute of Superannuation Trustees (AIST)

SunSuper

Workplace Super Specialists Australia (WSSA)

Table A.4 Submissions^a
Stage 3

<i>Participants</i>	<i>Submission number(s)</i>
Actuaries Institute	75
AIA Australia	76
Altenburger, Michael	93
AMP	80 #
Angelo, Greg	12
Ashurst, Geoff	13
Association of Superannuation Funds of Australia (ASFA)	47
Australia and New Zealand Banking Group (ANZ)	73
Australian Council of Trade Unions (ACTU)	50
Australian Institute of Superannuation Trustees (AIST)	39, 99
Australian Lawyers Alliance (ALA)	65
Australian Private Equity and Venture Capital Association Limited (AVCAL)	33
Australian Prudential Regulation Authority (APRA)	89
Australian Securities and Investments Commission (ASIC)	90
Australian Services Union (ASU)	28
Australian Super	43
Ayliffe, Rhett	18
Barr, Nicholas and Diamond, Peter	74
Bianchi, Robert, Drew, Michael and Walk, Adam	35
Bone, Ron	77
Boutsiavaras, Ilias	25
Breast Cancer Network Australia (BCNA)	41
BT Financial Group (BTFG)	32
Cbus	58
CHOICE	71
Clapham, Alan	14
ClearView	48, 86
Colonial First State	66
Consumer Action Law Centre, Berrill & Watson Lawyers, Chronic Illness Alliance	55
Hemming, David and Delliou, Daphne	38
Deane, Renuka	7
Dixon Advisory	61
Financial Planning Association	26
Financial Services Council (FSC)	69
First State Super	37
Gandevia, Robin	9
Gateway Association and Transaction Exchange (GATE)	54
Gateway Network Governance Body Limited (GNGB)	45
Gee, Ursula	20
Giannapolous, Perry	81
Graham, Alan	10
Greene, Paul	8
Gregan, John	84
Grenfell, Colin	4 #
Grow Super	36
Hannan, Danny	6

(continued next page)

Table A.4 (continued)

<i>Participants</i>	<i>Submission number(s)</i>
HESTA	70
Humphreys, Jeff	88 #
Independent Fund Administrators and Advisers Pty Ltd (IFAA), QIEC	
Super and Club Super	53
Industry Super Australia	5, 59, 87, 96, 100
Jacques, Nick and Virginia	21
Kingsley, Randall	22
Liu, Kevin and Ooi, Elizabeth	92
Martin, Heather	15
Maurice Blackburn	29
Mercer	57
MetLife Insurance Limited (MetLife)	68
Mine Wealth + Wellbeing Superannuation Fund	34
MLC and National Australia Bank	63 #
MLC Life Insurance	72
Morse, Russell	11
MS Australia (MSA)	44
Munro, Bruce	31
Murphy, Sean	85 #
Name withheld	51, 52, 78, 82, 94 *
Name withheld	95, 97, 98
Paul Hudson and Associates Super Fund	1
PricewaterhouseCoopers (PwC)	62
REST Industry Super (REST)	49
Revenue Review Foundation	64 #
Rice Warner	46, 56 #
Rogers, Rod	2
Self-managed Independent Superannuation Funds Association (SISFA)	60, 79
Smit, Nicolaas	40
SMSF Association (SMSFA)	67
SuperChoice	42
Tailored Superannuation Solutions	16 #
Thomson, Angus	23
Town, Robin	27
Twentyman, Daniel	3
United Voice	24
Vision Super	30
Waugh, Madonna	17
Williams, Trevor	83
Williamson, Murray	19
Young, Donald	91

^a An asterisk (*) indicates that the submission contains confidential material NOT available to the public. A hash (#) indicates that the submission includes attachments.

Table A.5 Consultations
Stage 3

Participants

Ambachtsheer, Keith
Association of Superannuation Funds of Australia (ASFA)
Australian Institute of Superannuation Trustees (AIST)
Australian Prudential Regulation Authority (APRA)
Australian Securities and Investments Commission (ASIC)
Australian Taxation Office (ATO)
AustralianSuper
AUSfund
Cameron Research
Chant West
Clark, Gordon
CEM Benchmarking
CHOICE
Department of Social Services
Donald, Scott
Financial Services Council
First State Super
Future Fund
Grattan Institute
GROW Super
Hartley, David
Industry Super Australia
Insurance in Superannuation Working Group
Knox, David
KPMG
Morris, Nicholas
QSuper
Rainmaker Group
REST Industry Super
Rice Warner Actuaries
Roy Morgan Research
SMSF Association
Spaceship Super
Sunsuper
Superannuation Industry Stewardship Group
SuperRatings
SuperTrace
The Treasury
TAL Australia
Vanguard Australia
Warren, Geoff
Williams, Raewyn

Table A.6 Roundtables

Organisation

Economies of scale in the superannuation system – 22 September 2017

Grattan Institute
Griffith Business School
Hartley, David
Rice Warner
Sy, Wilson
Warren, Geoff

Funds survey – 9 October 2017

Association of Superannuation Funds of Australia
Australian Catholic Superannuation
Australian Institute of Superannuation Trustees
Australian Prudential Regulation Authority
Financial Services Council, BT
Industry Super Australia

B Data sources

The Commission made use of existing data wherever possible for this inquiry, including by purchasing and requesting access to existing data where necessary. Where data required to undertake this inquiry could not otherwise be accessed, the Commission undertook four surveys — two of members, one of funds and one of Chief Executive Officers (these are reported in appendix C).

B.1 Publicly available data

The Commission drew on publicly available datasets as far as possible, including the:

- Australian Bureau of Statistics (ABS) superannuation data
- Australian Prudential Regulation Authority's (APRA) Annual Superannuation Bulletin, MySuper Statistics, Fund-level Superannuation Statistics and Superannuation Performance statistics
- Australian Tax Office's (ATO) self-managed superannuation fund (SMSF) statistics.

The Commission also obtained confidential data from regulators as follows:

- additional SMSF data from the ATO
- aggregate and fund level data from APRA
- member experience data from the Australian Securities and Investments Commission (ASIC), including from ASIC's Effective Disclosure Project and some preliminary data from ASIC's Employers and Super project and its Insurance in Super project.

The Commission has only used confidential data in aggregated formats and has cleared its publication of aggregated data with relevant parties.

B.2 Data from research firms

The Commission made use of data from several research firms.

Rainmaker

Rainmaker collects option level data reported by some APRA-regulated and exempt public sector funds.

The Rainmaker data purchased by the Commission for the purposes of this inquiry include background information about funds, their products and product options; the value of assets at the fund level; member demographics at the product level; product features; returns and fees at an option and product level; and asset allocation at an option level.

The Commission purchased the full historical dataset beginning in 1997, but mainly relied on data for the years 2005 to 2017 because of better coverage in those later years. Coverage of the APRA-regulated system was over 50 per cent of assets and member accounts in 2014-15 (table B.1). Rainmaker data covered 100 per cent of industry funds in 2014-15 and 59 per cent of retail funds.

Table B.1 Coverage of APRA-regulated system by research firms
Per cent

	<i>2004-05</i>	<i>2009-10</i>	<i>2014-15</i>
Number of funds			
SuperRatings	16	43	56
Rainmaker	9	22	33
Assets (funds under management)			
SuperRatings	61	81	90
Rainmaker	30	42	52
Member accounts			
SuperRatings	64	83	91
Rainmaker	42	50	55

SuperRatings

SuperRatings collects option level data from a number of APRA-regulated and exempt public sector funds. Data are self-reported by funds. The data are collated by SuperRatings from public information, such as product disclosure statements, and by surveying funds.

The SuperRatings data purchased by the Commission for the purposes of this inquiry include: background information about individual funds and their products; disaggregated fees by product; insurance cover offered by product; membership and asset data at the product level; product features; and asset allocation, returns and investment fees at an option level.

