



Australian Government
Productivity Commission

Superannuation: Assessing Efficiency and Competitiveness

Productivity Commission
Inquiry Report
Overview

No. 91, 21 December 2018

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The Productivity Commission

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

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

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

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The full report is available from www.pc.gov.au

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. Structural flaws — unintended multiple accounts and entrenched underperformers — are harming millions of members, and regressively so.
 - Fixing these twin problems could benefit members to the tune of \$3.8 billion each year. Even a 55 year old today could gain \$79 000 by retirement. A new job entrant today would have \$533 000 more 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 underperform, even after adjusting for differences in investment strategy. Underperformers span both default and choice, and most (but not all) affected members are in retail funds.
 - Evidence abounds of excessive and unwarranted fees in the super system. Reported fees have trended down but a tail of high-fee products remains entrenched, mostly in retail funds.
 - Compelling cost savings from realised scale have not been systematically passed on to members as lower fees or higher returns. Much scale remains elusive with too few mergers.
 - 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 that meet most members' needs, but members lack simple and salient information and impartial advice 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 product proliferation). Many funds lack scale, with 93 APRA-regulated funds — half the total — having assets under \$1 billion.
 - The default segment outperforms the system on average, but the way members are allocated to default products has meant many (at least 1.6 million member accounts) have ended up in an underperforming product, eroding nearly half their balance by retirement.
 - Regulations (and regulators) focus too much on the interests of funds and not members. Subpar data and disclosure inhibit accountability to members and government.
- Policy initiatives have chipped away at some problems, but architectural change is needed.
 - Default should be the system exemplar. Members should only be defaulted once, and move to a new fund only when *they* choose. Members should also be empowered to choose their own super product from a 'best in show' shortlist, set by a competitive and independent process. This will bring benefits above and beyond simply removing underperformers.
 - All MySuper and choice products should have to earn the 'right to remain' in the system under elevated outcomes tests. Weeding out persistent underperformers will make choosing a product safer for members.
 - All trustee boards need to steadfastly appoint skilled board members, better manage unavoidable conflicts of interest, and promote member outcomes without fear or favour.
 - Regulators need clearer roles, accountability and powers to confidently monitor trustee conduct and enforce the law when it is transgressed. A strong member voice is also needed.
- Implementation can start now, carefully phased to protect member (not fund) interests.

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. Super is compulsory for most workers and, with over 15 million members collectively owning over \$2.7 trillion in assets, it will play a central role in funding Australians' retirement into the future.

The super system's performance therefore matters for the wealth and wellbeing of Australians — and its role in intergenerational wealth means it will play a growing role in wealth inequality. 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 linked to employers and unions, with industrial awards cementing the relationship. Workplace relations have since changed, and the role of unions in the workforce 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 Australians retiring with substantial balances after contributing for many years — it is timely to ask whether it suits its members' needs. Much more is at stake today in financial terms than at the system's inception. Australians are much more likely to move between industries and occupations throughout their careers, and to hold multiple jobs. At the same time, the 'gig' economy and technologies such as automation are starting to break down some of the industry and occupational boundaries we once had. Australians are also working longer, retiring later and living longer — which means super balances are higher but also need to last for longer.

In this inquiry, we have examined 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). We have not looked at the broader role of super in funding retirement incomes or the impact of super on national savings, public finances or intergenerational equity — broader questions that should be answered by an independent inquiry ahead of any increase in the Superannuation Guarantee rate.

Box 1 Our approach

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). The assessment framework set out the prospective attributes of a competitive and efficient super system that are within the scope of influence of the system. It covered the system's contribution to members' retirement incomes, how it meets members' needs over their lifetimes, gains in efficiency over time, whether the system provides value for money insurance, and how competition drives the outcomes members need.
- **Stage 2** entailed developing a set of alternative models for allocating default members to products (PC 2017d). 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 has assessed the efficiency and competitiveness of the system, drawing on the stage 1 framework, and identified areas for improvement. It also provides final advice on default models.

