



Australian Government
Productivity Commission

Superannuation: Assessing Efficiency and Competitiveness

Productivity Commission
Draft Report
Overview

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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Publications enquiries

Media, Publications and Web, phone: (03) 9653 2244 or email: mpw@pc.gov.au

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.

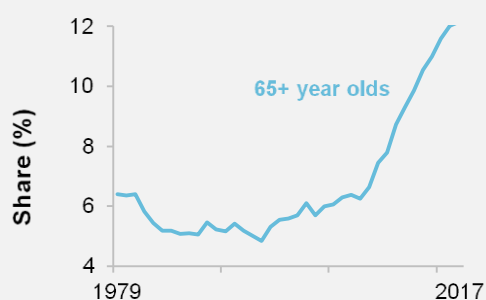
Box 1 Members in the modern workforce

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.

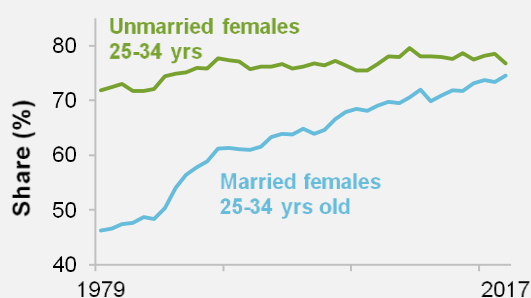
While job tenure has been relatively stable, many people still switch employers, which — combined with multiple job holding and a much greater tendency to move between industries and occupations — suggests that inefficient multiple accounts will be a persistent and costly problem without further reform. 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.

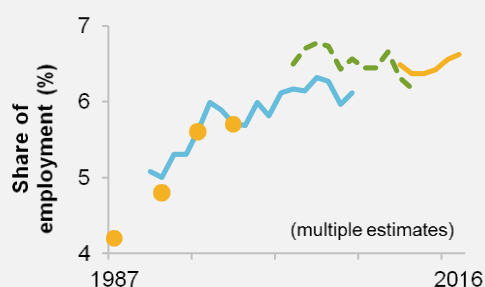
Participation rates by older people are rising steeply



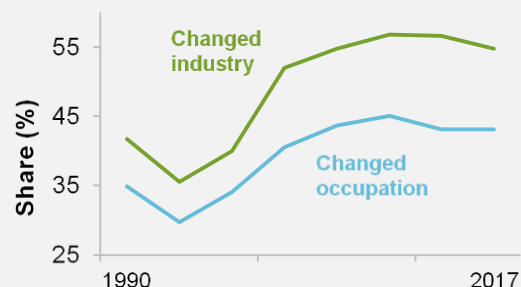
Marriage (and children) place less of a brake on participation



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.

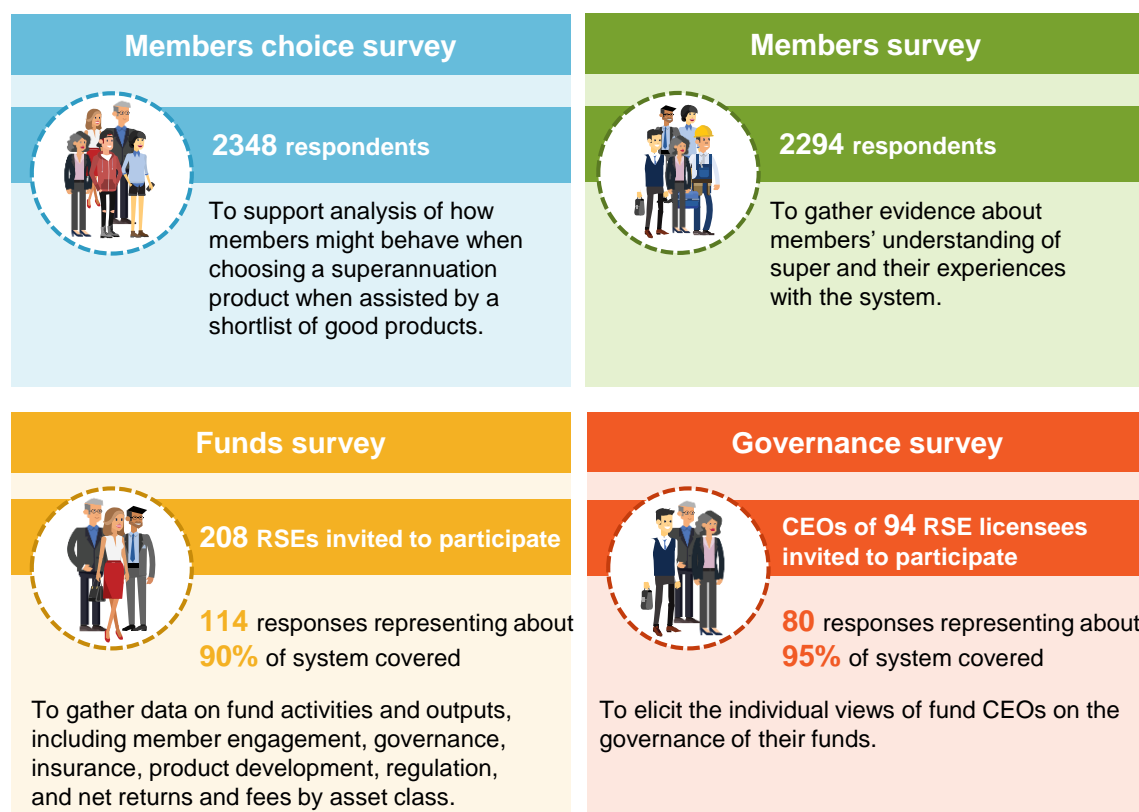
Stage 3, the current inquiry, derives from its own terms of reference. It is assessing the efficiency and competitiveness of the system, drawing on the stage 1 framework, and identifying areas for improvement. It is also providing advice on alternative default models based on feedback on the stage 2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

