

Superannuation

Productivity Commission
Locked Bag 2, Collins Street East
MELBOURNE VIC 8003

13 July 2018

Dear Commissioners,

Thank you for the opportunity to provide feedback on the Productivity Commission draft report titled 'Superannuation: Assessing Competitiveness and Efficiency'. QSuper would again like to thank the Commissioners for the opportunity to appear at a public hearing in Brisbane on 22 June 2018 and is pleased to provide this submission as part of our ongoing engagement with the Commission during its assessment of the efficiency and competitiveness of Australia's superannuation system.

For over 100 years, QSuper has been the default superannuation fund of the Queensland Government, helping current and former public-sector employees and their spouses create a financially secure future. QSuper is one of the country's largest and most respected superannuation funds, with more than \$78 billion in Funds Under Management. On 1 July 2017, QSuper became a public offer fund, opening our doors for all Australians to join.

QSuper congratulates the Commission on the considered and comprehensive nature of the draft report which contains many recommendations that, in our opinion, have the potential to drive some of the most significant changes in the industry's history.

In compiling this submission, QSuper has chosen to respond to the information requests, findings and recommendations where we believe we can provide the most value to the Commission in its completion of the final report.

In particular, QSuper contends in our submission that:

- opportunity cost exists in all default investment options, and QSuper believes that second-generation life cycle products using more than one cohort factor do not forego returns across a member's working life. For this reason, life cycle products are appropriate MySuper and Default fund products;
- the measurement of returns to establish top performers needs to take into account the likelihood of consistently producing high net risk-adjusted returns;
- insurance provided via superannuation is critical in supporting retirement adequacy; and,

- trustees must have the flexibility to consider individual member's circumstances in developing products and services and must at all times act in members' best interests.

I trust this feedback will be beneficial to your considerations and would welcome the opportunity to discuss our submission in further detail. We would also be pleased to share our detailed analysis and modelling with regard to life cycle funds.

Yours faithfully

Michael Pennisi
Chief Executive Officer
QSuper

QSuper Response

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.

QSuper acknowledges the negative effect that unnecessary multiple accounts may have on the retirement balance of members and supports the intent of the Commission, as well as Government and industry, to reduce the number of duplicate accounts.

QSuper believes that any changes to the current system must overcome the negative implications of members continuing in an inappropriate fund on the basis of a lack of engagement with their fund or superannuation in general. Not all funds are able to meet the needs of members at all stages of their life and a fund or product that was appropriate at one time, may not necessarily always be the best fund where a member's circumstances change.

This can be overcome by ensuring that product characteristics of default funds are able to respond to a member's individual circumstances rather than simply a 'one-size-fits-all' solution. This, of course, raises the responsibility of fund trustees and would require trustees to consider the makeup of their membership and use data they have on their members to determine the appropriateness of their products and services across members' lifetimes.

Such an approach would support the Commission's recommendation that default funds should be designed with the intent that, unless an individual makes an informed choice, the default fund will remain the member's superannuation fund across their lifetime. This further elevates the importance of the default fund selection mechanism.

The Commission is aware that QSuper is a strong advocate for innovation and in terms of default funds, second generation life cycle funds. We have expanded on our views on this point and the importance of tailored insurance solutions in this submission.

Balance Transfer Model

In response to a request from Deputy Chair Chester during QSuper's appearance at the Brisbane public hearing, we have given consideration to a 'balance transfer model' for a default for life system.

In commenting on this model, our understanding is that a 'balance transfer model' would result in an individual's superannuation balance automatically transferring to a new fund when the individual changes employment (therefore joining a new default fund).

In summary, QSuper questions the benefits of such a model on the basis that:

- such a model would likely further entrench disengagement towards superannuation as the automatic transfer to a new fund when employment changes could be further seen as disempowering individuals from having an active role in their superannuation;
- is likely to result in confusion for individuals as superannuation fund membership could change quite regularly for some given average job tenure in Australia is three years and four months¹;
- there may be unintended insurance outcomes which can be dependent on a member's individual circumstances;
- transitioning between two funds that provide a similar one-size-fits all proposition may not deliver any additional benefit to the member and therefore would not outweigh the issues raised above;
- fund transaction costs would increase to facilitate the ongoing transfers, with the costs borne by remaining members;
- finally, some funds such as QSuper, return the tax provisioned during the accumulation phase to members when they commence a Pension account. In QSuper's case, this is called the Income Account Transfer Bonus. The amount returned will typically depend on the length of time the member has been with the fund and the performance of growth assets within the fund. In a 'balance transfer default' system access to such a facility may be significantly impacted where a member's superannuation balance is transferred to a fund that does not provide such a benefit, or where the member's balance within the fund in question is only recent, the potential 'tax refund' to the pension account would be quite small.

For these reasons, QSuper does not support a 'balance transfer' model.

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.

QSuper supports the Commission's intent to lift the standard of default products and contends that a range of factors contribute to improving members' retirement outcomes. QSuper therefore endorses a holistic approach to the default selection process - one that recognises overall member value as the primary goal and supports a diverse range of measures being used in fund assessment.

¹Source: HILDA, Department of Employment

In particular, QSuper supports the Commission's position to include member engagement and intra-fund advice provision in any selection criteria. Over 6% (approximately 35,000 members) of QSuper membership attended one of the Fund's seminars in 2016/2017, with approximately 4% (more than 20,000 members) receiving personal or intra-fund advice. These numbers clearly indicate that the complete range of education and advice services are valued by members. QSuper contends that these services allow members to get the most out of their retirement savings.