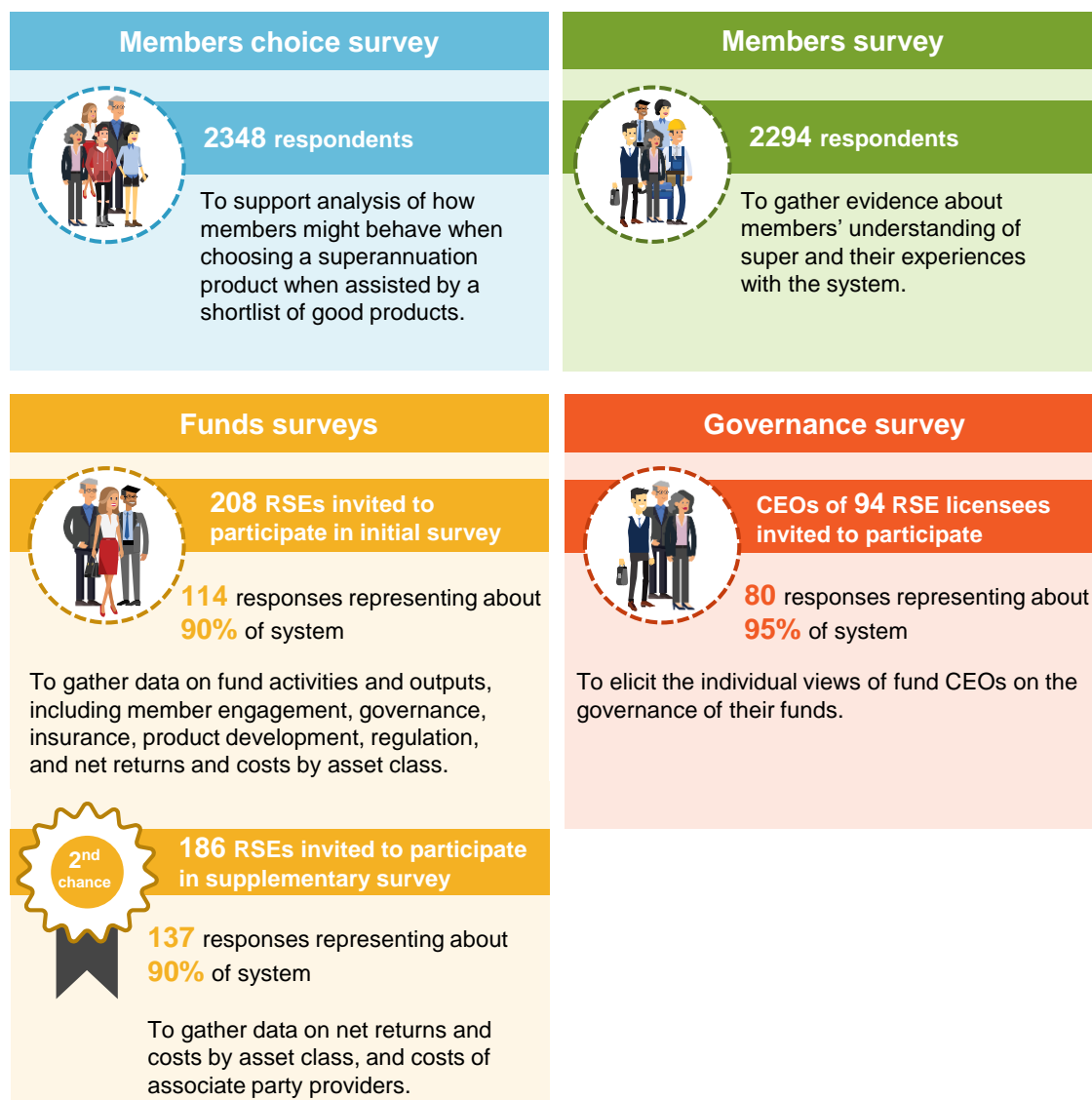
This stage 3 inquiry is focused on the outcomes for members in the super system, consistent with our remit to make recommendations that promote the wellbeing of the Australian community. It is a broad endeavour, spanning institutional and self-managed super funds, wholesale providers, the regulators and, foremost, members. But, broad as it is, the inquiry has not looked at the overarching retirement income policy architecture, the adequacy of retirement incomes or the impact of super on national savings. Nor has it produced league tables of individual funds.

There is little precedent in Australia and internationally for reviewing the efficiency and competitiveness of a superannuation or pension system in its totality. The inquiry has also been unique in its breadth and use of evidence — drawing widely on both existing data (held by regulators and research firms) and new data (gathered through a series of five surveys, covering super funds and their members — detailed in figure 1). The evidence we gathered was used to undertake several novel analyses. We have:

- constructed benchmark portfolios to compare investment performance across the system
- compared and benchmarked returns at the individual asset-class level
- developed cameos to illustrate how retirement balances can be eroded by poor practices
- simulated sequencing risks that members might face (to evaluate life-cycle products)
- quantified the cost savings from economies of scale and pass-through to members.

This inquiry has taken place in the context of other inquiries — indeed, its genesis is in a recommendation of the 2014 Financial System Inquiry. In May 2017, the Commission commenced a parallel inquiry on *Competition in the Australian Financial System*, which was completed in June 2018. In December 2017, the Government initiated a *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (hereafter, the 'Royal Commission'), which is expected to be completed by February 2019. We have developed our findings and recommendations in this inquiry in light of relevant evidence that has emerged through these other reviews.