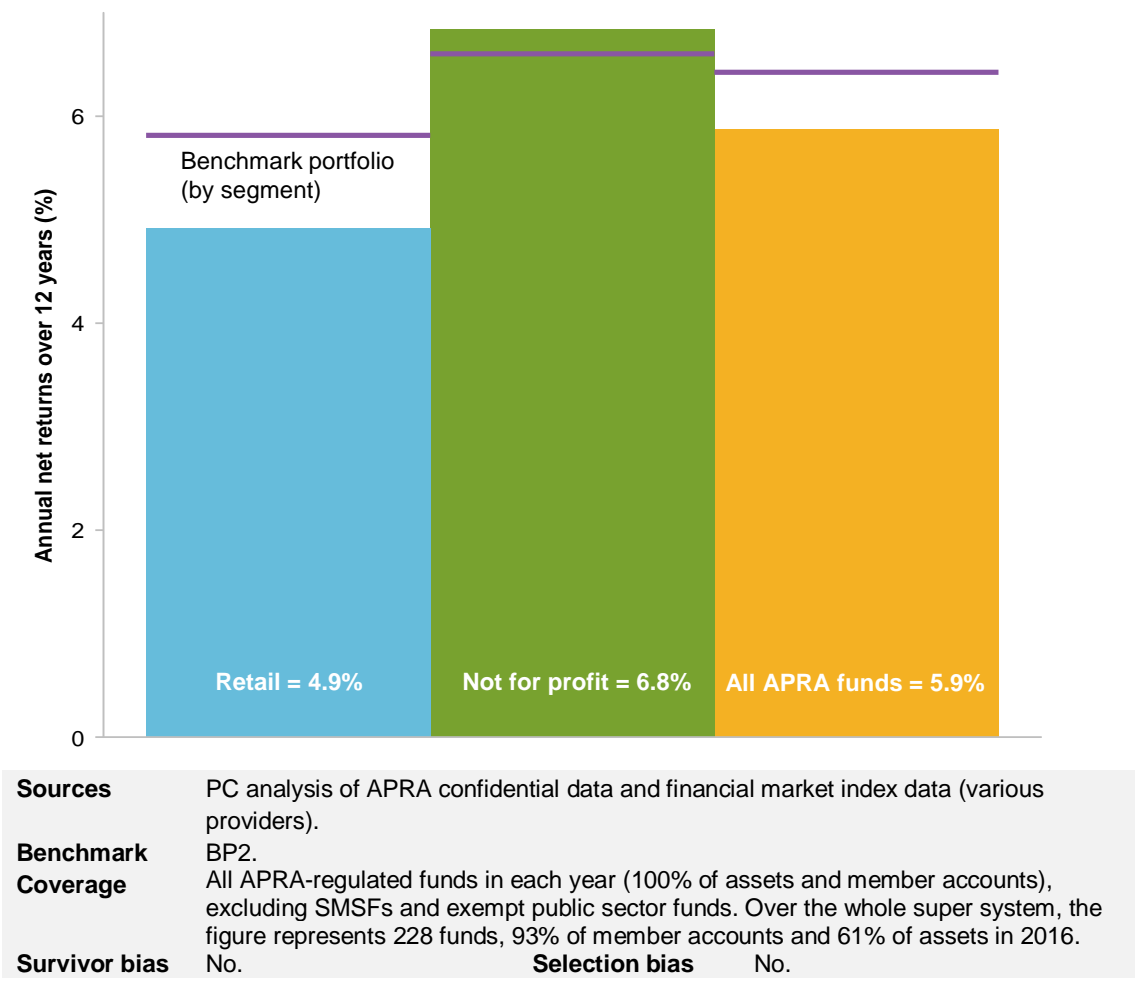
Our benchmarking against BP1 can be found in chapter 2.

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.