Importantly, the selection process by default will define industry best practice and set the design of the industry's future products and services. Consequently, the qualities and features of funds selected as 'best-in-show' will be seen as the benchmark for all funds to manage towards. QSuper contends that any selection process must take care to avoid inadvertently stifling industry innovation through a homogenous selection, as all funds manage/design products to be competitive with a 'best-in-show' criteria.

QSuper contends the criteria should set a high standard that will elevate members' best interests and while comparability is important it should not be simplified or come at a cost to member outcomes. There will be many ways for member outcomes to be achieved and therefore any 'best-in-show' suite of funds should include a diversity of product designs and features as opposed to a similar group of options from different funds.

Consistency of Returns Is Critical

QSuper considers the proposed criteria as reasonable, however recommends expanding some elements further to ensure a member who joins a 'best-in-show' fund can have confidence in that fund being of high quality.

An extract from the draft report states: *"the key focus of the selection process should be on a fund's likelihood of producing high net returns for members"*. QSuper believes this should be expanded to read: *'likelihood of consistently producing high net risk-adjusted returns for members'*.

Because funds do not know exactly when a default member is going to retire or change funds, sequencing risk matters. QSuper argues that measuring consistency of delivering high net risk-adjusted returns will encourage funds to deliver more consistent sets of results, thereby minimising sequencing risk at the point of retirement and delivering similar experiences/outcomes to similar (age, balance, gender) members over time.

Further, consistency of results provides confidence in asset outcomes, allowing members to plan their retirement income and structure their post-retirement spending capacity with more certainty.

Time-weighted returns is the correct measure for asset manager performance as asset managers do not have control over external cash flows. However, members do not experience rolling time-weighted returns, which is the suggested measure for assessing the likelihood of producing high net returns for members. Instead, members experience money-weighted (dollar-weighted) outcomes where ongoing contributions are made, as opposed to single lump sum investments. Therefore, the adopted measure needs to allow for actual member experiences.

Asset-only measures, such as time-weighted returns over a rolling 10-year period, may result in unintended consequences as explained in QSuper's response to Information Request 4.1.

Examples of such unintended consequences are as follows:

- Where a fund had a single good performance year over the last 10 years, that single performance year will remain in a rolling 10-year measure for 10 years. This is evidenced by certain funds currently in the rolling 'top-10' performing funds over 10-years, despite having only had one year in which they significantly outperformed peers. However, the other nine years' performance may have been relatively poor compared to peers.
- Funds just outside the 'best-in-show' list may take large risks to get into the 'top 10' at the expense of members should this create an adverse result. This may also mean that funds in the 'top-10' alter their asset allocation to mitigate peer risk (and improve their chances of staying in the top 10) just before the quadrennial review. Neither outcome is based upon providing the best outcome for members.
- Since the Global Financial Crisis (GFC), returns have been extraordinary and well above expectations. As such, most investment risks paid off. However, during the GFC, only those funds who appropriately managed investment risks achieved reasonable returns. Again, using a simple measure such as time-weighted rolling returns over the last 10-year period will result in the GFC performance figures rolling out and returns increasing for funds, especially for those funds that did not manage investment risks well during the GFC. As such, a 10-year return measure should be any 10-year period, not just the last 10 years.
- Rankings for one, three, five, and 10-year rolling returns are dominated by the last year's return and all include the return from the most recent period.

The assessment should rather be done on a risk-adjusted basis. Using a Sharpe Ratio is an example of a risk-adjusted measure. However, it is not an ideal measure as it only considers one type of risk (asset volatility). As such, Sharpe ratios can mask the riskiness of an investment vehicle or strategy during periods of subdued market volatility.

An alternative approach would be to use a measure of *persistence* (i.e. consistency).

Persistence generally means the ability for an investment vehicle or strategy to provide consistent returns over a long run time horizon (we suggest seven or 10 years), with no individual return dominating the overall compounded return. There are many ways to measure persistence from simple metrics to complicated mathematical inferences, each of which has its own limitations, as illustrated by the examples below:

The persistence example calculations over the page have been performed using data from SuperRatings and Bloomberg, and use annual periods ending June 30 each year from 2011 to 2017.

The SR50 Balanced Index and QSuper – Balanced returns are provided by SuperRatings with a proxy for the Equities market returns using a 50/50 split between Australian and Global Equities calculated from market index returns available on Bloomberg.

For illustrative purposes, two hypothetical portfolios that match the QSuper return stream - one showing 'perfect' persistence and the other 'poor' persistence have been included.

Performance numbers:

Period	SR50	Equities	QSuper	Perfect	Poor
FYE 2011	8.71%	19.04%	10.04%	9.42%	35.00%
FYE 2012	0.45%	-3.12%	6.18%	9.42%	-10.00%
FYE 2013	14.73%	23.83%	9.94%	9.42%	-20.00%
FYE 2014	12.66%	21.06%	12.63%	9.42%	25.00%
FYE 2015	9.60%	8.48%	12.01%	9.42%	30.00%
FYE 2016	2.81%	-0.38%	7.34%	9.42%	11.30%
FYE 2017	10.53%	17.34%	7.94%	9.42%	6.80%
Performance (annualised)	8.39%	11.87%	9.42%	9.42%	9.42%

In FYE 2011, the Poor portfolio would be at the top of the league tables, based upon one-year returns, followed by the Equities strategy. Over the long run, Equities is the top performer with QSuper, Perfect and Poor all tied with 9.42% p.a.