SuperRatings data are for the years 2002 to 2017. Coverage of APRA-regulated funds has been over 80 per cent of assets and member accounts at least since 2009-10 (table B.1). SuperRatings coverage of APRA-regulated funds was 100 per cent for industry funds in 2014-15 and was almost 50 per cent for retail and corporate funds in 2014-15.

Rice Warner

Rice Warner supplies a range of self-reported superannuation data.

For this inquiry, the Commission subscribed to Rice Warner's Super Insights database, purchased Rice Warner's Superannuation fees analysis 2017 data and purchased superannuation insurance data. The Rice Warner Super Insights member dataset is for the period 2013 to 2017. It includes member demographics, member balance and investment details and member movements between funds, all of which were utilised by the Commission. The Commission used Rice Warner's Superannuation fees analysis 2017 data to estimate APRA-wide total fees for the years 2006 to 2016. The insurance data analysed by the Commission include member take up rates, levels of cover and premiums by insurance type and fund type for the years 2013 to 2016.

Rice Warner data cover around 50 per cent of APRA-regulated funds.

CEM Benchmarking

CEM Benchmarking collect data for pension funds across six regions of the world. For this inquiry, the Commission purchased CEM's 2016 data covering the number of funds, the value of assets and investment management costs (net of all fees and taxes), and also ten-year investment return data for 2007 to 2016 to compare the performance of the Australian superannuation system with that of major economies and regions of the world.

The CEM Benchmarking dataset has a high representation of funds in the United States, Canada, Netherlands and the United Kingdom.

CHOICE survey report

The consumer group CHOICE surveyed 2498 CHOICE members' about their experience and perceptions of the superannuation system. Among other things, the survey obtained member responses about their level of engagement with their superannuation.

CHOICE provided the Commission with confidential access to the survey results for the purposes of this inquiry. The Commission used the results to help assess the superannuation system from the perspective of a sample of superannuation members.

Investment returns index data

The Commission acquired investment returns index data from a number of sources to inform its analysis of investment performance. Index data include that of S&P, Bloomberg, MSCI and FTSE Russell. For further details refer to technical supplement 4.

B.3 Quality assurance

The Commission has relied on a number of external experts to review its data work for this inquiry. This includes consulting with several technical experts and industry practitioners in using data for the construction of portfolio benchmarks.

External reviewers for the surveys undertaken by the Commission are reported in appendixes A and C.

The Commission asked APRA to review its approach to modelling the potential transition impacts of alternative default models and APRA confirmed that the methodology and underlying assumptions were reasonable and consistent with APRA's understanding of the industry. However, the views and conclusions in the report based on the modelling undertaken are solely those of the Productivity Commission.

C Surveys: an overview

This appendix details the conduct of the four surveys undertaken by the Commission as part of this inquiry (which addresses the terms of reference for both stage 2 and stage 3) (figure C.1). These include the:

1. **stage 2 members choice survey** — a survey of how members might behave when choosing a superannuation product when assisted by a shortlist of good products (section C.1)
2. **members survey** — a survey of superannuation fund members, to better understand their experiences with the system (section C.2)
3. **funds survey** — a survey of large institutional superannuation funds regulated by the Australian Prudential Regulation Authority (APRA), to gather data on fund inputs, operations and behaviour (section C.3)
4. **governance survey** — a survey of Chief Executive Officers (CEOs) of all large APRA-regulated superannuation funds, on fund governance (section C.4).

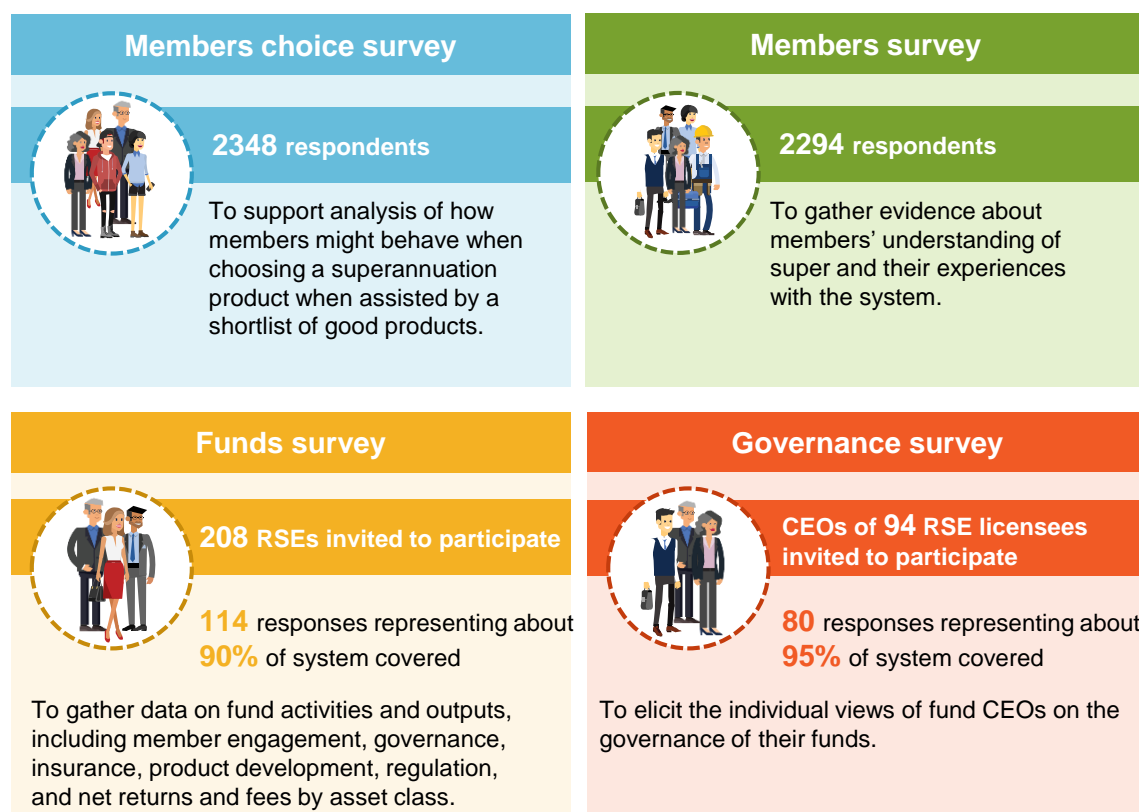
The stage 2 members choice survey results were published as a supplement to the stage 2 inquiry draft report (PC 2017c). Technical supplements 1, 2 and 3 present key supporting results for each of the members, funds and governance surveys.

All four surveys focused on filling the relevant evidence gaps faced by the inquiry, and were designed to minimise the compliance burden on superannuation funds. The evidence gaps were identified by the Commission as part of its stage 1 study (PC 2016b), which included consultation with a range of participants at that time. The Commission's surveys were identified as the primary means of gathering particular pieces of evidence that were not available from other sources.

The Commission's survey results presented throughout the inquiry report have been de-identified to protect the confidentiality of respondents.

The Commission thanks participants in all four surveys for their input. A list of survey recipients and respondents for the funds and governance surveys are in tables C.6 and C.9, respectively.

Figure C.1 The quartet of surveys



C.1 Stage 2 members choice survey

As part of its work on alternative default allocation models, the Commission undertook a survey of member behaviour. Respondents were surveyed on their past and present experiences and attitudes towards super, and also asked to complete some experimental tasks to enable the Commission to better understand how members make their decisions.

The survey was primarily designed to gather evidence relevant to understanding how people would likely behave if they had to choose a superannuation fund without any assistance (unassisted choice), as well as in the presence of a shortlist of superannuation products (assisted choice). The survey was also intended to address gaps in the evidence already available from other surveys and behavioural research.

Given the specialised nature of the research, the Commission sought external expertise, particularly in behavioural finance and randomised control trials (RCTs) to design and conduct the survey. Insight Analytics was engaged to design the survey on the Commission's behalf. Insight Analytics also conducted the survey, in conjunction with a third-party panel provider.