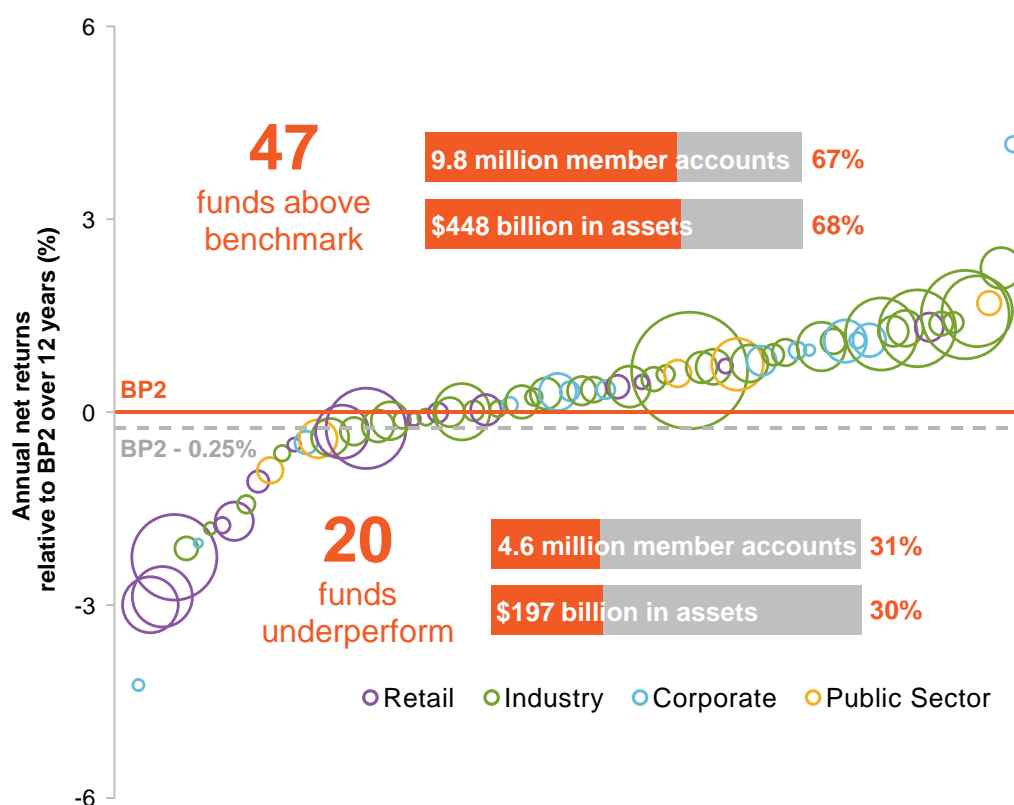
This analysis only covers funds that currently offer a MySuper product, due to data limitations and the need to make assumptions about asset allocations in past years. Using simpler (but likely less accurate) assumptions allows for a broader sample, in which about half of member accounts are in underperforming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

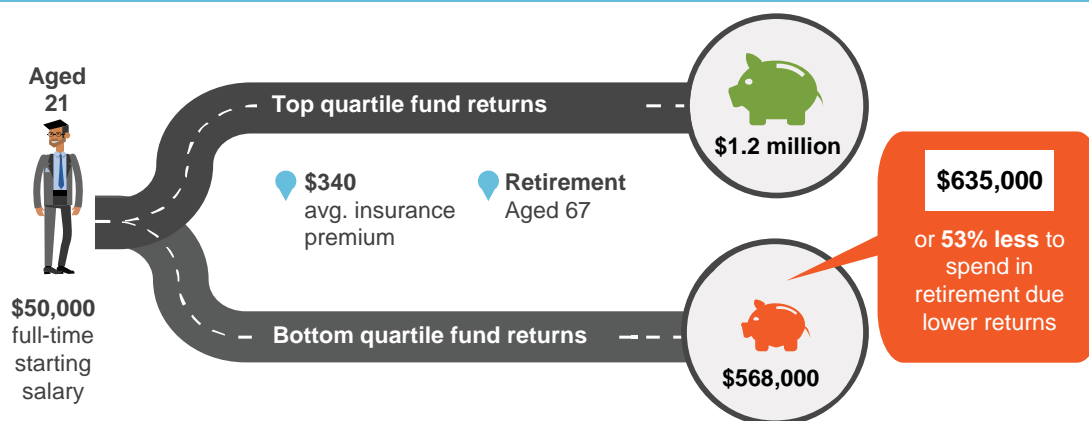
Size of circles indicates the size of each fund's assets under management



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.

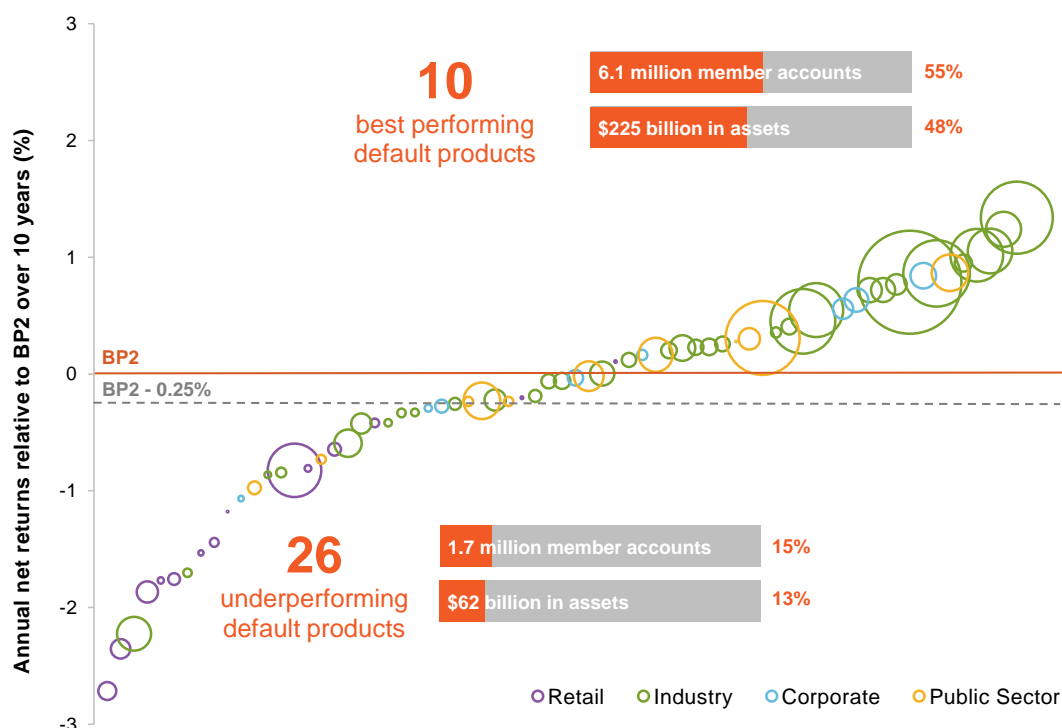
The analysis reveals that:

- 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).		