Figure 1 **Our five surveys to address data gaps**



What outcomes are members getting?

The super system exists to support its members in retirement. In the long term, members need strong investment performance and a balance that has not been 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 delivers good outcomes for many members, but not all. The industry's peak body submitted that 'the Australian superannuation system is not broken, and is in fact a world-class private pension system' (ASFA, sub. DR148, p. 3). The evidence suggests otherwise.

Members earn very different investment returns

Investment returns, after all fees and taxes, matter most for members' retirement incomes. Even a small difference in annual returns can leave a member substantially worse or better off at retirement — the power of compound interest.

We constructed a series of 'benchmark portfolios' to assess investment performance across the super system. These portfolios are measures of investment returns across a set of asset classes, with the mix of assets adjusted to match the investment strategy (asset allocation) of the funds, products (investment options) or segments of the system we are benchmarking (box 2). By being agnostic of asset allocation, the benchmarks allow investment performance to be compared right across the system. This approach has not been previously used to gauge the super system's performance.

Box 2 **Our two benchmark portfolios**

The Commission constructed benchmark portfolios (BPs) to assess the system's relative and absolute investment performance. This follows two technical workshops during our stage 1 study, input by way of submissions, and much consultation with industry experts.

The BPs allow comparable performance assessment across funds and products by tailoring for — and thus being agnostic of — asset allocation. They capture the investment performance (net of fees and taxes) of a set of investment strategies across a range of asset classes.

- **BP1** is a listed benchmark portfolio constructed using listed financial market indexes.
- **BP2** is a blended benchmark portfolio constructed using both listed and unlisted indexes.

BP2 is more representative of super funds' exposure to unlisted asset classes, and thus more closely represents how funds actually invest (in terms of implementing their asset allocations). It is used throughout this overview.

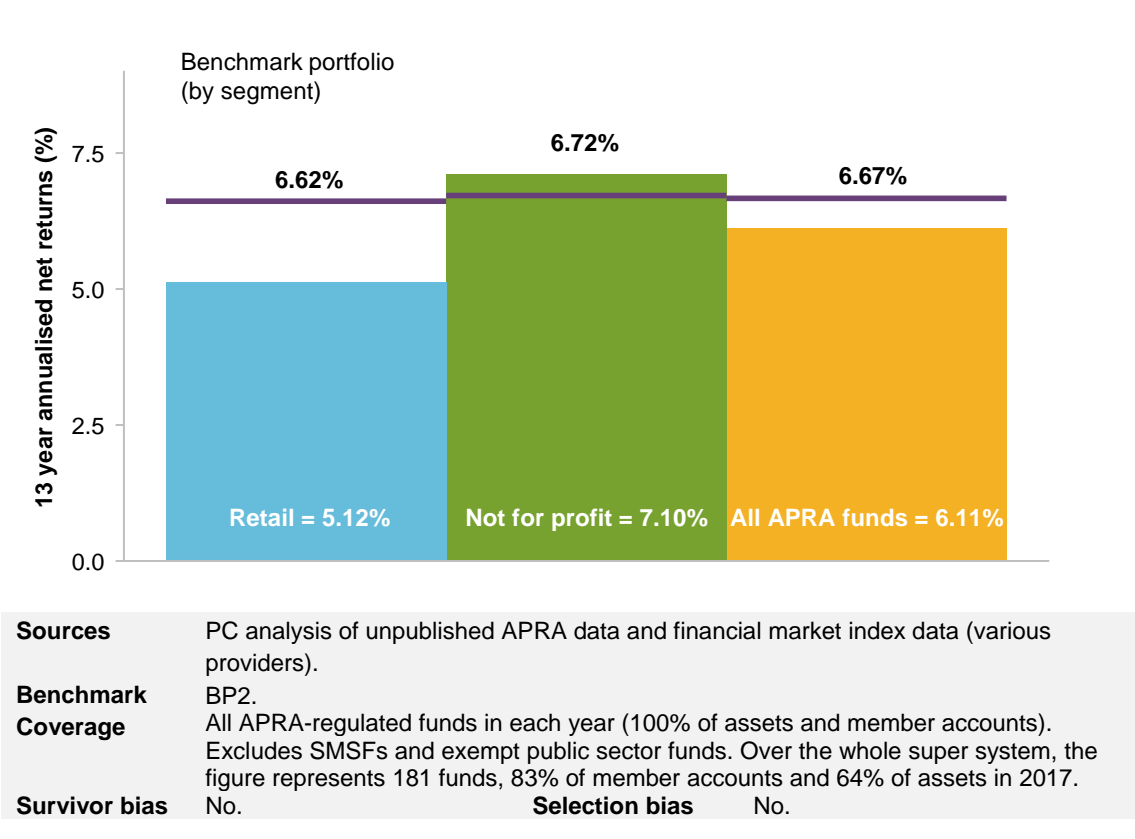
Data limitations mean this exercise is challenging and cannot be an exact science — indeed, our benchmarks are sensitive to assumptions (about tax, fees and the composition of some asset categories) and adjustments made to reflect funds' asset allocations in earlier years (chapter 2). The methods were further refined following our draft report, informed by further feedback and consultation. We have erred on the side of generosity to the funds in constructing the benchmarks, and we identify 'underperformance' only where performance falls short of the relevant benchmark by at least 0.25 percentage points (25 basis 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, 13 years). The exact time horizon has a modest effect on the results but in general does not change the conclusions.