Survey design

The survey contained two types of questions:

- general questions — to gather information on demographic characteristics of respondents, their past experiences and financial literacy
- experimental questions — to elicit information about respondents' decision making and behaviour by assigning different respondents to different 'treatments'. Treatment design varied across groups of respondents to test the impact of specific presentation elements.

Choice experiment

For this experiment, the 2348 respondents were randomly assigned to one of two main treatments: 17 per cent to unassisted active choice (the 'control group'), and the remaining 83 per cent to assisted employee choice (the 'treatment group'). Respondents were not told that they had been randomly assigned to different treatments. More respondents were assigned to the treatment group due to the number of variations being tested within that group. Respondents were requested to imagine they were starting a new job and had to choose their own superannuation fund; they were asked 'what super fund would you go with?'.

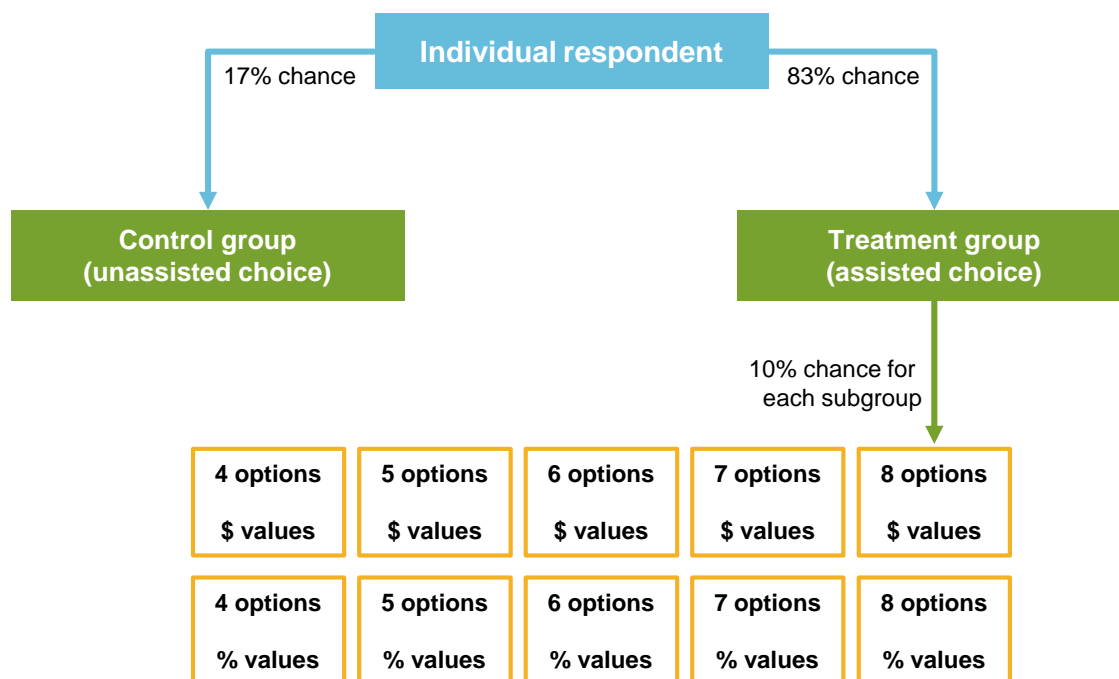
Respondents in the control group faced a nomination decision without any assistance. Respondents in the treatment group were provided a shortlist of funds to assist in their nomination. The shortlist included four metrics for each fund, covering the risk level, past returns, return target and fees associated with it. Within the group, respondents were assigned to one of ten specific treatment categories (figure C.2). Specifically, each respondent was presented with either four, five, six, seven or eight options, and with the fee and return metrics presented either in terms of the percentage of account balance or in dollar figures (based on a nominal \$50 000 balance). Respondents also had the option to select 'something else' and nominate a different fund in a free-text entry box.

The hypothetical products used for this exercise were loosely based on a selection of real MySuper products available in the market. In each instance, respondents were presented with a set of actual fund logos combined with a block of the four metrics (returns, fees, risk, and target return). The eight funds used in the experiment were chosen based on their actual size (total membership and assets under management), with the blocks of metrics based on real performance figures for these funds' MySuper products. The set comprised both industry and retail funds.

Within each of the ten treatment categories, there was further random assignment of the:

- order in which funds were listed
- specific fund name and corresponding logo
- block of metrics shown for each fund.

Figure C.2 **Choice experiment: control and treatment groups**



Source: PC (2017a).

These elements were randomised to allow for subsequent testing of (or control for) the effects of ordering, presentation and brand sentiment on decision making.

In addition to nominating a product on the shortlist, respondents were also able to nominate a fund of their choosing or not nominate at all. Once respondents had completed the experiment, they were asked why they chose the particular fund, in a free text field. They were also asked to explain how difficult they found the exercise, and to score this on a scale of one to five (where five was the most difficult).

List experiment

A ‘list experiment’ is a technique that is commonly used by psychologists and political scientists to gauge attitudes where respondents may not feel comfortable providing honest answers to questions asked directly. To overcome potential biases that can arise from social desirability, non-response and other effects, the questions of interest are asked indirectly by combining them with a set of other, less sensitive questions.

This list experiment was designed to elicit information on behaviours, decision making and attitudes related to the last time that respondents had to choose a superannuation fund (those who had never had a fund were excluded from the task). Respondents were randomly assigned to one of 12 ‘branches’. In each branch, four lists were shown with the treatment

branches containing the sensitive statement. The order of statements in each list was randomised for each respondent.

Fieldwork

Insight Analytics conducted the survey online from 22 February to 2 March 2017, via a third-party panel provider (Quality Online Research).

The survey was estimated to have taken most respondents about 10 to 15 minutes to complete.

The full sample included 2348 respondents, with approximately 2000 completing all major components of the survey. The survey was successful in achieving the Census quotas, resulting in a full sample broadly representative of the working-age Australian population.

Data

The final survey data and documentation were delivered to the Commission on 16 March 2017, following some cleaning and checking of the data by Insight Analytics.

Further details about the survey design (including the choice and list experiments) and the results were published online as a supplement to the stage 2 inquiry — *About the survey and the results* (PC 2017a). That publication along with the survey questionnaire, data and associated documentation can be downloaded on the Commission's website at <http://www.pc.gov.au/inquiries/current/superannuation/alternative-default-models/draft>.

C.2 Members survey

The members survey was commissioned to better understand members' experiences with the superannuation system, with a particular focus on evidence gaps identified in the Commission's stage 1 study (PC 2016b).

Following a competitive request for proposal process, Roy Morgan Research was engaged to design and conduct a survey of superannuation members on behalf of the Commission.

Survey design

A targeted sample size of 2000 members was set to achieve adequate samples of different types of members, of both institutional and self-managed superannuation funds.

Sample frame

The primary sample source was the Roy Morgan Research consumer panel, supplemented by an external panel provider (Survey Sampling International) for hard-to-reach young respondents (males aged 15–34 years and females aged 15–24 years). People aged 15 years or more who were members of superannuation funds and/or owned retirement income products qualified for the survey.

While consumer panels facilitate ready access to a specified sample size of individuals, they can be marked by unobserved bias. The size and significance of any bias is, however, difficult to measure.

To enable the final data set to have an adequate sample size of members across the full range of fund types, members with corporate and self-managed funds were over-sampled relative to their distribution in the population. To do this, quotas were set for superannuation funds and retirement income products (table C.1). In addition, age and gender quotas were set within each superannuation fund type, but not for retirement income products. Roy Morgan Research also applied quotas based on the balances of respondents' superannuation funds to ensure a representative sample by size of balance. In the final stages of field work, age and gender quotas within each superannuation fund type were relaxed so that more responses could be achieved from hard-to-reach individuals.