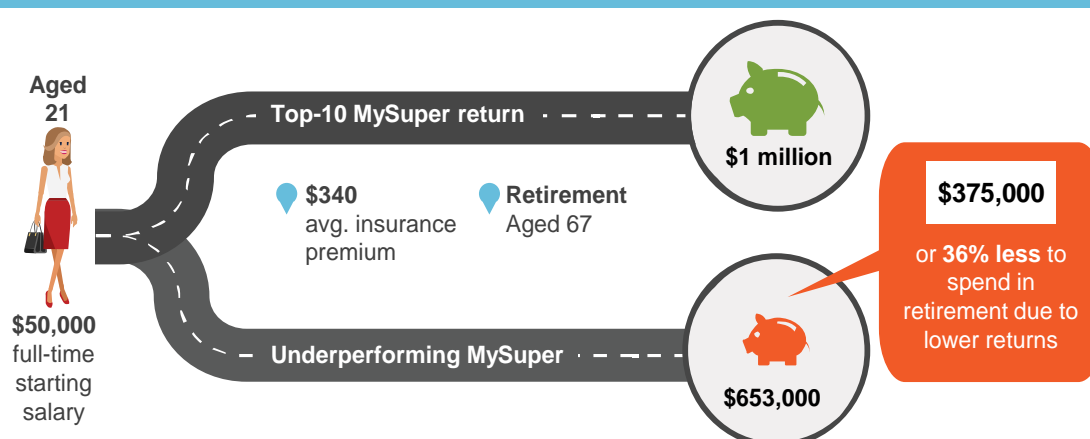
Nearly a third (8) of the underperforming MySuper products are life-cycle products — where members are automatically moved into less risky (and lower-return) asset allocations as they age (represented by a single ‘representative’ life stage in our data). Life-cycle products comprise about a third of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

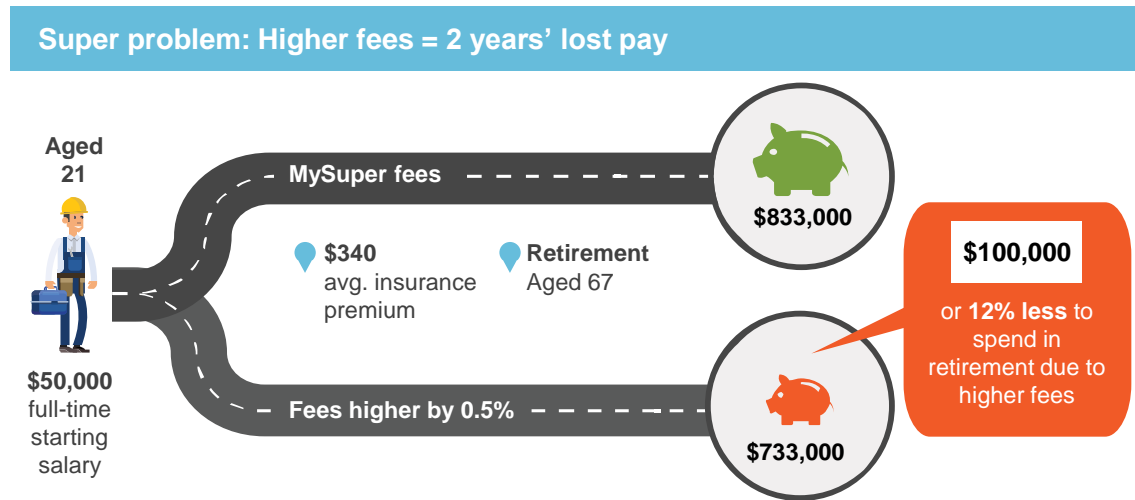
Clearly, some members — in choice as well as default — do well, but many could be doing a lot better.