However, this only tells one part of the story – how persistent / consistent were the investment vehicles in generating these returns? Considering each of the metrics outlined below illustrates the impact on the results, together with commentary on the strengths and weaknesses of each approach.

Metric 1 (Count of meeting objective):

The simplest metric would be to count the number of times an investment vehicle met its absolute (CPI + return) objective in any given period. For example, a vehicle might exceed its absolute return objectives in eight years out of the past 10 years.

Under an assumed 6% p.a. objective regime, the SR50 Balanced Index, Equities and the Poor portfolio would score five out of seven, with QSuper and the Perfect portfolio scoring seven out of seven.

While this metric is very easy to calculate it does mask very poor years when members would have suffered significant drawdowns in wealth. Another point to note is that a fund returning 5.99% p.a. each year for seven years would be a great generator of long term wealth but would score a 0 under this metric.

Metric 2 (Distance from objective):

Another straightforward persistency metric would be to look at the difference between the vehicle returns and the absolute return objective and then calculate the distance between these results.

Continuing with a 6% p.a. objective regime the distance can be calculated between each annual return and the objective using the following formula **(annual return – objective)²**. These distances are then summed across the seven years to arrive at a total distance.

Period	SR50	Equities	QSuper	Perfect	Poor
FYE 2011	0.07%	1.70%	0.16%	0.12%	8.41%
FYE 2012	0.31%	0.83%	0.00%	0.12%	2.56%
FYE 2013	0.76%	3.18%	0.16%	0.12%	6.76%
FYE 2014	0.44%	2.27%	0.44%	0.12%	3.61%
FYE 2015	0.13%	0.06%	0.36%	0.12%	5.76%
FYE 2016	0.10%	0.41%	0.02%	0.12%	0.28%
FYE 2017	0.21%	1.29%	0.04%	0.12%	0.01%
Total Distance	2.02%	9.73%	1.18%	0.82%	27.39%

A lower distance number is a more persistent return series when compared to the objective. While this metric is straightforward to calculate it does have a major drawback in that returns above the objective are treated the same way as returns below the objective. For example, a positive 25% return is just as distant as a -13% return when compared to a 6% return objective.

There is very little difference in this metric between the QSuper and Perfect portfolios, but the Poor portfolio has a large distance even though each vehicle returned the same annualised return over the seven-year period.

Metric 3 (Approximating time-weighted returns to money-weighted returns):

A more technical approach would be to use a decaying weighted average approach, where the most recent returns are provided with a higher weighting and older returns have less weighting – this is a crude approximation of the member experience on a money-weighted basis since the last return is upweighted due to the impact it has on the balance including contributions.

This approach seeks to approximate a move from time-weighted returns to money-weighted returns using a simplified approach. The final performance year will take its full return with each subsequent return indexed by a factor of 0.9. The results are shown below:

Period	SR50	Equities	QSuper	Perfect	Poor
FYE 2011	4.63%	10.12%	5.34%	5.01%	18.60%
FYE 2012	0.26%	-1.84%	3.65%	5.56%	-5.90%
FYE 2013	9.66%	15.63%	6.52%	6.18%	-13.12%
FYE 2014	9.23%	15.35%	9.21%	6.87%	18.23%
FYE 2015	7.78%	6.87%	9.73%	7.63%	24.30%
FYE 2016	2.53%	-0.34%	6.60%	8.48%	10.17%
FYE 2017	10.53%	17.34%	7.94%	9.42%	6.80%
Decayed Performance	6.31%	8.78%	6.98%	7.01%	7.66%

The main advantage to this metric is that returns in the past receive less weight to account for an assumed lower account balance (member in accumulation stage) – drawdowns in the past are also less of an impact than drawdowns that happened following significant wealth build up.

The biggest drawback is the difficulty in interpreting the decayed performance number – apart from the final year none of these numbers are observable in the Ratings Agency databases.

Metric 4 (Calculating the persistency via a contribution to return decomposition):

A very detailed and technical approach would be to measure persistency by looking at each period's contribution to the annualised return over the long run time horizon and then calculating the standard deviation of these period contributions. For example, an investment vehicle that generated 9.0% p.a. returns by generating 9.0% each year would have a persistency score of 10 (perfect persistency) whilst a fund that generated this return with large returns in some years but no or negative returns in others would have a persistency score that was much lower (poor persistency).