Table C.1 Members sampling quotas

<i>Quota groups</i>	<i>Quota size</i>
Superannuation fund type	
Industry	817
Retail	505
Public sector	278
Corporate	100
Self-managed	200
Retirement income products	100
Total	2 000

Questionnaire design and pilot testing

The Commission's initial questionnaire design focused on gathering information on 18 of the total 89 unique indicators developed in the Commission's stage 1 study (PC 2016b). Further questions about the retirement phase and a 'choice experiment' (discussed below) were also added to the questionnaire.

Broad areas covered in the online questionnaire comprised: superannuation and insurance literacy; retirement; satisfaction, member services and information on funds; use of advisers, account monitoring, intra-fund advice, beneficiary nominations; change in insurance

options, claims; switching and rolling over; financial literacy; choice experiment; and demographics.

The Commission's questionnaire design also benefited from the input of four external reviewers — Susan Bell Research, CHOICE, Australian Securities and Investments Commission (ASIC) and APRA — and advice from Roy Morgan Research.

A pilot test was conducted on 28 September 2017 prior to the start of the fieldwork. The pilot tested the programmed questionnaire with 50 respondents. No changes to the questionnaire or its operational functioning occurred as a result of pilot testing. The 50 pilot tested responses are included in the final data set.

A copy of the members survey questionnaire is available on the Commission's website at: <http://www.pc.gov.au/inquiries/current/superannuation/assessment/surveys>.

The choice experiment

The Commission's choice experiment in stage 3 builds on the previous choice experiment undertaken as part of the stage 2 members choice survey (section C.1).

The choice experiment in stage 3 explores the relative value attached to member services in the accumulation phase. The experiment follows a standard design from a well-established literature which includes work by Hensher et al. (2005) and Revelt and Train (1998).

Respondents were asked to choose between two superannuation products which differ only on the features, insurance offerings and yearly fees charged, with a total of 2880 possible combinations of product features.

The characteristics which define a product are listed in table C.2. The specific 'level' of each characteristic for each product was randomly chosen from the available levels with the exception of fees. Further information on implementation is in box C.1.

The Commission received 6585 observations from the experiment. This sample size is larger than Hensher's et al. (2005) choice experiment, based on 1266 observations and 1440 possible combinations of product features.

Results of the experiment are presented in technical supplement 1.

Table C.2 Product characteristics in the choice experiment

<i>Product characteristic</i>	<i>How was it introduced?</i>	<i>Levels available</i>
Member services — engagement channels	Ways you can engage with your superannuation product provider (to ask questions/raise concerns/make insurance claim/change insurance options/change investment options, etc. ...)	<ul style="list-style-type: none"> • Over the phone, email • Over the phone, email, online website • Over the phone, email, online website including real time online support • Over the phone, email, online website, smartphone app • Over the phone, email, online website including real time online support, smartphone app
Member services — engagement content	Ways a superannuation product provider engages with you	<ul style="list-style-type: none"> • Low: Only statements of account balances and obligated engagements • Medium: Everything in low, newsletters and surveys to better understand members such as yourself • High: Everything in low and medium, education seminars and webinars
Member services — promotions	Discounts on products and services unrelated to superannuation, for example on travel and clothing	<ul style="list-style-type: none"> • Yes • No
Member services — convenience of multiple services	The ability to purchase other financial products from the superannuation product provider such as home loans, banking accounts and insurance	<ul style="list-style-type: none"> • Yes • No
Control of assets	The level of control you have over investments	<ul style="list-style-type: none"> • No control (You can assume that the product will deliver a high level of returns) • Choice of investment strategy (is it a growth, balanced or conservative investment strategy?) • Choice over underlying assets (this would allow you to choose specific investments, such as in high-tech companies and ethical investments)
Level of life and total and permanent disability (TPD) insurance cover	Level of Life and TPD insurance cover	<ul style="list-style-type: none"> • None • A low level of cover — \$90,000 for both life and TPD insurance • A medium level of cover — \$200,000 for both life and TPD insurance • A high level of cover — \$500,000 for both life and TPD insurance
Level of income protection insurance cover	Level of income protection insurance cover	<ul style="list-style-type: none"> • None • A low level of cover – Coverage of up to the equivalent of a \$40,000 after tax salary in monthly payments • A medium level of cover – Coverage of up to the equivalent of a \$60,000 after tax salary in monthly payments • A high level of cover – Coverage of up to the equivalent of a \$100,000 after tax salary in monthly payments
Total administration fees	Total fee for the year. (These fees are comprehensive so that there are no additional fees to consider.)	<ul style="list-style-type: none"> • Fees were drawn with a specific algorithm as described in box C.1.

Box C.1 How the choice experiment was conducted

Overview of the method

Each respondent saw three sets of choice experiments. Each one compared two superannuation products which differed in their features, insurance and yearly fees. For the features and the type of insurance cover, the level presented — for example whether the fund allowed members to engage with them via phone or website — was randomly selected by an algorithm.

However, having a similar random selection process for fees would have resulted in too many choices (including some unrealistic products).

To reduce complexity fees were created to be specific to each type and level of insurance (table below). For example, if the algorithm had randomly selected a medium level of Life and TPD cover for a respondent, the algorithm was instructed to choose from fee levels that had been set for this level of insurance, i.e. from \$0 to \$4000.

Fee levels associated with each type of insurance and level of cover

<i>Level of cover</i>	<i>Fee (\$)</i>
No cover	25, 50, 75, 100, 125, 150, 175, 200
Life and TPD	
Low — \$90,000	0, 25, 50, 75, 100, 150, 200, 300, 400, 500, 750, 1 000
Medium — \$200,00	0, 25, 50, 100, 150, 200, 250, 300, 400, 500, 700, 900, 1 200, 1 500, 2 000, 2 500, 3 000, 4 000
High — \$500,000	0, 50, 100, 150, 200, 300, 400, 500, 750, 1 000, 1 250, 1 500, 2 000, 2 500, 3 000, 3 500, 4 000, 5 000, 7 500, 10 000
Income protection (IP)	
Low — up to \$40,000 after tax	0, 30, 60, 90, 120, 180, 240, 300, 375, 450, 525, 600
Medium — up to \$60,000 after tax	0, 50, 100, 150, 200, 300, 400, 500, 625, 750, 875, 1 000
High — up to \$100,000 after tax	0, 80, 160, 240, 320, 480, 640, 800, 1 000, 1 200, 1 400, 1 600

The fees were calculated using data from APRA MySuper (2016 fourth quarter) data.

When the pairs of products are identical

It is possible that the algorithm could create two identical products. When this happened, the product pair was rejected by the system and replaced.

(continued next page)

Box C.2 (continued)

When one of the pair of products is clearly superior

An adjustment was also made to ensure that a different type of unrealistic product offering was excluded, specifically a superior product being offered at an unrealistic price. For example, take two products, A and B:

- A has at least one characteristic that is better than B
- the fee for A is the same as B, or lower than B
- for all the other features, A and B are the same, or A is better than B.

To exclude these cases, the algorithm rejected:

- any pair where the fees for Product A were lower than fees for B if B had no features that were superior to A. Superior is defined as lower on the list in each cell of column 3, table C.2
- any pair where product A fees and product B fees were the same
- any pair where if the fees of product A were greater than the fees of product B, then at least one characteristic of A must be better than for B.

Finally quotas were used to ensure that all levels of each characteristic are adequately represented in products presented to participants.

Fieldwork

The members survey was conducted online between 28 September and 20 October 2017.

On average, superannuation members took around 21 minutes to complete the questionnaire. However, as those with retirement income products had fewer questions directed to them, they took less time to complete the questionnaire, with an average online interview length of around 13 minutes.

Responses achieved

A total of 2294 online responses were collected, comprising 2195 superannuation members and 99 retirement income product owners (with no superannuation). Of the 2195 respondents who were superannuation fund members, 204 held both a retirement income product and were members of a superannuation fund. Table C.3 provides an overview of the number of interviews achieved by fund and product type, and by age and gender.