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

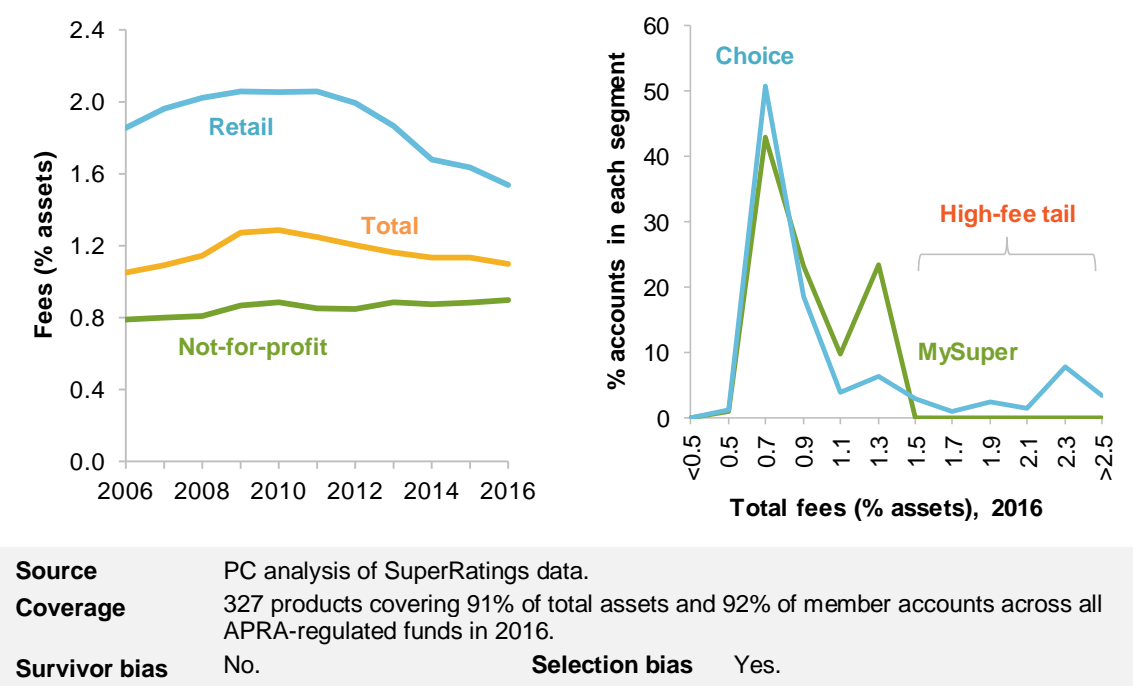


While fees often increase in line with growing balances, average reported fees have fallen in percentage terms since the global financial crisis for APRA-regulated funds (figure 5). This downward trend is observed for both administration and investment fees, and in both the accumulation and retirement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



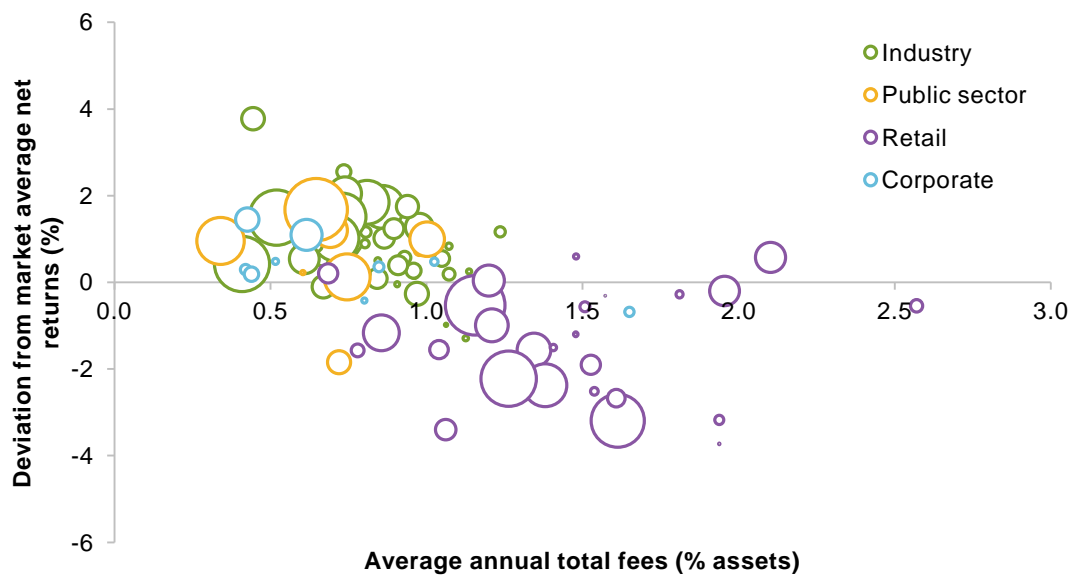
By contrast, fees for not-for-profit funds have been largely flat over time, but on average remain well below the fees charged by retail funds. And fees charged by retail funds remain relatively high, at least for choice products. Roughly 14 per cent of member accounts appear to be paying annual fees 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.

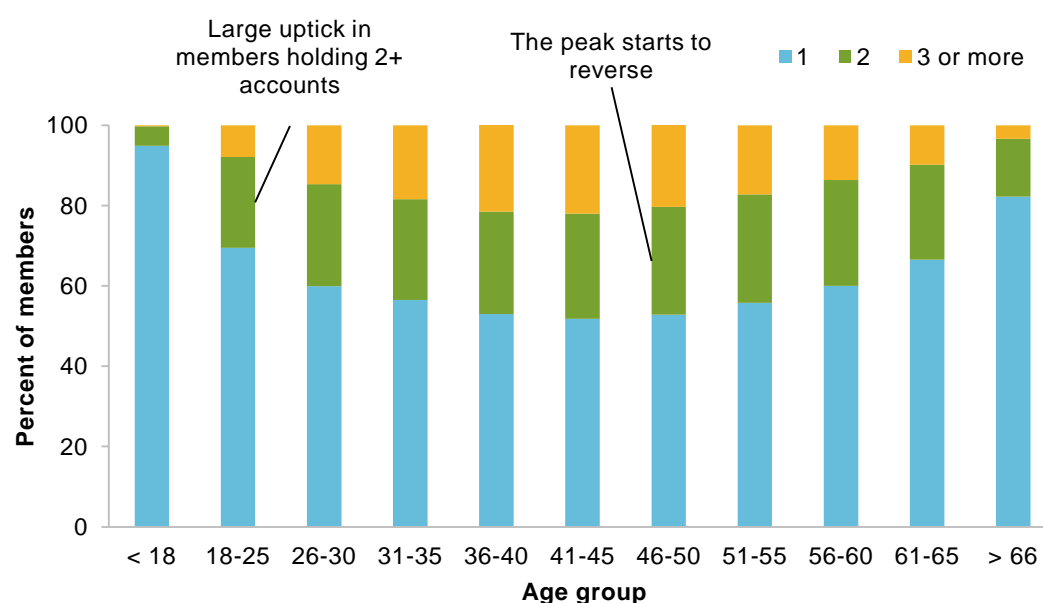
Reported fees in Australia are higher than in many other OECD countries. International comparisons are fraught, mainly due to large differences in asset allocation and tax, so we attempted to collect information from Australian funds on the costs they incur at an asset-class level to inform comparisons 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**