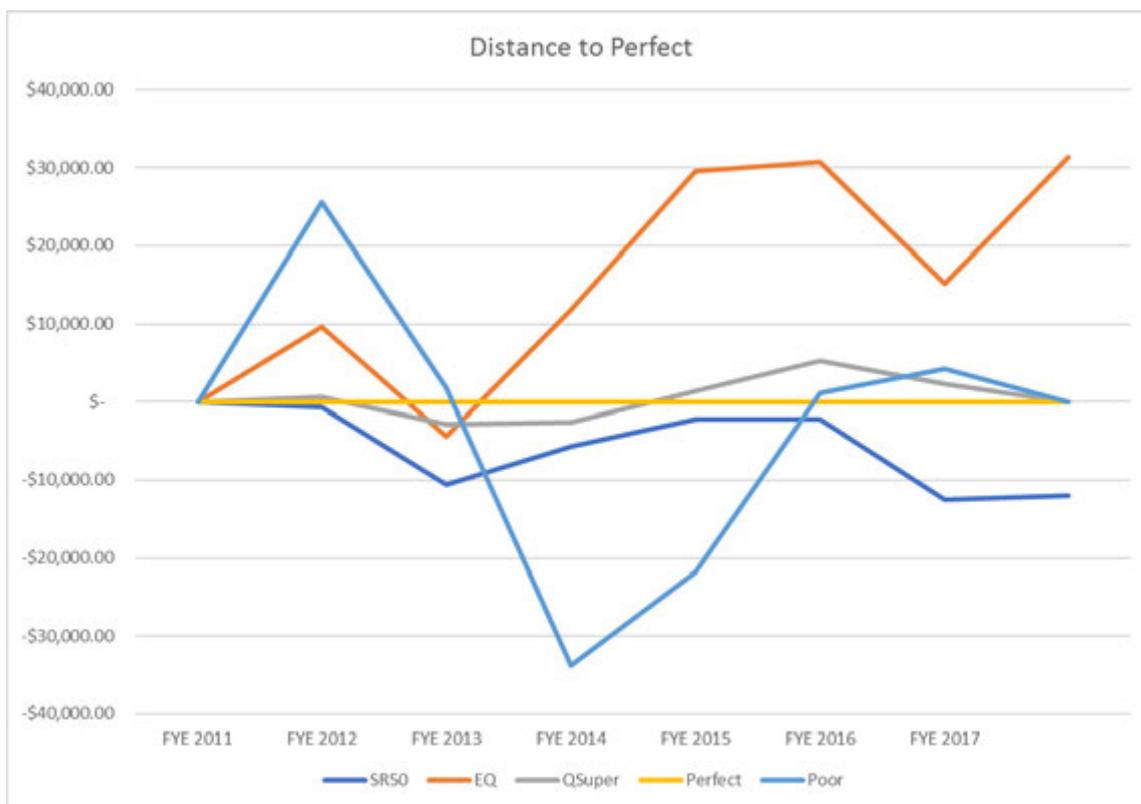
This is the most complicated approach to the calculation and involves a geometric decomposition of the contribution of return through time. Noting that the standardised persistency score (0 to 10) is easy to understand, however the mathematics required to determine the score is complicated. This approach is mathematically precise but requires the score and the annualised performance to be read in conjunction to ensure the correct conclusions are drawn. All information calculated comes from readily available performance data, with no assumptions required. The only drawback is the understanding of the decomposition calculations which is mathematically consistent but complex.

Performance contributions and Persistency results:

Period	SR50	Equities	QSuper	Perfect	Poor
FYE 2011	8.71%	19.04%	10.04%	9.42%	35.00%
FYE 2012	-4.21%	-11.65%	-1.95%	0.00%	-24.77%
FYE 2013	3.31%	5.22%	0.61%	0.00%	-11.17%
FYE 2014	1.19%	2.05%	0.97%	0.00%	5.93%
FYE 2015	0.12%	-1.27%	0.46%	0.00%	4.58%
FYE 2016	-1.08%	-2.42%	-0.47%	0.00%	0.29%
FYE 2017	0.35%	0.89%	-0.25%	0.00%	-0.44%
Performance (annualised)	8.39%	11.87%	9.42%	9.42%	9.42%
Persistency	2.51%	5.78%	1.05%	0.00%	11.71%
Persistency score	7	4	9	10	0

Metric free alternative

A final and metric-free alternative approach looks at the sequencing risk of investment vehicles with similar returns, but different levels of persistency. In this example, each vehicle begins with \$100,000 at the beginning of the FYE 2011 – the graph below shows the difference between each investment vehicle and the perfect one.



QSuper acknowledges potential challenges around communications and understanding of measures. However, this should not take precedence over better member outcomes.

QSuper does not support a framework that ranks funds. Rather, selection criteria and subsequent communication of the 'best-in-show' should seek to identify a number of funds that comply with the highest standards of governance. Every new entrant to the workforce should feel comfortable to choose any one of the funds on a 'best-in-show' list, without any inference that #1 is 'better' than #8. QSuper's response to Information Request 4.1 is relevant in this regard.

In conclusion, QSuper believes that there is no single metric that can be used in isolation to determine which funds are consistently high performing and have a high degree of persistency in their returns. QSuper would be happy to work with the Productivity Commission to develop appropriate metrics to capture the various considerations required to appropriately assess member outcomes as part of developing 'best-in-show' criteria.

Draft Finding 4.1:

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

Information Request 4.1:

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

Should life cycle products continue to be allowed as part of MySuper?

QSuper strongly endorses the use of fit-for-purpose second-generation life cycle products as part of MySuper. Life cycle strategies provide the means through which trustees in Australia can exercise their fiduciary duty to act on behalf of default members.

Clarification of life cycle funds

The Commission's assertions regarding opportunity cost relate to first generation (traditional) life cycle funds and is constructed on two premises:

- Investment risk levels commence at standard levels of Balanced funds and decline with age to reach a minimum around retirement age.
- Age is the only factor used to vary investment strategy.