Table C.3 Interviews achieved by type of superannuation fund and retirement income product by age and gender

Gender and age	Superannuation fund						Total	Retirement income product	Total
	Industry	Retail	Public sector	Corporate	Self-managed	Fund not specified			
Male									
15–24	37	16	8	13	2	7	83	0	83
25–34	99	41	30	38	6	13	227	1	228
35–49	152	85	41	23	25	19	345	0	345
50–64	112	91	41	16	54	13	327	16	343
65+	21	32	15	4	36	10	118	41	159
Female									
15–24	83	12	4	5	2	7	113	0	113
25–34	126	34	22	13	4	9	208	0	208
35–49	163	77	55	19	20	24	358	1	359
50–64	121	60	49	15	45	25	315	11	326
65+	24	23	18	3	22	11	101	29	130
Total	938	471	283	149	216	138	2 195	99	2 294

Source: Members survey.

Table C.4 provides an overview of the distribution of accumulation members by balance of main superannuation fund.

Table C.4 Superannuation balances in main fund by type of fund^a
Per cent

	Industry	Retail	Public sector	Corporate	Self-managed
Less than \$100,000	77.9	65.1	55.7	53.6	25.1
Between \$100,000 and \$249,999	12.7	21.8	25.5	23.0	23.4
\$250,000 or more	9.5	13.2	18.8	23.5	51.5

^a Based on members in the accumulation phase. Results weighted by Commission weights. Those without accumulation products and those who respond to question S8a with 'Can't say/Don't remember' or 'Prefer not to say' are omitted.

Source: Members survey.

Data

On completion of the fieldwork, Roy Morgan Research coded responses for 'other — please specify' questions. The final data was provided to Commission in spreadsheet format.

Weighting

Weighting enables population totals to be inferred from survey responses, reflecting the fact that some subsets of the population are likely to be over- or under-represented in the sample.

The Commission constructed population weights for the members survey data using a technique called minimum cross entropy; an approach taken from information theory (Preckel 2001). This approach constructs a set of weights to enable population-weighted aggregations of the survey data to hit a set of targets (for example, population aggregates from additional data sources, or additional judgments). It does this by minimising the cross-entropy — a measure of the difference between the initial data (which assumes that all observations have equal weight) and the set of weights that would hit all the targets (imposed as constraints on the system). The advantages of this approach is that it involves less manual data manipulation, and can be used when there are a large number of complicated targets.

The Commission's population weights were constructed using a number of external data sources, specifically the ABS' *Survey of Income and Housing* (SIH) (ABS 2015) and 2016 Census (ABS 2017a), confidential APRA superannuation data (provided to the Commission for the purpose of the inquiry), and data from the Australian Tax Office (ATO).

Specifically, the constraints were:

- 88 equality constraints based on APRA confidential data: fund type (4 categories), gender (2 categories) and age ranges (11 categories).
 - Another (single category) constraint based on ATO data was used to identify the proportion of self-managed super funds
- 85 equality constraints based on ABS' SIH and Census data: the proportion of people in age ranges (5 categories) that are receiving a pension or annuity
- 2294 inequality constraints placing an upper bound on each observation's weight of five times the mean weight.

The approach used by the Commission was reviewed by Susan Bell Research.

Results

Key results from the members survey data are presented in relevant chapters and technical supplements to this inquiry report. A set of summary statistics and supporting results from the members survey are provided in technical supplement 1.

In adherence to the Commission's transparency principles (PC nd), a copy of the members survey data set (in de-identified form) and associated documentation will be made available on the Commission's website following the conclusion of the inquiry.

C.3 Funds survey

Following a competitive request for proposal process, Roy Morgan Research was engaged to design and conduct a survey of institutional superannuation funds on behalf of the Commission.

Survey design

Sample frame

As the focus of the funds survey was on large superannuation funds (that is, those with more than four members) regulated by APRA, APRA's list of registrable superannuation entities (RSEs) was used as the sample frame. In an attempt to seek universal participation, all RSEs were invited to participate.

APRA provided the Commission with a list of contact details of these funds' CEOs. In turn, these details were provided to Roy Morgan Research for the purposes of this inquiry.

Initial questionnaire design

The Commission's questionnaire design focused on gathering information on 30 of the 89 unique indicators developed in the Commission's stage 1 study (PC 2016b).

The Commission's questionnaire design phase included extensive consultation with the Australian Bureau of Statistics' (ABS) Statistical Clearing House, APRA, and two former senior executives of large RSEs: Howard Rosario, a former CEO, and David Hartley, a former Chief Investment Officer. This consultation process sought to ensure that the survey was fit-for-purpose and minimised the compliance burden on participants. The covering note to the funds survey also outlined the context for the survey, basic instructions and assurances about data confidentiality and protection arrangements.

Broad areas covered in the online questionnaire comprised: general information about the fund; member engagement; governance; insurance; market contestability; fund activity and product development; regulation; and net returns and fees by asset class.

Once the questionnaire was designed, Roy Morgan Research constructed an online version. Prior to entering the field, the online functionality of the questionnaire was tested by Roy Morgan Research reviewers and Commission staff.

Strategies to ensure an adequate response rate and a representative sample

At the outset of this inquiry, the issues paper signposted the Commission's aim to achieve universal participation in the funds survey and its intention to publish a list of funds survey recipients and survey respondents. Prior to the commencement of fieldwork, on 22 August

2017 the Commission wrote to all survey recipients alerting them to the funds survey, requesting their cooperation in completing the questionnaire and providing assurances about data confidentiality.

Participants were also provided with the option to deliver the survey online or in hard copy.

Fieldwork

On 18 September 2017, Roy Morgan Research emailed the questionnaire to the Chief Executive Officer (CEO) (or designated officer) of all large APRA-regulated funds. Survey responses were sought by 10 October 2017.

Following the launch of the survey, the Commission and Roy Morgan Research received a large volume of questions and comments reflecting participant concerns about the content of the survey, its functionality, timelines for completion and data protection and confidentiality arrangements.

Consequently, the survey was paused on 2 October 2017 to provide time to resolve those concerns. During this time, the Commission hosted a roundtable on 9 October 2017 with selected groups and organisations (appendix A). Further discussions surrounding questionnaire design with interested parties occurred following the roundtable. The Commission concurrently worked with Roy Morgan Research to implement the changes in the questionnaire design and survey functionality.

The Commission also strengthened existing confidentiality and data security protections through: establishing a stronger confidentiality clause in the Commission's contract with Roy Morgan Research; and creating non-disclosure agreements with specified personnel at Roy Morgan Research. Further, Roy Morgan Research gave an undertaking to:

- survey recipients to: treat their responses and the identity of respondents as confidential information; and that it would have correspondingly robust data storage arrangements
- the Commission to: destroy all funds' survey data on interim storage locations as soon as it was transferred to Roy Morgan Research servers; destroy the funds' survey data held on its servers at the conclusion of the inquiry; and notify the Commission once these steps have occurred.

The above confidentiality protections were broadly outlined to CEOs (or designated officers) in a letter from the Commission advising of the resumption of the survey and the extended deadline. In addition, the covering note to the survey was extended to explain the changes to the questionnaire and its functionality following the Commission's consultations, the extended deadline and the revised confidentiality and data protection arrangements.

Following online testing of the questionnaire by the Commission, Roy Morgan Research and APRA, the survey resumed on 8 November, with a 5 week deadline for responses of 13 December 2017. As previously, emails were sent to the representatives of 208 funds

inviting them to take part in the survey. A reminder email was sent on 20 November. Subsequently, several participants requested an extension and were granted an extension to 20 December 2017. To facilitate the extensions, the survey remained open for all respondents until 22 December 2017.

A copy of the final funds survey questionnaire is available on the Commission's website at: <http://www.pc.gov.au/inquiries/current/superannuation/assessment/surveys>.

Responses achieved

A total of 114 funds responded to the online survey, representing 55 per cent of all 208 funds invited to participate. Funds that did not respond tended to be small, meaning responding funds accounted for about 90 per cent of total assets, and 88 per cent of all member accounts (table C.5).

