

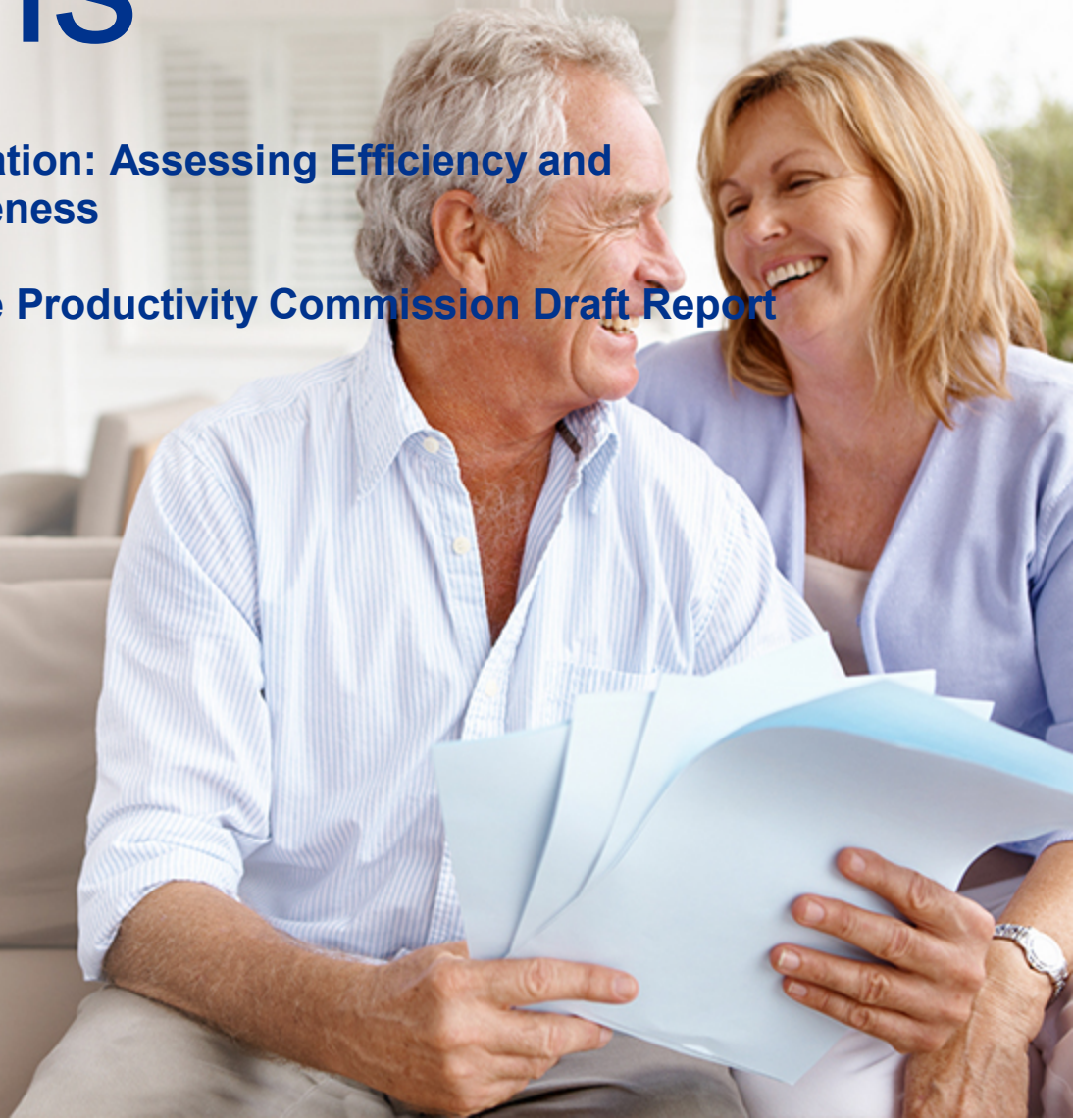


# KPMG Observations and Recommendations

**Superannuation: Assessing Efficiency and Competitiveness**

**Stage Three Productivity Commission Draft Report  
(April 2018)**

July 2018



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**Superannuation: Assessing Efficiency and Competitiveness – Stage Three Productivity Commission Draft Report (April 2018)**

KPMG welcomes the opportunity to respond to the Productivity Commission’s Draft Report (“Draft Report”) in relation to *Assessing Efficiency and Competitiveness* in the Superannuation System.