QSuper does not advocate this first-generation de-risking life cycle as a default. However, there are more advanced life cycle funds, which QSuper has adopted and would recommend as best practice for designing default defined contribution solutions.

Opportunity cost

It is important to point out that opportunity costs exist in everything, even a Balanced fund. With hindsight, a Balanced fund has been a relatively poor outcome over the last five years. Instead, funds should have been invested in very high-risk assets. This raises the question why a 70/30 Balanced Fund has been adopted for comparing the performance of life cycle funds rather than a 100/0 full growth exposure fund, as this would have derived the best asset-based return.

Rather than accepting a single one-size-fits-all risk level, strategies should be more targeted and accept lower risk for only those members that warrant it. The 'de-risking' opportunity cost thesis does not apply to more advanced life cycle funds where risk-adjusted outcomes are targeted. The majority of QSuper Lifetime (MySuper) members below age 50 have 100% growth assets.

Evidence on returns

QSuper's second-generation (advanced) life cycle approach resulted in 77% of QSuper Lifetime members accruing higher or equivalent (within 1% pa of the Balanced Fund) returns for the period since inception. This has been an exceptional period in markets and returns have been high, well above equilibrium expectations. At the same time, volatility has been quite low. This reflects the importance of raising asset risk for members with a plausible tolerance (asset/liability funding basis), rather than simply lowering asset risk as members age as many simple life cycle funds do.

The other 23% of QSuper's Lifetime members had outcomes which, by design, managed risks of transition to retirement income close to retirement. This is key, resulting in proper risk setting early and around retirement across the life cycle. On a risk-adjusted basis, Sharpe ratios were exceptionally high compared to the Balanced Fund for all QSuper Lifetime members.

QSuper would welcome the opportunity to further demonstrate our advanced modelling and analysis with regard to life cycle funds.

Purpose of superannuation

The (draft legislated) purpose of the superannuation system is to provide an income in retirement to support or supplement the age pension entitlements. It is this point that often gets overlooked when assessing life cycle performance on an asset only basis.

The best basis for comparison of strategies is members' prospective wellbeing (income and the ability to fund their liabilities). Many things influence this as much, or more, than asset returns and any measure for the value proposition of life cycle strategies need to allow for this.

If so, do they require re-design to better cater for the varying circumstances of members nearing retirement, and how should this be achieved?

Offering tailored investment solutions for default members through advanced life cycle strategies provides a sound way for funds to manage the default members' best interest. Using improvements in member data and technology, larger better resourced funds can be challenged to create improved, more individualised solutions.

Life cycle is more suited to default because it empowers trustees to act. Trustees should be challenged to do the right thing for members, based on sound principles. Comparability should be a secondary consideration. QSuper is doing this and is seeking to improve on it continuously.

Considering life cycle investing in its second-generation (and beyond)

The standard analysis frames risk in terms of asset returns and account balances only (asset volatility). Wealth maximisation at an assumed retirement age is not aligned with the superannuation system objective of providing income streams in retirement to substitute or supplement the Age Pension.

There is rich literature regarding the use of life cycle strategies. The generic life cycle approach varies investment strategy by reducing investment risk by age. However, a growing number of philosophies and strategies fall under the broad 'life cycle' terminology, including 'goals-based investing'. This next wave of thinking draws on these premises:

- The objective of advanced life cycle funds is to maximise risk-adjusted returns across the life cycle, not simply reduce risk.
- Members face a range of different risks throughout their accumulation lifetime. The behavioural literature reveals evidence that a member's risk appetite and tolerance also change over time.
- Members' risk tolerances, which behavioural research establishes as strongly asymmetric to loss, increasing at later ages when balances and engagement levels are high, and more so for women than men.
- As risks change, so too should strategy. This is not restricted to asset price sequence risk and is influenced by a number of different factors, of which age is only one. Other risks are inflation, real rates (i.e. cost of income), asset volatility, outcome certainty, Age Pension, longevity.
- Life cycle investing should be seen as a risk management tool and not a risk reduction strategy. It is as important to analyse where risk levels should rise as well as fall.
- Life cycles should be responsive to risks changing as members age and accumulate more wealth and these tolerances differ between genders.
- Heterogeneity amongst members demands individualisation.

Australia has been at the forefront of taking up this emerging, richer analysis.

The Superannuation Industry Supervision Act (SIS Act) and the current MySuper legislation contain the 'life cycle exemption' for a superannuation default investment option and prescribe five factors in addition to the single traditional one of age. These allowable prescribed factors are account balance, contribution rate, salary, gender and time to retirement.

MySuper legislation correctly challenges trustees to consider the impact of these factors on a member's retirement outcome. It makes accountability more complex, however it provides greater flexibility for trustees to act where they consider it appropriate for their members.

QSuper's approach to second-generation life cycle investing

Offering tailored solutions for members provides a sound way of managing default members' best interest. Using improvements in member data and technology, larger better resourced funds can be challenged to create improved, more individualised solutions.

The weakness that advanced life cycles address is a single investment strategy across the life cycle being pitched at one level, best suited to all on average; but none specifically. How is this selected? Australia defaults to a Balanced risk level but why is that the suitable level for investors with long and shorter horizons? This is no longer necessary in modern superannuation funds with advanced technology (investment, data, communication and administration) capabilities. Some examples of how modern life cycle strategies empower trustees beyond this is:

- Investment risk can be materially elevated for younger members with lower balances and longer investing horizons.