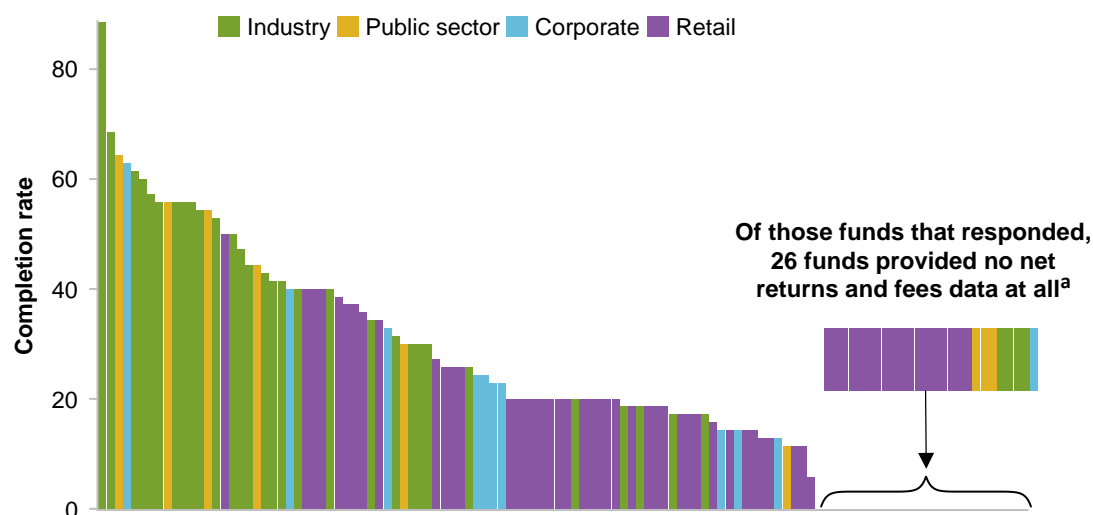
However, a response does not indicate that the survey was completed in full, with a number of responses missing information in different parts of the survey. For example, at an aggregate level, 18 per cent of all data items were missing from the general fund-level section that requested information about numbers of members, accounts and total assets for different years. The quality of information provided about assets, net returns and investment management costs for different asset classes was highly variable, with nearly 23 per cent of responding funds providing no 2016-17 data at all for these questions (figure C.3).

Table C.5 Funds survey response statistics

<i>Superannuation fund type</i>	<i>Responses received (number)</i>	<i>As a share of total funds invited to participate (%)</i>	<i>As a share of total assets (%)</i>	<i>As a share of total number of accounts (%)</i>
Corporate	11	48	90	92
Industry	34	83	97	94
Public sector	9	50	78	71
Retail	57	48	89	91
Retail – Eligible Rollover Fund	3	38	60	74
Total	114	55	90	88

^a Total assets and total number of accounts data is from APRA Annual Fund-level Superannuation Statistics.

Figure C.3 Completion rates by fund type
Net returns and fees data, 2016-17



^a Of the funds asked to participate in the survey and were not screened out, 73 did not respond. This means that no net returns and fees data was received from 99 of the 208 funds included in the survey.

Source: Commission fund survey.

A list of funds survey recipients and respondents is in table C.6.

Table C.6 List of funds survey recipients and respondents

<i>RSE licensee</i>	<i>Response submitted</i>	<i>RSE licensee</i>	<i>Response submitted</i>
Advance Retirement Suite	✓	Beacon Superannuation Plan	na
AIA Superannuation Fund	na	Betros Bros Superannuation Fund No 2	na
Alcoa of Australia Retirement Plan		Bluescope Steel Superannuation Fund	na
AMG Super		Boc Gases Superannuation Fund	
AMP Eligible Rollover Fund		BT Classic Lifetime	✓
AMP Retirement Trust	✓	BT Lifetime Super	✓
AMP Superannuation Savings Trust	✓	BT Superannuation Savings Fund	na
ANZ Australian Staff Superannuation Scheme	✓	Building Unions Superannuation Scheme (Queensland)	✓
Aon Eligible Rollover Fund		Care Super	✓
AON Master Trust		CBH Superannuation Fund	✓
ASGARD Independence Plan Division Four	na	Challenger Retirement Fund	✓
ASGARD Independence Plan Division Two	✓	Christian Super	✓
Australia Post Superannuation Scheme	✓	Citibank Australia Staff Superannuation Fund	✓
Australian Catholic Superannuation and Retirement Fund	✓	ClearView Retirement Plan	✓
Australian Defence Force Superannuation Scheme		Clough Superannuation Fund	na
Australian Eligible Rollover Fund	✓	Club Plus Superannuation Scheme	✓
Australian Ethical Retail Superannuation Fund	✓	Club Super	✓
Australian Meat Industry Superannuation Trust	✓	Colonial First State FirstChoice Superannuation Trust	✓
AustralianSuper	✓	Colonial First State Rollover & Superannuation Fund	✓
Australia's Unclaimed Super Fund	✓	Colonial Super Retirement Fund	✓
Austsafe Superannuation Fund	✓	Combined Super Fund	✓
Avanteos Superannuation Trust	✓	CommInsure Corporate Insurance Superannuation Trust	
AvSuper Fund	✓	Commonwealth Bank Approved Deposit Fund	✓
AvWrap Retirement Service	✓		

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Table C.6 (continued)

<i>RSE licensee</i>	<i>Response submitted</i>	<i>RSE licensee</i>	<i>Response submitted</i>
Commonwealth Bank Group Super	✓	Fairbrother Employees Retirement Fund	
Commonwealth Essential Super	✓	Federation Alliance Superannuation Fund	
Concept One The Industry Superannuation Fund	na	Fiducian Superannuation Fund	✓
Construction & Building Unions Superannuation	✓	Fire and Emergency Services Superannuation Fund	
Crescent Wealth Superannuation Fund		First State Superannuation Scheme	✓
Crown Employees (NSW Fire Brigades Firefighting Staff Death & Disability) Superannuation Fund	na	First Super	
CSS Fund		Gillette Australia Superannuation Fund	
CUBS Superannuation Fund	✓	Goldman Sachs & JBWere Superannuation Fund	✓
Definitive Superannuation Plan	✓	Grosvenor Pirie Master Superannuation Fund Series 2	
Deseret Benefit Plan for Australia		Guild Retirement Fund	✓
DIY Master Plan		Health Employees Superannuation Trust Australia	✓
Dow Australia Superannuation Fund		Heidelberg Australia Superannuation Fund	
DPM Retirement Service	✓	HHH Superannuation Fund	na
DuluxGroup Employees Superannuation Fund		Holden Employees Superannuation Fund	
e-Clipse Super	na	HOSTPLUS Superannuation Fund	✓
Elphinstone Group Superannuation Fund		HUB24 Super Fund	
EmPlus Superannuation Fund	✓	IAG & NRMA Superannuation Plan	✓
Encircle Superannuation Fund	✓	Incitec Pivot Employees Superannuation Fund	
Energy Industries Superannuation Scheme-Pool A	✓	ING Direct Superannuation Fund	
Energy Industries Superannuation Scheme-Pool B		Intrust Super Fund	
Energy Super	✓	IOOF Portfolio Service Superannuation Fund	✓
Enterprise Super		IRIS Superannuation Fund	na
Equisuper	✓	ISARF Superannuation Fund	
Factory Mutual Insurance Company Superannuation Fund	✓		

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Table C.6 (continued)