Over the past 21 years (to 2017), many super funds regulated by the Australian Prudential Regulation Authority (APRA) have delivered solid returns to their members — averaging about 5.9 per cent a year in nominal terms, or about 3.5 percentage points above inflation (after fees and taxes). Over the past 13 years (to 2017) — the period over which we could undertake more detailed analysis — the system delivered average annual net returns of

6.1 per cent (after investment and administration expenses, and taxes). This falls below the system-level benchmark (figure 2).

Figure 2 Funds by segment: not-for-profit funds outperform retail funds on average
Benchmark adjusted for asset allocation, 2005–2017



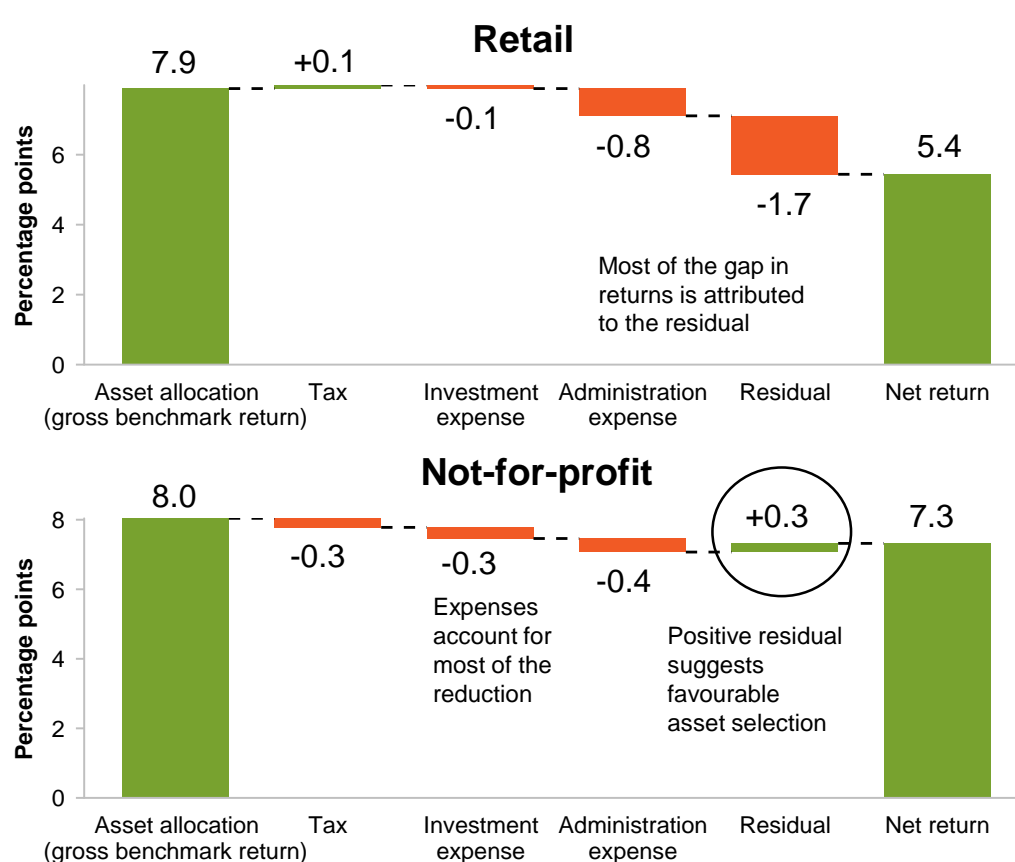
But investment performance varies considerably across the system. As a group, not-for-profit funds delivered returns above a benchmark tailored to their average asset allocation, but retail funds as a group fell below theirs. These results suggest that while many products have been delivering solid returns for members, there are also many that underperform, particularly in retail funds. (The tailored benchmarks take into account that retail funds have typically had more conservative asset allocations compared with not-for-profit funds; the benchmarks are similar across the segments over this period because of relatively strong returns to fixed income assets, though this will not always be the case.)