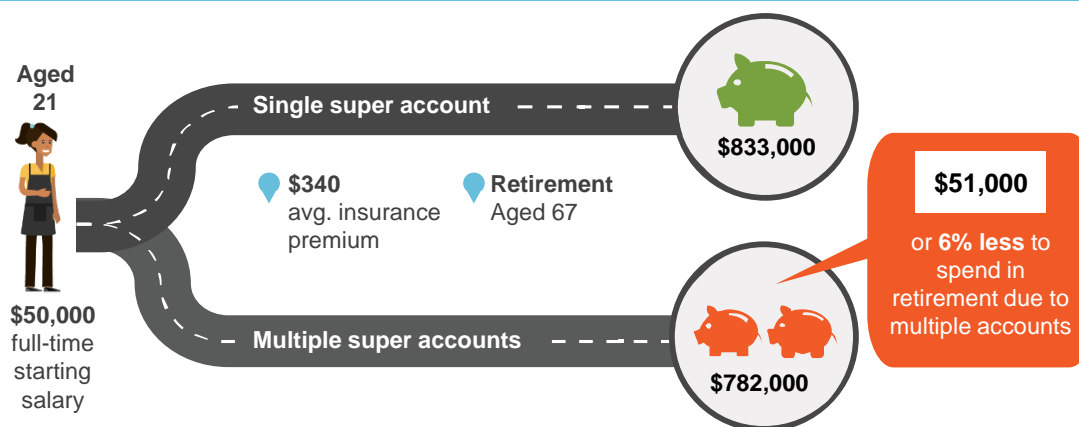
These unintended multiples collectively cost the members who hold them \$1.9 billion a year in excess insurance premiums and \$690 million in excess administration fees. Over time, the foregone returns compound and unnecessarily erode members’ retirement balances, and can leave a typical full-time worker 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

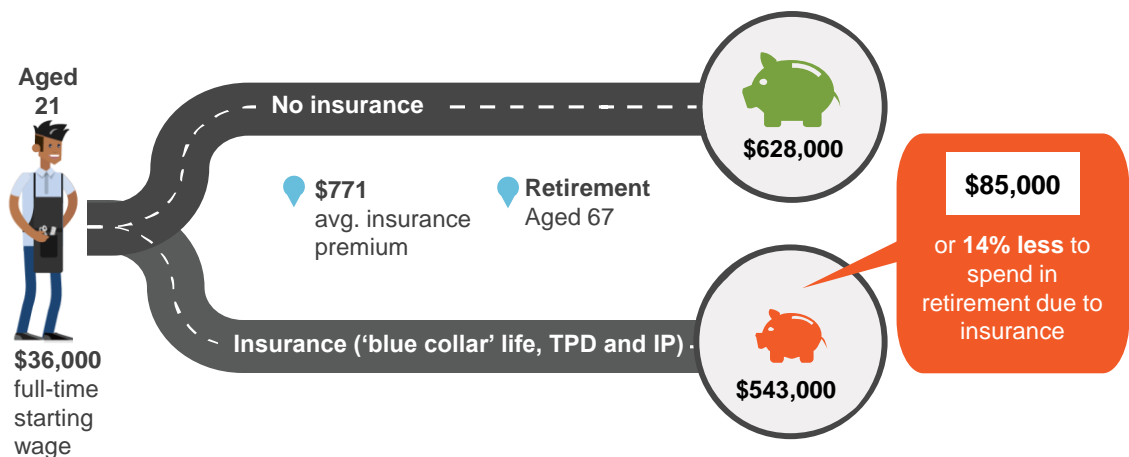
(not least because the latter is often subject to large adviser commissions). Because most of these group policies are provided on an opt-out basis, the large share of low-risk members in the pool acts to keep premiums down for everyone. Some have argued that insurance in super has been a key factor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

Super problem: Insurance = 2.5 years' lost pay



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.