<i>RSE licensee</i>	<i>Response submitted</i>	<i>RSE licensee</i>	<i>Response submitted</i>
Itochu Australia Superannuation Plan	✓	Mercer Super Trust	✓
Jamestrong Packaging Australia Superannuation Fund		Mercy Super	✓
Kinetic Superannuation Fund	na	Military Superannuation & Benefits Fund No 1	
Kingston Superannuation Trust	na	Mine Wealth and Wellbeing Superannuation Fund	✓
L&H Group Superannuation Fund	✓	MLC Super Fund	✓
Labour Union Co-Operative Retirement Fund	✓	MLC Superannuation Fund	✓
Legalsuper	✓	Mobisuper	na
LESF Super		MTAA Superannuation Fund	✓
Lifefocus Superannuation Fund		Munich Holdings of Australasia Pty Ltd Superannuation Scheme	
Linfox Staff Superannuation Fund		MyLifeMyMoney Superannuation Fund	✓
Local Authorities Superannuation Fund	✓	National Mutual Pro-Super Fund	
Local Government Super		National Mutual Retirement Fund a	
Local Government Superannuation Scheme	✓	Nationwide Superannuation Fund	✓
Lutheran Super	✓	NESS Super	✓
Macquarie ADF Superannuation Fund	✓	Nestle Australia Group Superannuation Fund	
Macquarie Superannuation Plan	✓	Netwealth Superannuation Master Fund	✓
Macquarie University Professorial Superannuation Scheme		Newcastle Permanent Superannuation Plan	na
Manildra Flour Mills Retirement Fund		NGS Super	
Map Superannuation Plan		Nissan Superannuation Plan	
Maritime Super	✓	Oasis Superannuation Master Trust	✓
Max Super Fund		OnePath Masterfund	✓
Meat Industry Employees Superannuation Fund		Oracle Superannuation Plan	
Media Super	✓	Perpetual Super Wrap	✓
Mercer Portfolio Service Superannuation Plan	✓	(continued next page)	

Table C.6 (continued)

<i>RSE licensee</i>	<i>Response submitted</i>	<i>RSE licensee</i>	<i>Response submitted</i>
Perpetual WealthFocus Superannuation Fund	✓	StatePlus Fixed Term Pension Plan	✓
Perpetual's Select Superannuation Fund	✓	StatePlus Retirement Fund	✓
Personal Choice Private Fund		Statewide Superannuation Trust	✓
Pitcher Retirement Plan		Stone Superannuation Fund	
Port of Melbourne Superannuation Fund		Suncorp Master Trust	✓
Powerwrap Master Plan		Sunsuper Superannuation Fund	✓
Praemium SMA Superannuation Fund		Super Directions Funda	✓
Premiumchoice Retirement Service	✓	Super Safeguard Fund	
Prime Super	✓	SuperTrace Eligible Rollover Fund	✓
Public Sector Superannuation Accumulation Plan		Symetry Personal Retirement Fund	✓
Public Sector Superannuation Scheme		TAL Superannuation and Insurance Fund	
Qantas Superannuation Plan	✓	Tasplan Superannuation Fund	✓
Queensland Independent Education & Care Superannuation Trust	✓	Telstra Superannuation Scheme	✓
Rei Super	✓	The ARA Retirement Fund	
Retail Employees Superannuation Trust	✓	The Bendigo Superannuation Plan	
Retirement Portfolio Service	✓	The Executive Superannuation Fund	✓
Retirement Wrap	✓	The James Superannuation Fund	✓
Rexel Australia Superannuation Plan		The Paragon Superannuation Fund	
Russell Investments Master Trust	✓	The PPS Corporate Superannuation Fund	
Smartsave 'Member's Choice' Superannuation Master Plan		The Retirement Plan	
SMF Eligible Rollover Fund		The State Bank Supersafe Approved Deposit Fund	✓
Staedtler Executive Superannuation Fund	na	The Super Money Eligible Rollover Fund (SMERF)	
Star Portfolio Superannuation Fund	✓	The Towers Watson Superannuation Fund	
State Public Sector Superannuation Scheme	✓		

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Table C.6 (continued)

<i>RSE licensee</i>	<i>Response submitted</i>
The Transport Industry Superannuation Fund	na
The University of Adelaide Superannuation Scheme A 1 985	
The University of New England Professorial Superannuation Fund	✓
The University of New South Wales Professorial Superannuation Fund	✓
The University of Sydney Professorial Superannuation System	
The University of Wollongong Professorial Superannuation Scheme	
The Victorian Independent Schools Superannuation Fund	✓
Tidswell Master Superannuation Plan	
Toyota Super	
TWU Superannuation Fund	✓
Ultimate Superannuation Fund	✓
Unisuper	✓
United Technologies Corporation Retirement Plan	
Victorian Superannuation Fund	✓
Virgin Superannuation	na
WA Local Government Superannuation Plan	✓
Wealth Personal Superannuation and Pension Fund	
Westpac Mastertrust - Superannuation Division	✓
Westpac Personal Superannuation Fund	✓
Zurich Master Superannuation Fund	✓

na — A number of funds were invited to participate in the fund survey but were ‘screened out’ because they were in the process of merging or winding down, had ceased to exist or responded that they were purely defined benefit. These funds were not considered to be non-responders to the survey.

Data

On completion of the fieldwork, Roy Morgan Research undertook basic data cleaning and coded responses for ‘other — please specify’ questions. The final dataset was provided to the Commission as an excel file.

Coding of hard copy responses

Fifteen funds submitted surveys in paper format. These were then entered by Roy Morgan Research into the online survey format.

Funds who submitted their surveys on paper were able to modify/amend the survey questions in Word or provide answers/comments that were blocked in the online version due to programmed survey format and logic. For example, some questions required a single answer online but received multiple answers on paper. In other cases questions were answered on

paper that should have been skipped due to the survey question sequence logic built into the online version. These occurrences required Roy Morgan Research to establish ‘data cleaning’ rules to fit the paper survey submissions into the online format. The rules avoided the need to guess the respondent’s intention while also trying to utilise as much of the contributed responses as possible. The 15 cleaned data sets were then merged into the final data set.

Results

Key results from the funds survey data are presented in relevant chapters and appendixes to this inquiry report. A set of summary statistics and supporting results from the funds survey are provided in technical supplement 2.

Analysis of the funds survey data has aggregated the data to ensure that individual funds are not identifiable. As agreed with participating funds, the Commission will not publish raw survey data.

C.4 Governance survey

The Commission utilised an online survey tool, LimeSurvey, to develop and publish its own survey which was hosted on an internal server.

Survey design

Sample frame

As with the funds survey, the focus of the governance survey was on large (that is, those with more than four members) superannuation funds regulated by APRA. APRA’s list of large RSEs was used as the sample frame. The initial list of 208 large RSEs (which formed the basis of the funds survey) was consolidated as a number of CEOs (or their equivalents) were responsible for multiple RSEs, and a further 7 RSEs were removed on the basis that they accounted for a small number of assets and accounts managed.⁸² The consolidation resulted in a final list of 94 RSE licensees.

Table C.7 provides an overview of the population of CEOs of large RSEs that were invited to participate in the survey by the type of fund for which they are responsible.

⁸² Henceforth, references to CEOs in connection with the governance survey refer to CEOs or their equivalents.

Questionnaire design and pilot testing

The survey was designed to elicit the personal views of CEOs on governance by RSE licensees of funds for which they are responsible.

Table C.7 Population of large RSE CEOs by fund type

<i>Superannuation fund type</i>	<i>Number of CEOs</i>
Corporate	15
Industry	40
Public sector	13
Retail (incl. Retail – ERF)	26
Total	94

The survey was based on a longstanding international survey on fund governance — as designed and conducted by Keith Ambachtsheer of the University of Toronto with a number of collaborators. Details are presented in Ambachtsheer et al. (2008). To date, that survey has been conducted in 1997, 2005 and 2014, and involved funds from Australia, New Zealand, the United States, Canada and Europe. About 80 CEOs or their equivalents have participated in each year, including three and eight Australian fund CEOs in 2005 and 2014, respectively.

The Commission added a number of questions to the international survey to further address the evidence needs of the inquiry. Broad areas covered in the online survey comprised: general information about the respondent and the structure of the trustee board as well as subjective questions concerning governance quality and challenges faced by the board.