We undertook further analysis to decompose this systemic difference in returns between the not-for-profit and retail segments into various drivers (figure 3). For retail funds as a whole, some of the gap between actual returns and the pre-expenses benchmark is due to tax and expenses. But most of the gap is a residual — a component we cannot directly measure. In this case it is negative, meaning actual returns were lower than can be explained by asset allocation, tax or expenses. Because the benchmark largely controls for asset allocation, the

residual is likely to mainly capture how well (or poorly) funds select assets within individual asset classes. It could also, to a lesser extent, reflect unreported (indirect) investment expenses.

By contrast, the not-for-profit segment had a smaller gap between actual returns and its pre-expenses benchmark. After accounting for tax and expenses, there is a positive residual — which suggests favourable asset selection within the individual asset classes.

Figure 3 Funds by segment: components of different returns
2005–2017



Sources	PC analysis of unpublished APRA data and financial market index data (various providers).
Benchmark	BP2.
Coverage	All APRA-regulated funds in each year (100% of assets and member accounts). Excludes SMSFs and exempt public sector funds. Over the whole super system, the figure represents 181 funds, 83% of member accounts and 64% of assets in 2017.
Survivor bias	No.
Selection bias	No.

We then looked at how the system is performing within each asset class — something that has not been done comprehensively before. Consistent with our other analysis, not-for-profit funds outperformed retail funds in most asset classes, including for the largest asset classes in the system, listed equities and fixed income (figure 4).

Figure 4 Funds by segment: Not-for-profit returns exceed retail returns in most asset classes
 Net returns weighted by assets in the corresponding asset class, 2008–2017



Sources	Supplementary funds survey and financial market index data (various providers).
Benchmark	Asset-class benchmarks as per BP2.
Coverage	In 2008, the funds in this figure represent up to 66% of total assets and 69% of member accounts in APRA-regulated funds. In 2017, they represent up to 86% of total assets and 87% of member accounts in APRA-regulated funds.
Survivor bias	Yes.
Selection bias	Yes.

Across the system as a whole, funds outperformed their benchmark in most asset classes. This may appear contrary to the earlier benchmark results. But our asset-class level analysis relied on our supplementary survey results that were positively biased due to missing data for funds that have exited the system (survivor bias) and that did not provide the requested data (selection bias).

Australian funds in our survey also performed comparably, on average, to large pension funds in other developed countries across most asset classes.

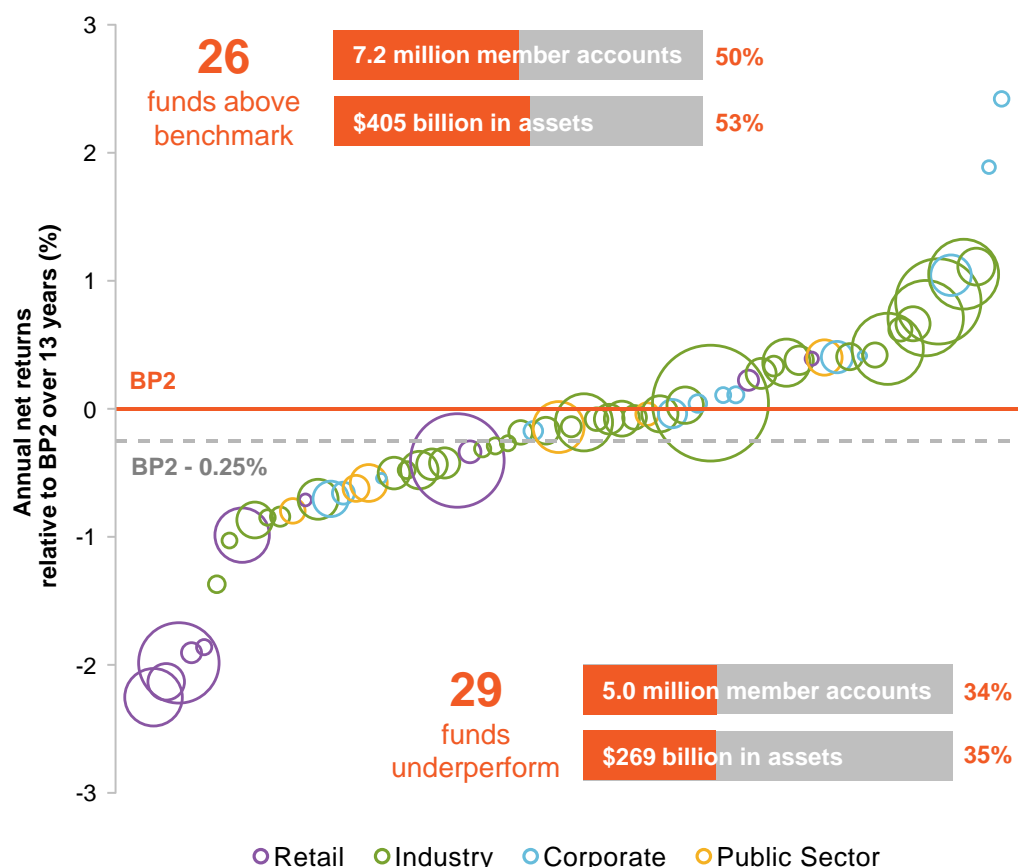
Averages can conceal a lot of variation, especially across individual funds and products. After adjusting for differences in the asset allocation of each fund, we found a wide range of performance (figure 5).