KPMG would like to congratulate the Productivity Commission (“the Commission”) in relation to the depth of the analysis undertaken and supports a number of the recommendations contained within the Stage 3 Draft Report (“the Draft Report”), however, has some concerns in relation to the impact of some of the recommendations on the structural nature of the superannuation system.

KPMG is supportive of measures that assist in:

- The removal of underperforming funds from the superannuation system;
- The use of a broad range of measures to assess the performance of superannuation funds;
- Better disclosure of superannuation fund data to assist members with fund comparisons; and
- The targeting of insurance products aligned with that proposed within the Insurance and Super Working Group paper.

KPMG provides more detailed comments to the Draft Report in the following section *KPMG Observations and Recommendations*. Our submission focuses upon the “Draft findings, recommendations and information requests” section of the Draft Report.

KPMG would be pleased to provide further information to assist you in the refinement of the Productivity Commission’s final paper and recommendations.

Should you require further information or have any questions please do not hesitate to contact Peter Bentley.

Yours sincerely,

**Adam Gee**  
Partner,  
Superannuation Advisory

# KPMG Observations and Recommendations

Superannuation: Assessing Efficiency and Competitiveness – Stage Three Productivity Commission Draft Report (April 2018)

## Investment Performance

KPMG recognises the modelling undertaken by the Productivity Commission (“PC”) as a strong methodology for assessing investment performance across the superannuation industry.

Based upon broader industry analysis by research firms such as SuperRatings, it is evident that there continues to be divide in investment performance between retail funds and industry/profit for member funds. KPMG continues to believe, however, that comparisons between different segments of the market are generally irrelevant as there is evidence that both sectors of the market have some constituents that perform better than others over different timeframes and market conditions. As noted within the Draft Report, KPMG supports the notion that there are a number of funds that have underperformed broader medians and default asset allocation benchmarks, which continue to receive default contributions, resulting in poorer outcomes for disengaged members.

KPMG is also supportive of the framework noted within the Draft Report, which discusses the assessment of investment performance which is net of all fees (including investment and administration fees) and net of all taxes as this is the true representation of the benefit that is delivered to a fund’s members. We also agree that this should be the manner in which investment performance should be assessed across all disclosure material created by superannuation funds and included within the data reported to Regulators and to members via dashboards or the like. We believe this will facilitate greater transparency within the system by ensuring the disclosure to members is consistent with member statements.

In spite of our agreement with the use of net investment performance as the key assessment of a fund’s success, we note that one of the key challenges associated with this is that funds will often seek to provide members with strong risk-adjusted returns (particularly those members with larger balances or those nearing retirement). On this basis, we suggest that it would be prudent to include some form of risk-adjusted return metric within any key assessment criteria used to assess the success of a superannuation fund’s investment performance. Metrics such as Sharpe Ratios or Sortino Ratios have been utilised by some in the past, however, we recognise the challenges associated with these, particularly in getting members to understand exactly what these measure.

### ***Information request 2.1***

We believe that the assumptions that underpin the Commission’s benchmark portfolios are sound, albeit there are some additional factors that will impact the performance of funds under certain segments and market conditions.

### **Information request 2.2**

KPMG believes that there are a number of additional factors that explain differences in investment performance between funds and different segments of the market.

The key area is the manner in which funds account for risk within their investment portfolios, particularly where members of a particular fund have an older demographic or a higher average account balance, which may result in members being less prone to taking on risk. In this instance for example, the fund may seek to reduce risk through the use of protection strategies to defend against potential downward market corrections or may seek to invest in certain stocks within asset classes that have lower than average risk characteristics. We note that this is evident for a number of funds within the industry, which, when compared on a pure net performance basis appear to underperform, however, on a risk-adjusted basis, provide better than average outcomes for members.

As per our comments above, we therefore believe that it is imperative that any measure that assesses the success of the investment outcomes delivered to members has a reasonable account for the level of risk taken to achieve returns.

## **Fees and costs**

We agree that the reporting of fees and costs by superannuation funds (and the Regulators) requires significant additional focus to help members to better compare what they are being charged.