- Members who achieve high account balances (and consequent lower retirement risk) can remain at risk levels well above Balanced or average throughout their life cycle because they can legitimately absorb sequence risk.
- Members with normal incomes who accrue solid but not high balances can receive some protection from sequence risk later in life. Trustees can also adapt strategy in the knowledge that the means-tested Age Pension impacts the future retirement incomes of these members (a tax on investment returns and a call option on income) and adjust accordingly.
- Women with equivalent account balances to men face effectively lower retirement incomes because of longer life-expectancy. Life cycle strategies enable trustees to tailor strategies to compensate for that.

Link to 'best-in-show' selection criteria

The Commission is proposing a selection process to identify 'best-in-show' funds. One of the criteria canvassed in the draft report is 'identifying and meeting member needs'. Holding basic member data is fundamental to this. QSuper believes it would be easy to include appropriate life cycle qualifying data in any future selection criteria. Funds will therefore need to demonstrate how member information and data is used. This will not relate exclusively to investment strategies, although investment is a key determinant of ultimate outcomes. It should also extend to matters such as personalising insurance and engagement activities.

QSuper Lifetime as an Example

Within Australia, QSuper is leading the adoption of advanced life cycle funds and provides an example of what is possible if trustees accept the challenge of managing these multiple risks. *QSuper Lifetime* commenced in 2013 and is a continuously improving, progressive philosophy that takes into account other factors in addition to age, namely:

- Account balance – The means tested Age Pension may form a material part of a member's retirement outcome and therefore impacts the extent to which the various risks in retirement fall on the member, and the extent to which the member is rewarded for taking investment risk.
- Gender – To date, account balance has been used as a proxy for some factors. However, we have evidence that, within QSuper, males and females accumulate their superannuation balances differently; driven by time out of the workforce and lower salary profiles for females relative to males. In addition, females need higher retirement balances to cater for longer life expectancies compared to males.
- Investment markets – There is scope to adapt all strategies depending on actual performance of investment markets.

QSuper's life cycle product does not 'de-risk'. All members under 50 (long horizons) have essentially 100% growth assets. Risk is elevated appropriately and in future it will become progressively more granular.

Recognition

In 2014 QSuper was presented with the Pensions and Investment Magazine (USA) Global Innovation Award for designing a new product (*QSuper Lifetime*) that ‘incorporated an innovative, tailored investment strategy’. The fund has been nominated for various industry innovation awards for its life cycle strategy. *QSuper Lifetime* was recognised by SuperRatings as the MySuper Product of the Year 2016 and 2017.

What information is needed on members to develop a product better suited to managing sequencing risk?

QSuper accesses all available sources of information when analysing membership to set default investment strategies. This includes behaviours and transactions observed on the administration system and financial planning questionnaires. To operationalise the life cycle strategy, currently two data points are used: age and account balance, which is data that should be available to all funds.

What member data is needed?

QSuper’s life cycle approach enables the setting of investment strategies to manage multiple risks, and not just sequencing risk. QSuper uses the following data to enable this, which most funds should have access to on their members:

- Age - as a result QSuper can infer time to retirement from wider member data. This gives QSuper a time horizon for setting investment strategies.
- Account balance - allows QSuper to project estimated balances at retirement using sensible assumptions about future contributions and investment returns (this is very important for differentiating males and females with interrupted work patterns).
- Gender – males and females have different retirement challenges and risk tolerances as well as different lifetime accumulation patterns.

QSuper’s approach to data and assumptions

In developing *QSuper Lifetime* a data scientist was appointed in the Investments team to analyse:

- More than 20,000 financial planning questionnaires and interviews about assets and debts outside super, household position, activities, risk tolerances, desires, goals and actions by members.
- Activities of members from the administration system in regard to retirement income, retirement age, lump sum and regular withdrawals, propensity to commence income stream, make contributions etc by various member cohorts and gender .
- Actions by choice members in regard to market risk events and switches.

Actions taken as a result of the analysis include:

- Use the information known about members (e.g. age, account balance, salary, contributions, gender) to assist in setting investment strategies.

- Make informed judgement and assumptions about other information for default members.
- Decide when to start adjusting risk profiles.
- Establish whether to have different risk paths for women vs men.
- Consider what risk levels members gravitated to themselves, or when advised by planners to set cohort risk levels.
- Allow for various decisions members make around retirement, including when they retire and whether they will draw down a lump sum or an income, which gives the basis for default accumulation strategies linking to these behaviours.

QSuper does not have access to the following data:

- Members' risk tolerances. However, QSuper has developed rational models through which trustees make decisions about quantifying risk. QSuper supplements this with behavioural research and with focus group and survey feedback from members to get a better understanding of risk tolerances.
- Members' non-superannuation assets. QSuper can infer from industry and member research and make sensible assumptions.
- Age pension eligibility. Through making informed assumptions about the future QSuper estimates the potential impact of Age Pension benefits across given account balances. This has a very material impact.

QSuper advocates using all the knowledge available and engaging with members using technology to find more. It is not necessary therefore to have a financial planning business to access information to make informed decisions about members - it helps but it is not mandatory. A modern life cycle fund allows the trustee to use that extra information as part of a continuous improvement process.