- Over the 13 years to 2017, 26 funds performed above their benchmark. Over 7 million member accounts (about half the accounts in the dataset) and over \$400 billion in assets were in these funds.
- Over the same period, 42 funds performed below their own benchmark portfolio, of which 29 underperformed by more than 0.25 percentage points. These 29 underperforming funds contain 5 million member accounts and about \$270 billion in assets. About half are industry funds and almost a third are retail funds. Notably, the retail funds were larger on average, collectively accounting for 77 per cent of member accounts in underperforming funds (some 3.8 million accounts).

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

Performance relative to individual funds' benchmark portfolios, 2005–2017

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



Source	PC analysis of unpublished APRA 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 (60% of assets and 66% of member accounts in all APRA-regulated funds with a MySuper product in 2017). Over the entire super system, the figure represents 68 funds, 30% of assets and 51% of member accounts in 2017.
Survivor bias	Yes.
Selection bias	Yes.
Further results	13 funds performed between BP2 and 0.25 percentage points below BP2 (2.4 million member accounts and \$85.5 billion in assets).

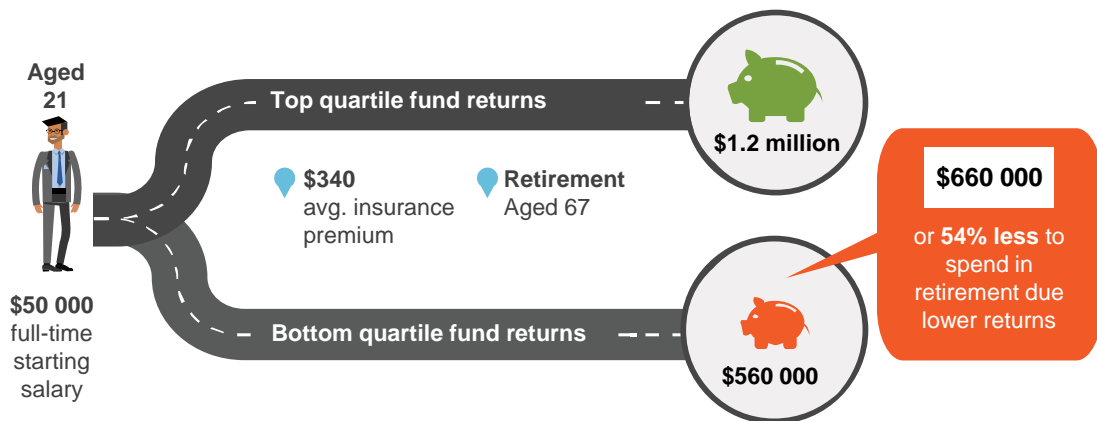
These results have been updated since our draft report — by adding another year of data and refining our methods. But data limitations still confine the analysis to funds that currently offer a MySuper product — and thus only about half the member accounts in the system.

It is nigh impossible to overstate the significant implications for members' retirement incomes from this wide dispersion in fund performance over the long term. For example, a typical full-time worker experiencing the investment performance of a bottom-quartile fund

over their lifetime would retire with a balance 54 per cent (or \$660 000) lower than if they experienced returns commensurate with the top quartile (based on the median fund's return in each quartile) (cameo 1).

Cameo 1 Underperformance compounds to substantially lower retirement balances

Super problem: Underperforming fund = 13 years' lost pay



Asset allocation is the largest driver of total returns at the fund level, but most of the variation across funds is captured by the residual, likely reflecting how well funds invest within asset classes.