In terms of Draft Finding 3.2, KPMG remains concerned that there remains challenges with international comparisons given the structure of the Australian superannuation system is materially different to those operating within other jurisdictions. Similarly, KPMG continues to believe that a pure focus on fees does not always deliver strong outcomes to members, as has been demonstrated recently within the Chilean pension system, which ran a fee-based auction to determine the successful recipient of default contributions for the country's members. To this end, it is KPMG's view that net investment performance outcomes should be the key determinant of a fund's success with a lower emphasis on the fees charged to achieve these returns. To this end, KPMG supports the PC's views that net investment performance, rather than fees, should be the key assessment criteria for a fund's success.

Aligned to this, and one area in which KPMG disagrees with the findings of the PC within the Draft Report, is in relation to Draft Finding 3.4, which suggests that "higher fee funds are clearly associated with lower net returns over the long term". KPMG agrees that those funds with higher administration fees will generally deliver lower net returns (given administration services are unlikely to result in any uplift in investment performance), however, based on a range of net investment performance surveys (such as those provided by research houses such as SuperRatings), it is evident that many funds with higher investment fees (often related to investments within asset classes that charge higher fees but deliver better performance) have delivered well above average returns to fund members. As noted above, KPMG supports the use of net investment performance as the key measure of success, rather than any focus on the level of fees charged to members, particularly where the higher fees may be a result of accessing better performing assets or asset classes.

## Members' needs

We note that there are a number of findings in relation to member needs and believe that the majority of default member needs can be met through a simply designed accumulation product, albeit the choice segment should continue to operate in a manner that provides greater flexibility, driven by specific member demand and needs.

KPMG also agrees that the level of information provided to members through Product Disclosure Statements, product dashboards and information provided by the Regulators does not assist members in making active decisions in relation to their superannuation, given that much of this information is inconsistent and is very rarely aligned to members' needs. To this end, KPMG believes that, at a minimum, disclosure information provided to members, whether it be via the Product Disclosure Statement and supporting materials or, the Product Dashboard, should be consistent and provide sufficient information to enable members to engage with, and make choices in relation to, their superannuation benefits.

In relation to a MyRetirement default product, KPMG is of the view that funds should be able to determine the appropriateness of the retirement products that they offer to their membership base, rather than a default product necessarily legislated that could potentially meet all members' needs. KPMG notes that, in the past, some funds have attempted to offer a 'one-size-fits-all' retirement product, however, these were overly complex, generally expensive and as such, resulted in a very low take up. KPMG believes that a range of products could be offered by superannuation funds in order to meet member retirement needs, whether this be through the combination of an account based pension, term annuity, lifetime annuity or deferred annuity, however, none of these should be mandatory, nor should members be forced to commence any of these products upon retirement. In essence, KPMG believes that funds should offer a broad range of products, supported by high quality, non-conflicted financial advice, to assist members in choosing the best product, or combination of products, appropriate to their individual circumstances and needs.

### **Information Request 4.1**

KPMG notes the Draft Report's Draft Finding 4.3 in relation to lifecycle products only being offered within the choice segment, rather than within default arrangements. We believe that lifecycle continues to be an appropriate default arrangement for funds with highly disengaged membership bases, who are unlikely to make choices for themselves during their lifetime within superannuation.

Whilst the modelling undertaken by KPMG in relation to a comparison between the average lifecycle investment option and the average standard 'balanced' default investment option (based on the achievement of appropriate CPI+ investment objectives) illustrates that members will generally achieve higher overall outcomes in a balanced investment option, we do believe that for those members that remain disengaged, the de-risking of the investment option in later years in life is likely to protect these members from large balance drawdowns.

Conversely, for funds with highly engaged member bases, we believe that the use of a 'Balanced' default remains appropriate as these members should be appropriately engaged to make an active choice to de-risk their investment portfolio at a time that they feel is appropriate based upon their individual needs.

To this end, KPMG believes that for some funds, a lifecycle default remains appropriate, whilst for others, a 'Balanced' default is also appropriate, such that no change to the current system is required.



## Member engagement

KPMG broadly agrees with the majority of the Draft Report's findings in relation to member engagement, with the exception of Draft Finding 5.2, which suggests that "Demand-side pressure in the superannuation system is relatively weak".