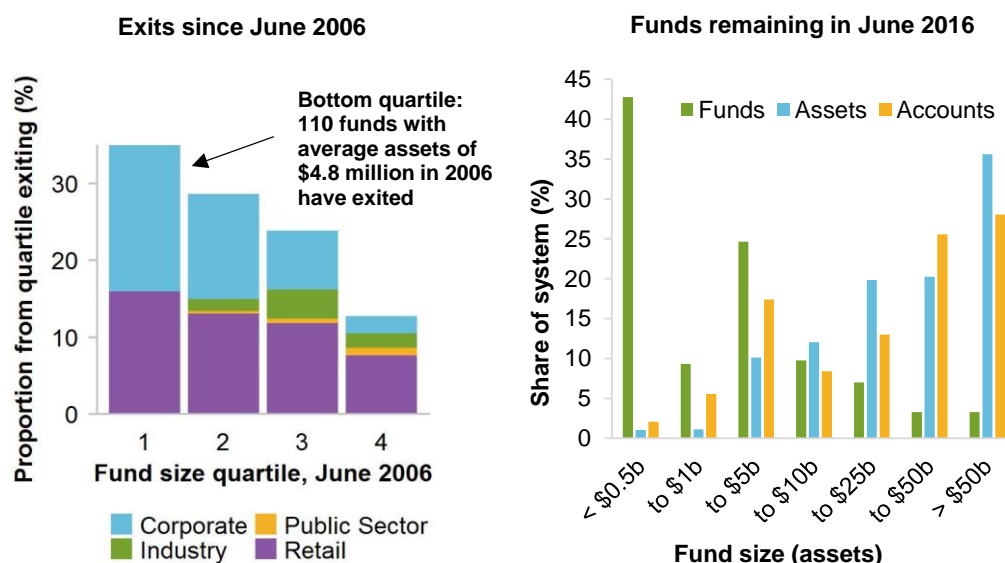
In the default segment, competition is at best superficial. Members who default are typically disengaged and exert no competitive pressure — there is limited or no competition *in* the market. As a result, any competitive pressure within the default segment has to come from competition among the funds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

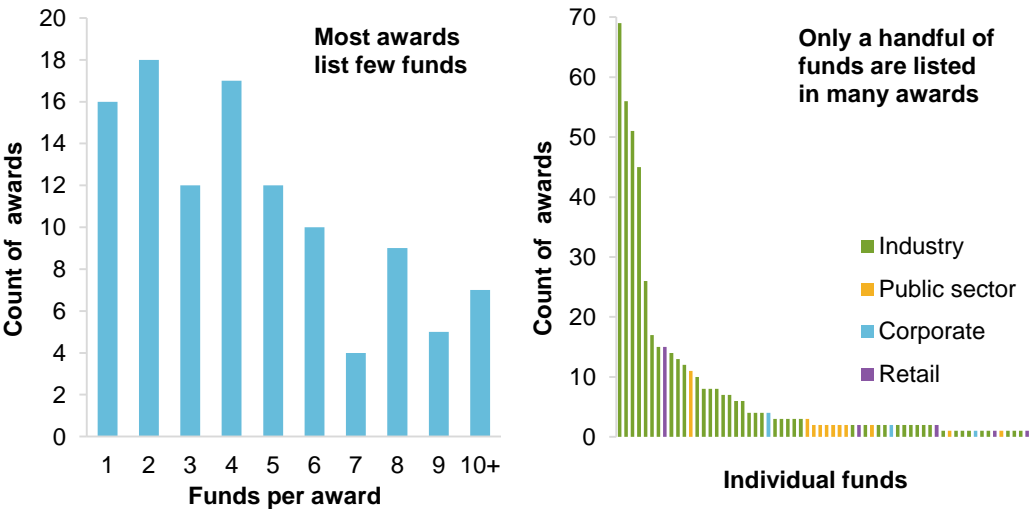
But member outcomes are too variable. Current policy settings fail to ensure members are placed in the very best funds, with significant consequences for members' balances and ultimately their wellbeing in retirement (at the extremes, there are 6 million member accounts in top-performing MySuper products 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