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

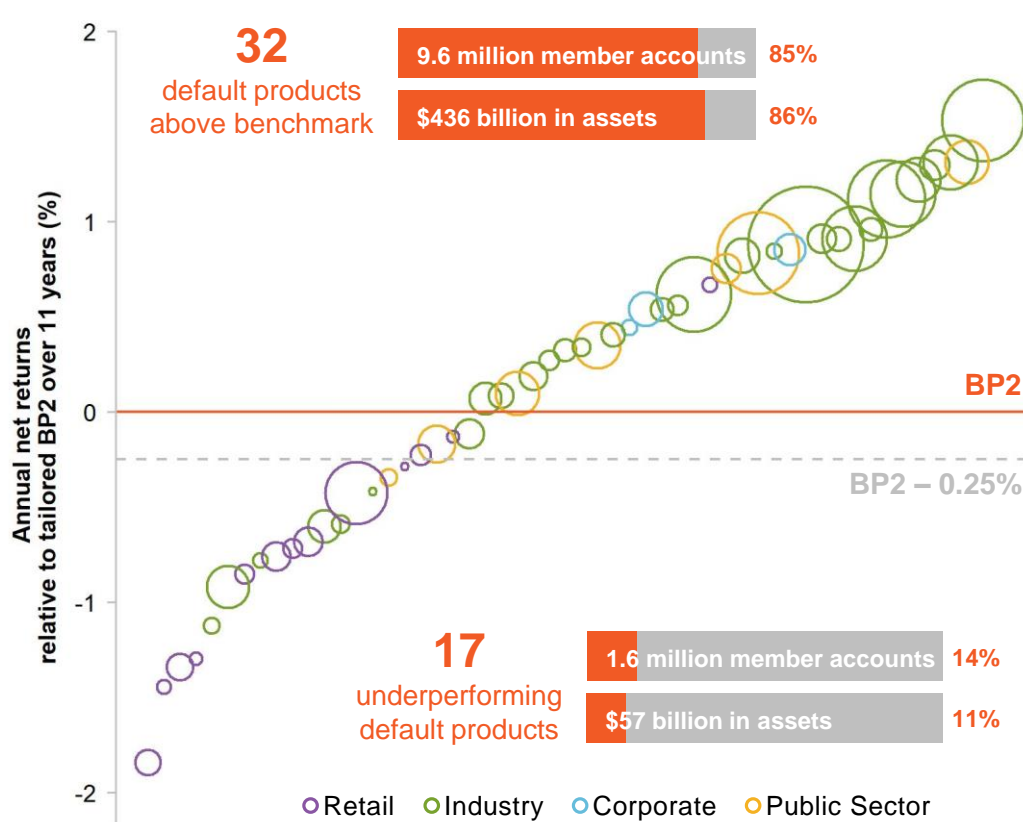
The analysis suggests that some members have ended up in funds with very good performing MySuper products (after controlling for asset allocation), whereas many others are experiencing considerably poor performance (figure 6).

- In the 11 years to 2018, 32 MySuper products (of 53 in the sample) performed above their tailored benchmark, and generated a median net return of 5.5 per cent a year. Nearly 10 million member accounts and \$440 billion in assets were in these products, almost all of which were associated with not-for-profit funds (of varying sizes).
- Over the same period, 21 products performed below their tailored benchmark, of which 17 underperformed by more than 0.25 percentage points and generated a median net return of 3.8 per cent a year for their members. These 17 underperforming products

contain about 1.6 million member accounts and \$57 billion in assets. They comprise 10 products from retail funds, 6 from industry funds, and 1 from a public sector fund. And over a third (7) are life-cycle products — where members are automatically moved into less risky and lower-return asset allocations as they age.

Figure 6 Default products: vastly different net returns, with 1.6 million member accounts in underperforming default products

Performance relative to individual products' benchmark portfolios, 2008–2018
Size of circles indicates the size of each product's assets under management



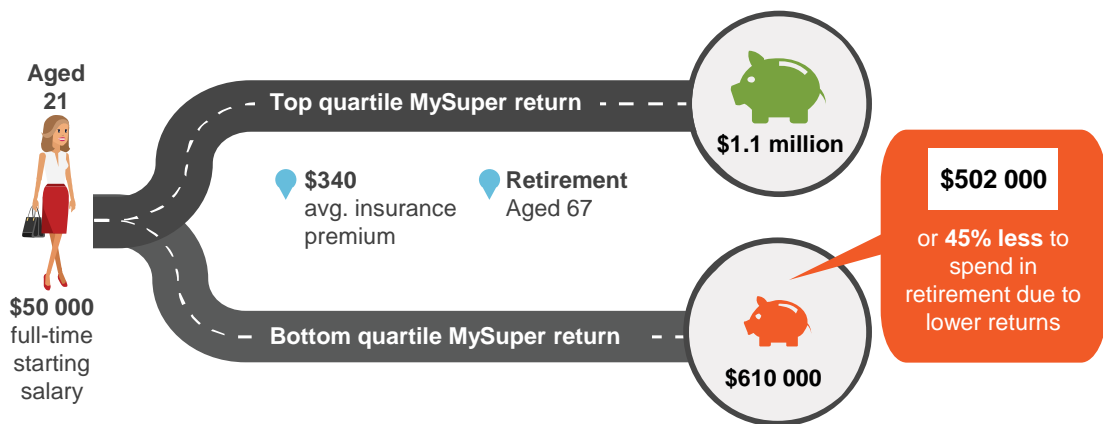
Sources	PC analysis of APRA (2018a, 2018k), financial market index data (various providers), and SuperRatings data.		
Benchmark	Product-tailored BP2.		
Coverage	53 of 105 current MySuper products covering 76% of member accounts and 75% of assets in all MySuper products as at June 2018.		
Survivor bias	Yes.	Selection bias	Yes.
Further results	4 products performed less than 0.25 percentage points below BP2 (150 000 member accounts and \$12.6 billion in assets).		