Having undertaken a number of reviews for employers in recent years, KPMG believes that within the employer default superannuation segment, competition between a number of players within the profit for member and retail segments of the market remains substantial. Whilst we recognise that this has not necessarily translated into all segments of the market, we note that competition within this sector is significant.

## Erosion of member balances

KPMG also agrees with the majority of findings in relation to the erosion of member account balances and notes that the industry, subsequent to a number of policy announcements within the 2018 Federal Budget and recent draft legislation, is being driven down a path of greater account consolidation which will drive better outcomes for members as a whole. KPMG notes that the amendments announced in relation to the removal of multiple accounts, proposed changes to insurance as well as better engagement of members will play a material role in ensuring members interests are protected.

On this basis, we do not believe any additional changes are required in relation to this area.

## Market structure, contestability and behaviour

KPMG also recognises a number of the findings emanating from the Draft Report and has similar concerns, particularly in relation to the concentration of certain service providers within the industry as well as many of the challenges that vertical integration has led to in relation to member outcomes.

We note the comment that minimal cost efficiencies have been delivered by individual funds within Draft Finding 7.5, but believe that this is largely attributable to the raft of legislative change, compliance costs and expenditure on a raft of member-centric changes to superannuation, such as digitisation, member education and other associated services. KPMG believes that in time and with a greater number of fund mergers likely to occur in the coming years, further efficiencies will be realised by individual funds, assuming minimal material legislative changes occur in the short to medium term.

### ***Information request 7.1***

KPMG notes that there are a range of costs associated with the merging of two superannuation funds, with the total cost often a barrier for many funds that must consider total operating costs when acting in the best interests of members.

In terms of costs, the main costs are due diligence costs, such as financial, legal and commercial whereby each fund will need to understand the complexities of the other fund and whether there may be any issues that might compromise the funds merging (such as issues with either fund's constitution, financial complexities (such as tax considerations) or challenging investment arrangements that one fund may not be keen to take on).

These items are generally all considered pre-merger and once the trustees of the respective funds have agreed that there are no material issues, there will be legal costs involved in drafting the respective merger documentation surrounding the legal structure of the merged entity, the benefits to be offered and the design of the merged entity.

Costs will then be incurred in assessing existing service providers and undertaking tenders for future providers where these are not common between the funds. Material communication costs are also incurred throughout the merger process as members must be informed regarding the process, impact and timing of any merger.

In addition to these, there are also the internal costs of having staff involved in meetings, due diligence work and ongoing discussions during the merger in order to agree specific processes and procedures, which haven't been factored into the above numbers.

In KPMG's experience, the costs associated with undertaking a merger are generally not materially dis-similar when looking at the size of the merging entities as the same processes are usually required for a merger, regardless of size. Additional costs are often seen as a result of greater complexity of a fund's arrangements, such as alternative investments, defined benefit obligations, reserves or different operating structures.

### ***Information request 7.2***

Whilst some merging funds have experienced reasonable economies of scale as a result of merger activity and have passed these on to members via reduced fees, it is KPMG's view that much of these cost savings or efficiencies have been expended by funds in other areas of their operations.

As noted previously, funds have increased expenditure materially in areas such as legislative change, risk and compliance as well as data analytics and member engagement tools, many of which have resulted in cost savings to members appearing to have not been passed on to members via fee reductions.

This may have therefore masked the passing on of cost savings or efficiencies as a result of successful fund mergers.

## Insurance

KPMG has been quite forthright in relation to insurance within superannuation and has produced a number of papers which outline our support for the changes announced within the Insurance and Superannuation Working Group (“ISWG”) Code of Practice.

KPMG remain concerned about the proposed changes to insurance announced within the Federal Budget in May 2018 and the unintended consequences that may emanate from these proposals.