The survey design phase included consultation with (and an external review by) Keith Ambachtsheer, APRA and four expert academics and other consultants. Prior to entering the field, the survey was pilot tested by four fund CEOs, as nominated by ISA, the Association of Superannuation Funds of Australia, AIST and the Financial Services Council. The online functionality of the survey was tested by Commission staff.

The Commission was able to implement this survey itself given its nature and form. As the survey was hosted on an internal server, the Commission engaged a third party to undertake penetration testing to evaluate the Commission's IT infrastructure security, with all vulnerabilities and risks identified and patched prior to the commencement of the survey on 4 December 2017.

A copy of the governance survey questionnaire is available on the Commission's website: <http://www.pc.gov.au/inquiries/current/superannuation/assessment/surveys>.

Strategies to ensure an adequate response rate and representative sample

At the outset of this inquiry, the issues paper signposted the Commission's aim to achieve universal participation in the CEO survey by its intention to publish a list of fund CEO recipients and survey respondents. Prior to the commencement of fieldwork, on 22 August 2017 the Commission wrote to all fund survey recipients alerting them to the CEO survey covering governance. The Commission then wrote to all survey recipients on 4 December 2017 requesting their cooperation in completing the survey.

The introduction to the online governance survey provided recipients with assurances about data confidentiality and protection arrangements. Specifically, this included assurance that survey responses would be received and stored securely within the Commission's IT environment, and would only be accessible to Commission staff working on the inquiry. The Commission also assured recipients that responses would be de-identified in published data to protect the identity of funds (and CEOs or their equivalents). Furthermore, the Commission undertook to only use the survey data for the sole purpose of the inquiry, and sought CEOs' permission at the end of the survey for their de-identified responses to be included in a dataset that other researchers (including other government agencies) will be able to apply to the Commission to access following completion of the inquiry.

The majority of participants undertook the survey online. Four responses were received in hard copy, and entered into the dataset by Commission staff.

Fieldwork

On 4 December 2017, the Commission emailed the survey to recipients, with a deadline for responses of 22 December 2017. Subsequently, several participants requested an extension and were granted an extension to 15 January 2018. To facilitate the extensions, the survey remained open for all respondents until 15 January 2018.

Responses achieved

A total of 80 CEOs provided responses to the survey questions, representing a response rate of 85 per cent. However, non-responding CEOs tended to be associated with small RSE licensees, meaning that the CEOs who provided responses accounted for about 95 per cent of member accounts and 94 per cent of assets held by the population of 94 RSE licensees at 30 June 2016.

Table C.8 provides details of the number of responses received by type of fund.

A list of governance survey recipients and respondents is in table C.9.

Table C.8 Governance survey response statistics

<i>Superannuation fund type</i>	<i>Responses received (number)</i>	<i>As a share of RSE licensees invited to participate (%)</i>	<i>As a share of total assets (%)</i>	<i>As a share of total number of accounts (%)</i>
Corporate	13	87	96	96
Industry	34	85	96	96
Public sector	12	92	83	75
Retail (incl. Retail – ERFs)	21	81	98	98
Total	80	85	94	95

Data

On completion of the fieldwork, the Commission coded responses for free text questions and exported the data from the survey tool as an excel file.

Results

Key results from the governance survey are presented in relevant chapters to the inquiry report. A set of summary statistics and supporting results from the governance survey are provided in technical supplement 3.

Table C.9 List of governance survey recipients and respondents

<i>RSE licensee</i>	<i>Response submitted</i>	<i>RSE licensee</i>	<i>Response submitted</i>
Alcoa of Australia Retirement Plan Pty Ltd	✓	Commonwealth Superannuation Corporation	
AMP Superannuation Limited	✓	Concept One Pty Ltd	✓
ANZ Staff Superannuation (Australia) Pty. Limited	✓	CSF Pty Limited	
AUSCOAL Superannuation Pty Ltd	✓	Diversa Trustees Limited	✓
Australian Ethical Superannuation Pty Ltd	✓	Electricity Supply Industry Superannuation (QLD) Ltd	✓
Australian Meat Industry Superannuation Pty Ltd	✓	Energy Industries Superannuation Scheme Pty Ltd	✓
AustralianSuper Pty Ltd	✓	Equisuper Pty Ltd	✓
Austsafe Pty Ltd	✓	Equity Trustees Superannuation Limited	
AvSuper Pty Ltd	✓	Fiducian Portfolio Services Limited	✓
BEST Superannuation Pty Ltd	✓	Fire and Emergency Services Superannuation Board	✓
BOC Superannuation Pty Ltd	✓	First Super Pty Limited	
BT Funds Management Limited	✓	FSS Trustee Corporation	✓
BUSS (Queensland) Pty Ltd	✓	Guild Trustee Services Pty. Limited	
C.B.H. Superannuation Holdings Pty Ltd	✓	H.E.S.T. Australia Ltd.	✓
CARE Super Pty Ltd	✓	Holden Employees Superannuation Fund Pty Ltd	
Challenger Retirement and Investment Services Limited	✓	Host-Plus Pty. Limited	✓
Christian Super Pty Limited	✓	I.O.O.F. Investment Management Limited	✓
Citibank Australia Staff Superannuation Pty Limited	✓	IAG & NRMA Superannuation Pty Ltd	✓
ClearView Life Nominees Pty Limited	✓	Industry Funds Investments Ltd	✓
Club Plus QLD Pty Ltd	✓	IS INDUSTRY FUND PTY LTD	
Club Plus Superannuation Pty Ltd	✓	Kinetic Superannuation Ltd	✓
Colonial First State Investments Limited	✓	L.U.C.R.F. Pty. Ltd.	✓
Combined Fund Pty Ltd	✓	LCA NOMINEES PTY. LTD.	✓
Commonwealth Bank Officers Superannuation Corporation Pty Limited	✓		

(continued next page)

Table C.9 (continued)

<i>RSE licensee</i>	<i>Response submitted</i>	<i>RSE licensee</i>	<i>Response submitted</i>
Legal Super Pty Ltd	✓	QSuper Board	✓
LGIAsuper Trustee	✓	Rei Superannuation Fund Pty Limited	✓
LGSS Pty Limited	✓	Retail Employees Superannuation Pty. Limited	✓
Macquarie Investment Management Ltd	✓	Sandhurst Trustees Limited	
MAP Funds Management Ltd	✓	SCS Super Pty. Limited	✓
Maritime Super Pty Limited	✓	State Super Financial Services Australia Limited	✓
Meat Industry Employees Superannuation Fund Pty. Ltd.		Statewide Superannuation Pty Ltd	✓
Media Super Limited	✓	Suncorp Portfolio Services Limited	✓
Mercer Superannuation (Australia) Limited	✓	Sunsuper Pty. Ltd.	✓
Mercy Super Pty Ltd	✓	T W U Nominees Pty Ltd	✓
Motor Trades Association of Australia Superannuation Fund Pty. Limited	✓	Tasplan Pty Ltd	
NESS Super Pty Ltd	✓	Telstra Super Pty Ltd	✓
Netwealth Investments Limited		Tidswell Financial Services Ltd	✓
NGS Super Pty Limited	✓	Total Risk Management Pty Limited	✓
NSF Nominees Pty. Limited	✓	Towers Watson Superannuation Pty Ltd	✓
NSW Fire Brigades Superannuation Pty Limited	✓	Toyota Super Pty Ltd	
Nulis Nominees (Australia) Limited	✓	Unisuper Ltd	✓
OnePath Custodians Pty Limited	✓	United Super Pty Ltd	✓
Perpetual Superannuation Limited	✓	V.I.S. Nominees Pty. Limited	
Pitcher Retirement Plan Pty Ltd	✓	Vicsuper Pty Ltd	✓
PostSuper Pty Ltd	✓	Vision Super Pty Ltd	✓
Prime Super Pty Ltd	✓	WA Local Government Superannuation Plan Pty Ltd	✓
Qantas Superannuation Limited	✓	Zurich Australian Superannuation Pty Ltd	✓
QIEC Super Pty Ltd	✓		

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