The aim of reform should be to encourage trustees to gather information and understand their members in order to set strategy for them in defaults, which will raise the standards and quality of life cycle funds. If default strategies are fixed, why do trustees need to know anything about their members? QSuper believes that it is indefensible to know a lot about members and not use any of it to differentiate strategies.

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.

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?

The 2013 Stronger Super reforms required that Death and Total and Permanent Disability (TPD) cover be provided on an opt out basis to all MySuper members.

In QSuper's view, these products provide valuable benefits to members, including replacing income to the member (upon permanent disablement) or their dependants (upon death). Our default benefit design is structured in a way that broadly reflects the needs of the average member, and to limit the overall cost of insurance.

QSuper provides default death and TPD cover automatically to all members upon joining the fund under the reasoning of:

- a. on joining the fund, insufficient data is available to know every member's individual situation and determine what cover would be appropriate for their needs;
- b. TPD provides a valuable benefit to members of all ages, as it supports the member's financial wellbeing in the event of their inability to work again, and;
- c. death benefits provide dependants with a capital sum to make up for the loss of the member's future income.

QSuper recognises that younger members are unlikely to require a high level of death cover (as there will be limited dependency at the younger ages) and provides a lower level of death cover than TPD cover to members under age 21. Default death cover increases automatically and without the need for underwriting at age 21.

We acknowledge that younger members with dependants have a higher need for both lump sum death and TPD cover than older members given the longer duration of family dependency in the event of death or permanent disablement. However, data is not currently available to support further segmentation of the default design to provide different levels of cover to younger members with dependants.

Consistent with our philosophy of recognising the changing needs of members throughout their lifetime, we change the level of default death and TPD cover with age.

It should be noted that QSuper allows members to personalise their insurance cover and a member can elect to unbundle death and TPD cover and hold death only, TPD only or any combination of death and TPD cover.

Draft Finding 8.2:

In terms of premiums paid, default insurance in superannuation offers good value for many, but not for all members. For some members, insurance in superannuation is of little or no value — either because it is ill suited to their needs or because they are not able to claim against the policy. Income protection insurance and unintended multiple insurance policies are the main culprits for policies of low or no value to members. Younger members and those with intermittent labour force attachment — groups which commonly have lower incomes — are more likely to have policies of low or no value to them.

Information Request 8.2:

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

QSuper recognises the benefits of Income Protection (IP) insurance within superannuation supporting members who have their work interrupted or ceased due to injury or illness.

Where a member is disabled as a result of injury or illness, the ability to meet living expenses and maintain retirement funding is interrupted.

However, the social security system has limited capacity to provide income replacement due to injury or illness. Members on low incomes (eg. casual/part-time) may often be precluded from entitlements where they have a partner who is also working, despite the fact their income may be fundamental to the family unit's financial wellbeing.

Financial hardship further contributes to disability through increased anxiety/depression and other social impacts (marriage breakdowns etc) often impacting the ability for the member to recover, thereby further impacting retirement funding and increasing the level of TPD incidence.

However, access to adequate financial resources in the event of ill-health assists members to improve their wellbeing. Replacement of lost income can be used to fund medical treatment and other healthy lifestyle expenditure which speeds recovery and/or reduces the risk of further health deterioration.

In QSuper's view, IP benefits can meet the need of both total but temporary disability and total and permanent disability (providing a replacement income stream) by payments to make up for lost income and by making superannuation contributions to ensure long term savings continue to accrue.

Further, IP provides the opportunity for early intervention to assist the member's recovery while maintaining their retirement funding. It is widely recognised that early intervention significantly improves claim outcomes for returning a member to health and work and that a delay in intervention contributes to an increased likelihood of TPD.

Members who return to work as a result of IP claims management support are able to continue independently funding their retirement. The additional retirement funding generated over the member's working life is a benefit generated from IP cover in addition to the income protection payments made from the insurance.

QSuper's default product protects retirement adequacy through a combination of death cover, IP cover and TPD cover while providing full flexibility for members to personalise cover to their own specific needs. Income protection and TPD benefits are integrated with the default IP benefit ceasing in the event a member is paid a TPD benefit. The integrated model recognises that:

- a. determining whether a condition is total and permanent is often difficult and requires time for recovery, for the condition to be appropriately treated and return to work opportunities explored and supported;
- b. financial stress is a significant contributor to poor return to health and work outcomes. IP supports members during their recovery reducing financial stress and continuing the retirement funding through payment of superannuation contributions;
- c. IP provides the opportunity to support return to work initiatives, enabling the insurer to support rehabilitation and retraining where appropriate to improve claims management outcomes, improving member self-funding of retirement benefits and reducing the incidence of TPD. There are other socio-economic benefits from returning members to health and work;
- d. in response to deteriorating TPD experience, on 1 July 2014 QSuper introduced an increased focus on return to work outcomes within IP claims management. and
- e. where a member is unsuccessful in returning to health and work, the IP benefit has essentially provided a retirement benefit meeting living costs and additional retirement funding (additional superannuation contributions).

To complement the return to work focus, QSuper commenced holistic claims management during the second half of 2016. This approach is characterised by early and ongoing engagement with the member, their employer and allied health professionals and considers functional, biopsychosocial, occupational and medical factors to optimise member outcomes.

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.