We provide the following links to KPMG’s papers on these matters and would be happy to discuss these with the PC, as required:

### **Review of default group insurance in superannuation**

<https://home.kpmg.com/au/en/home/insights/2017/09/default-group-insurance-superannuation-review.html>

### **Insurance in superannuation: The impacts and unintended consequences of the proposed Federal Budget Changes**

<https://assets.kpmg.com/content/dam/kpmg/au/pdf/2018/insurance-in-superannuation-impact-2018-federal-budget.pdf>

Furthermore, KPMG notes the following comment within the Draft Report:

*“KPMG (2017) estimated that removing insurance from multiple accounts would only have a modest effect on the average level of balance erosion because it assumed that a large share of duplicate accounts were likely to be very small balances (less than \$1000) resulting in multiple insurance policies being limited by exhaustion (or triggering of a fund cessation rule). However, this assumption is implausible. First, ATO data indicates that in 2016-17, around 50 per cent of members with duplicate accounts had less than 90 per cent of their total balance in their main fund. This, coupled with data that shows that members with multiple accounts on average have similar total balances to members with a single account (chapter 6), suggests that many multiple accounts have non-trivial balances. Second, the persistence of multiple accounts across all ages (figure 6.5) suggests that duplicate accounts are not being exhausted.”*

We make the following comments to clarify our position in relation to this:

We believe that the comments made by the PC on the KPMG report are inaccurate. KPMG did not make the assumption that “a large share of the duplicate accounts are likely to have very small balances”. The APRA data indicates that approximately 30% of all accounts have an account balance of less than \$1,000 and our model point file reflects this fact.

The draft PC report questions KPMG’s conclusion that removing duplicate accounts has a marginal impact on benefit erosion. Logically, removing duplication would have a significant impact if insurance premiums were able to be deducted from duplicate accounts for a long period of time. However, the data from APRA and the ATO when considered together indicates that in a typical scenario, a member would have a non-trivial main account balance but very small duplicate account balances.

Typically, a member who would have 3 accounts, and a total account balance of \$80,000. 90% of the balance would be in the active account (\$72,000) and each of the other accounts would have significantly smaller account balances. In our model, each of the duplicate accounts would have \$4,000 each. We believe this example is not inconsistent with the PC’s observation that members with more than one account have similar account balances to members with one account.



In terms of the PC specific comments:

- (a) 50 per cent of members with duplicate accounts had less than 90 per cent of their total balance in their main fund.

This is not inconsistent with the KPMG model point file or our findings. The APRA Statistics indicate that the distribution of account balance is highly skewed. Specifically, there are a large number of accounts with very small account balances - 30% of all accounts have an account balance of less than \$1,000.

- (b) Members with multiple accounts, on average, have similar total balances to members with a single account.

This statement is not inconsistent with KPMG's findings as noted above.

## Fund Governance

KPMG recognises that the Federal Government has been attempting to pass legislation on a number of occasions in order to introduce the requirement for trustee boards to maintain at least one third of board positions as independent directors. Whilst this has yet to pass through parliament, KPMG believes that it is more imperative to first have a specific definition as to what constitutes an Independent Director for superannuation trustee board purposes before attempting to legislate a certain percentage of independent directors on a board.

Furthermore, KPMG agrees with the Draft Report finding that funds should maintain an appropriate level of skills and experience to ensure that, as a whole, the board is able to appropriately meet their responsibilities to fund members. KPMG does not necessarily believe that this must be achieved through a structure that utilises at least one-third independent directors, however, believes independence of mind and thought is the most appropriate test.

KPMG is also supportive of the finding that boards should undertake a regular assessment of performance to ensure they continue to meet their fiduciary responsibilities in relation to members.

## System Governance

KPMG remains supportive of the proposed 'member outcomes test', which is contained within the Treasury Legislation Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill.

Specifically, KPMG believes that this should form the key tenet for the ongoing viability and sustainability of funds going forward. This should provide the impetus for APRA to be able to cancel a fund's MySuper authorisation should the trustee not be able to demonstrate that it is achieving the outcomes that it set out to over the assessment period(s).

Whilst this will be discussed later within our submission, KPMG believes that, rather than the introduction of a 'Best in Show' list of up to 10 funds, the member outcomes test should be utilised to assess funds against an 'elevated' MySuper authorisation. This would allow only a certain number of funds to accept default contributions going forward by ensuring that a broader number of strongly performing funds would continue to exist within the industry, which would drive continued competition, whilst also removing a number of underperforming funds from the marketplace.

### **Information request 10.1**

KPMG believes that the current regulatory focus areas of APRA and ASIC remain appropriate and that the use of the new Australian Financial Complaints Authority (with appropriate funding) will lead to strong outcomes for members and trustees.

KPMG also believes that the regulators need to play a more forceful role in removing underperforming participants from the industry, rather than continuing to allow these players to participate, regardless of the respectively poorer outcomes that they are delivering to members. As noted above, we believe the member outcomes test is a strong positive step to assist in this regard, however, APRA must enforce the requirements of this test to remove underperforming funds from the system.