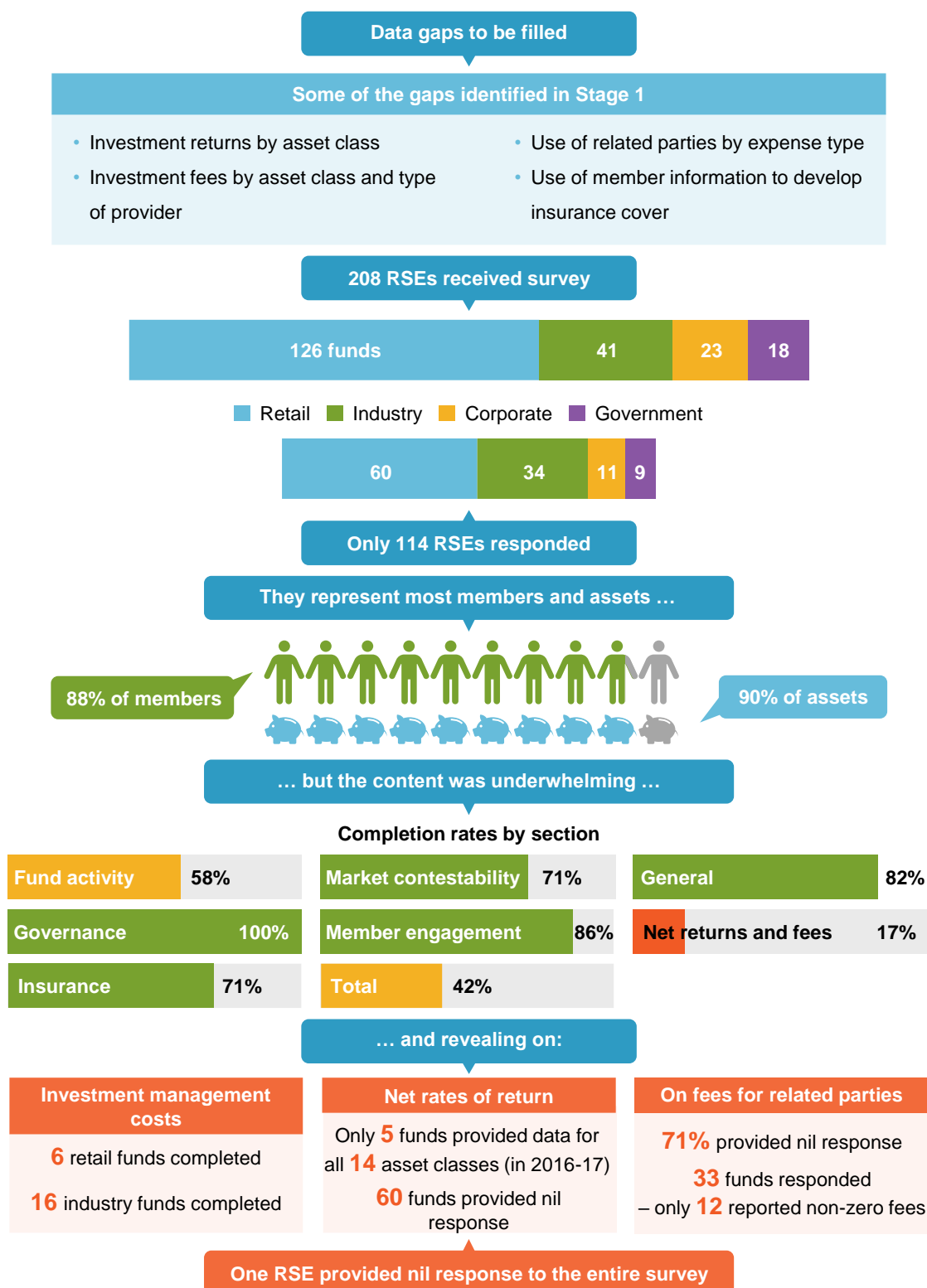
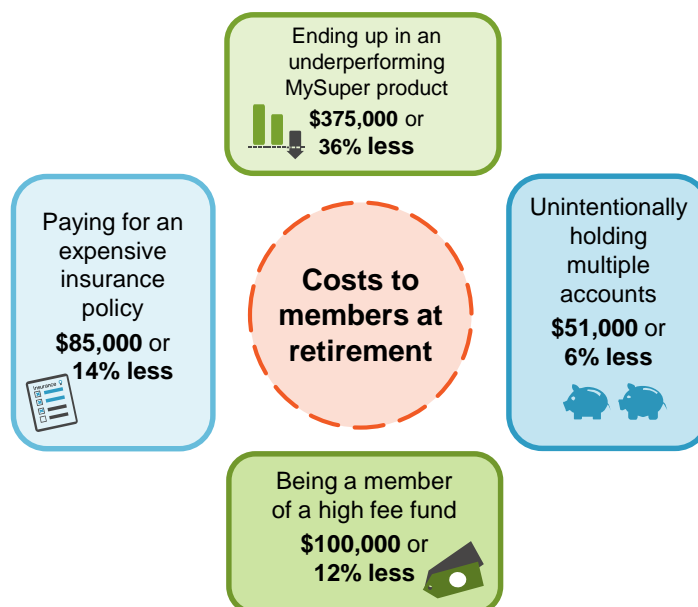


Figure 11 **The character of member harm**

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

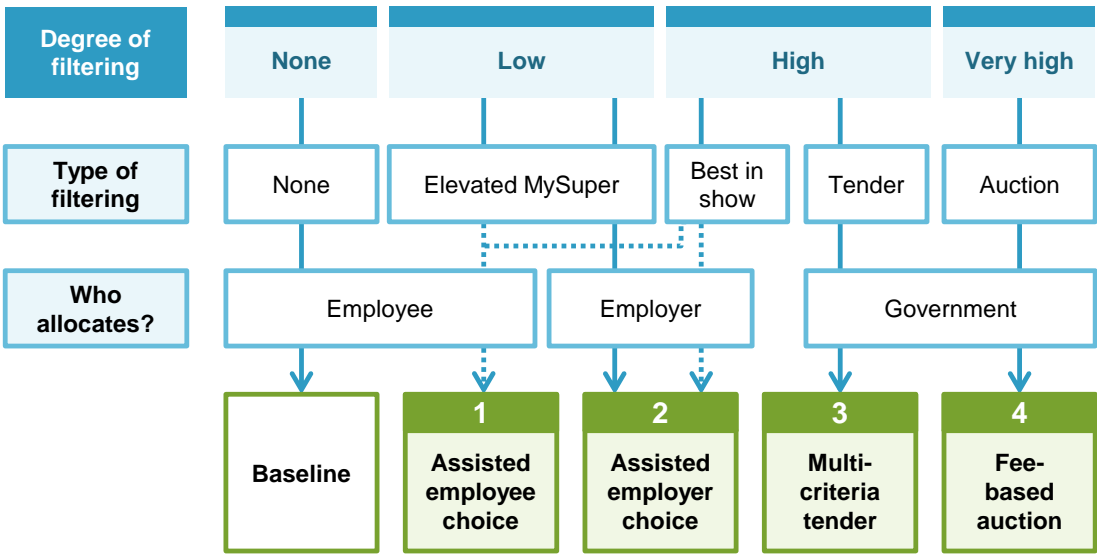
In a world of compulsion the onus is on government to ensure that default super is the system exemplar, mitigating the costly (and highly regressive) twin risks for a default member: defaulting more than once or into an underperforming product.

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.