In relation to insurance provided via superannuation, QSuper restates our contention, made in previous submissions to the Commission as well as Government and industry consultations that:

1. Life insurance remains key to supporting member retirement adequacy;
2. Default insurance under group arrangements within superannuation remains an efficient mechanism to provide insurance, at value, to a large number of Australians; and
3. To meet the trustee's fiduciary duty to act in members' best interest, a meaningful level of default cover is essential.

QSuper's purpose statement is 'to make every member confident that, with QSuper, they can look forward to their best years'. Central to this purpose is ensuring members are adequately funded for retirement, which we believe must include not only growing members' retirement balances, but also protecting them, and their dependents, against the risks that could impact their retirement saving capability. This includes protection against loss of income due to injury, early disability or death.

In this context, QSuper believes life insurance plays an important role in bridging the gap between a member's retirement account today and their retirement 'estimated future value'. Central to this is the provision of income replacement benefits as this 'protects' members for periods where they are not able to earn an income.

By nature, trustees must strike a balance between providing adequate levels of insurance cover and the costs of this cover.

Trustees have a fiduciary duty to act in the best interests of their members. QSuper believes that if trustees are discharging their 'best interests' duty correctly, the adequacy of cover provided is an essential consideration and should not be overshadowed by a focus on cost alone.

This approach is central to QSuper's philosophy on insurance, which promotes the provision of meaningful levels of default cover for members, supported by sustainable premiums and with the ability and support to personalise cover to meet individual circumstances.

Balance Erosion Trade-Off

To guide the development of insurance products for QSuper, the QSuper Board has defined and approved eight design principles, including adequacy and affordability. In making any changes to QSuper insurance benefit design, the design principles are considered in the context of QSuper's membership profile and needs. An explanation of the application of the adequacy and affordability design principles follows.

Adequacy

QSuper believes meaningful cover includes integrated protection (Death, Total and Permanent Disability (TPD) and Income Protection (IP)) that appropriately supports members' ability to return to health where possible, while not inappropriately eroding retirement balances.

As discussed above, this has resulted in QSuper implementing tailored, age-based default levels which provide for lower levels of coverage for younger members, increasing in years when members are likely to have material commitments and responsibilities, before reducing in older ages. This benefit design is complemented by a focus on return to health and income generation. QSuper therefore believes that meaningful cover must have reference to the

quantum of default levels of cover, the type, terms and conditions of the cover provided, where 'value', not cost is paramount.

This view is supported by the member research undertaken when designing our 2016 product in which members affirmed that:

- The Trustee should determine the appropriate safety net of default cover;
- Members should be able to personalise the cover to suit their needs; and
- 93% of members polled supported provision of IP benefits.

Affordability

QSuper's affordability principle tests the impact of premiums on the erosion of members' benefits. This is formally considered when designing insurance benefits and must meet Board-approved levels of appropriateness, taking into account unique member segment characteristics.

It should be noted that the affordability principle and test have resulted in the current default levels of cover being set below the levels the Board would consider appropriate if it was seeking to meet the retirement adequacy principle alone. This demonstrates the importance, interplay and tension between these two design principles.

Market research undertaken to inform the 2016 product design showed that funds were on average charging 17% of Superannuation Guarantee (SG) to provide default insurance benefits.

In common with most of the group insurance sector and prior to 2016, QSuper members had experienced significant premium increases, and the Board required that the 2016 design improve product sustainability of pricing.

Board approved tolerances were established to inform the product design and establish an appetite for average lifetime premium levels expressed as a percentage of employer contributions.

Transparency

QSuper supports the Commission's view that there should be increased transparency for members to better understand how funds have designed their default insurance package. However, it is important that both the cost of the cover and its potential benefits are highlighted to mitigate the risk of unintended consequences. Members should be assisted by funds in understanding the factors they should consider before reducing or cancelling their cover purely on the basis of cost. There is a risk that members will fail to recognise the value of their cover which will only become apparent in the event of a claim.

Calculator

A retirement impact calculator would present the member with information on the impact of insurance premiums on retirement funding, however this only represents one side of the equation. It would be more challenging to develop a calculator that also takes into account the impact of loss of retirement funding in the event of temporary or permanent ill health. Both

factors need to be included in any calculation, and explained, for members to truly understand the impact of insurance on retirement adequacy both in the event of the member needing to claim, and should they never need to claim.

QSuper provides an insurance premium estimator on its public website to allow members to easily work out the cost of increasing or decreasing their cover. They can also obtain a personalised calculation and make the changes to their cover through Member Online.

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.

QSuper is broadly supportive of the Code and has announced an intention to adopt the code, therefore we support Recommendation 17.

However, QSuper would recommend that the current flexibility within the Code for trustees to comply with measures where they are in the best interest of their members is retained.

In QSuper's view, mandatory adoption of all measures within the Code will lead to a shift in the prioritisation of funds when designing insurance offerings i.e. price will become the primary driver of insurance cover, at the detriment of value.

Where trustees have sufficient information about their membership, they have an obligation to design insurance benefits that are appropriate for their members.

QSuper contends that if trustees are discharging their 'best interests' duty correctly, then the adequacy of cover provided is an essential consideration and should not be overshadowed by a focus on cost alone.

QSuper's insurance product was designed after extensive consultation with members and other stakeholders, including employers and unions, ensuring the needs of Queensland Government workers were considered. Our product design provides for the unique needs of emergency service workers. The flexibility required to cater for these and other high-risk occupations may be eroded under a mandatory adoption of prescriptive measures.