## **Competing for Default Members**

KPMG remains concerned with the proposals in relation to the use of a 'Best in Show' shortlist of default funds for new members as well as the use of an independent expert panel to determine which funds should sit on this shortlist.

Whilst KPMG agrees with the Draft Report findings in relation to the fact that there are a number of underperforming superannuation funds that continue to be eligible to receive default contributions, we believe that the use of a shortlist of funds as described within the Draft Report could lead to a number of challenging outcomes, including:

- A reduction in competition across the sector;
- The removal of tailored products (mainly insurance-related) that meet the needs of a certain member demographic or industry segment;
- An increased level of risk-taking with regard to investments by some funds to ensure they remain on the shortlist, or gain access to the shortlist at subsequent assessment dates;
- The potential removal of non or limited public offer funds from the superannuation system;
- The possible impact of dis-economies of scale as a small number of funds become materially larger, resulting in potential servicing challenges and/or administrative inefficiencies; and
- The potential removal of a substantial number of funds and industry players within a very short period of time, which will cause material risks to the overall structure and operation of the superannuation system.

In addition to the above, KPMG remains concerned that the proposed independent expert panel that will oversee the 'Best in Show' shortlist will be extremely difficult to constitute and will also be particularly challenged in assessing a list of up to 10 funds. KPMG recognises that the level of due diligence and analysis required to accurately assess the performance of a superannuation fund requires material investment in time and effort, which may be difficult for an independent panel to offer.

Whilst this has been partly addressed in subsequent industry discussions, the challenges associated with the politicisation of such a panel are real and could create an ongoing burden for the industry.

## Additional KPMG comments

### Elevated MySuper license model

As noted above, KPMG would prefer a model that was discussed at the PC hearing in Sydney in June 2018, which considered the use of an 'elevated' MySuper license to determine 'default fund status' and enable funds to continue to accept default contributions. KPMG believes that the entity best placed to determine which funds would receive an elevated MySuper license would be APRA and that the assessment criteria for such a license should be closely aligned to the proposed member outcomes test, which considers a range of metrics such as net investment performance, cashflow and fee competitiveness to determine a fund's ongoing viability. This is coupled with whether the outcomes delivered to funds' members are in their best interests.

Under such a model, the number of funds that could be considered appropriate may be reduced from the existing 100-odd MySuper licensed entities to approximately half or even less, with the remaining number of funds being required to compete on a choice basis, given the outcomes they have delivered to default members are unlikely to be within the top half of funds.

KPMG believes that such a model would remove almost all of the potential challenges noted above in relation to the 'Best in Show' shortlist overseen by the independent expert panel and would result in an appropriate uplift in the outcomes delivered to default superannuation fund members, noted within the Draft Report.

### Auto-consolidation of accounts

Through past experiences with the New Zealand KiwiSaver system, which is one of the most efficient retirement income systems, KPMG believes that there are a number of possible learnings that could be implemented within the Australian system to drive further efficiencies and improve outcomes for members.

Specifically, KPMG notes that the KiwiSaver system operates on the basis of an elevated default license, where 8 providers are currently able to receive default contributions. Furthermore, the KiwiSaver system utilises a notion of auto-consolidation of accounts, which results in the automatic rollover of member balances into a single account as soon as an account is opened. Specifically, where a member opens a new KiwiSaver account, a trigger is sent to the NZ Inland Revenue Department (which is effectively the ATO equivalent) requesting a rollover of any other KiwiSaver accounts automatically, such that members only ever have a single retirement account.

KPMG believes that such a system, if introduced into the Australian context, would almost immediately remove the multiple account issue, which has caused many issues to date within the current system. This would ensure that members maintain only a single account for their retirement needs. The only challenge associated with the introduction of such a structure within Australia is insurance. The KiwiSaver system does not offer default insurance to members and as such, the cancellation of an account and subsequent consolidation of accounts into the new account remains a simple process. In Australia, however, we note that insurance remains a crucial part of the

superannuation system and the automatic consolidation of accounts may present some issues in this regard. Given the recent ISWG Code and Federal Budget announcements in relation to insurance, we do believe that this could be appropriately addressed going forward.

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