These conclusions do not change materially when MySuper products are benchmarked using the average asset allocation across MySuper products (as we did in our draft report). And APRA data on a near complete set of MySuper products — over the four 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 ends up in the median bottom-quartile MySuper product would retire with a balance 45 per cent (or \$502 000) lower than if they were in the median top-quartile product (cameo 2).

Cameo 2 MySuper returns can be a lottery for default members

Super problem: Underperforming MySuper = 10 years' lost pay



Some choice members in APRA-regulated funds are also earning poor returns (across both the accumulation and retirement phases). Part of this may be due to their investment strategy, or a preference for more costly services that detract from net returns. But after we controlled for asset allocation, we found that about 36 per cent of choice products in our sample, with about 15 per cent of assets, underperformed benchmarks tailored to their own asset allocation (in the 13 years to 2017). Almost all were offered by retail funds. This is likely to be a conservative estimate of underperformance in the whole choice segment, as our data disappointingly only cover about 16 per cent of assets in the segment — a chasm of selection bias.

More than one million members have chosen to self-manage their super in a self-managed super fund (SMSF). Large SMSFs earn broadly similar net returns to APRA-regulated funds, but smaller ones (with less than \$500 000 in assets) perform significantly worse on average. This is mainly due to the materially higher average costs they incur (relative to assets) due to being small. While some SMSFs expand quickly and perform better, others appear to start small and stay small — and an estimated 380 000 members are in smaller SMSFs that have

been established for more than two years (about 200 000 SMSFs, comprising 42 per cent of all SMSFs). Some of these members may be benefiting from high returns or tax advantages, but on average they are paying relatively high costs and facing low net returns.

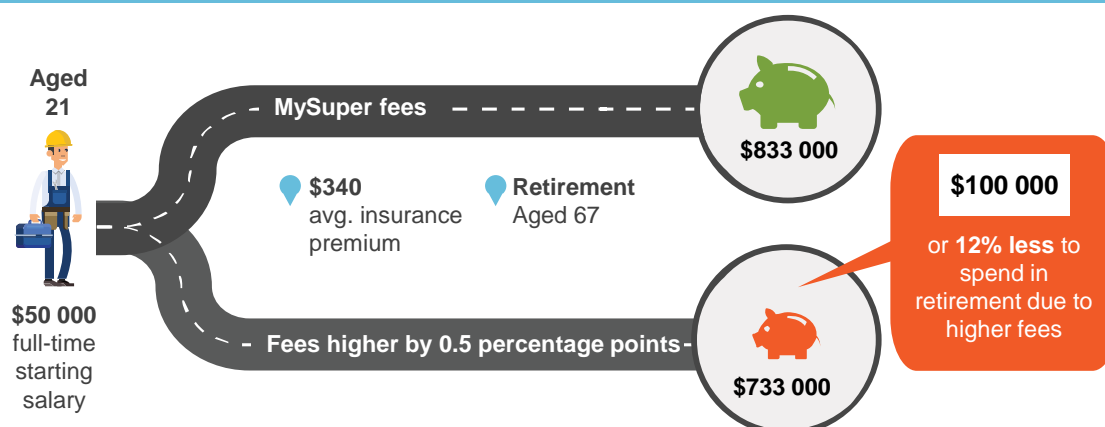
Clearly, some members — in choice as well as default — do well, but many could be doing a lot better.

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 percentage points 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

Super problem: Higher fees = 2 years' lost pay



Reported fees in Australia are higher than in many other OECD countries. While some of the difference may reflect regulatory or other factors beyond funds' control, we obtained data on investment costs by asset class, which are much more comparable across countries. The data reveal that Australian super funds pay higher costs for the biggest asset classes (equities and fixed income) compared with their peers in other developed countries.

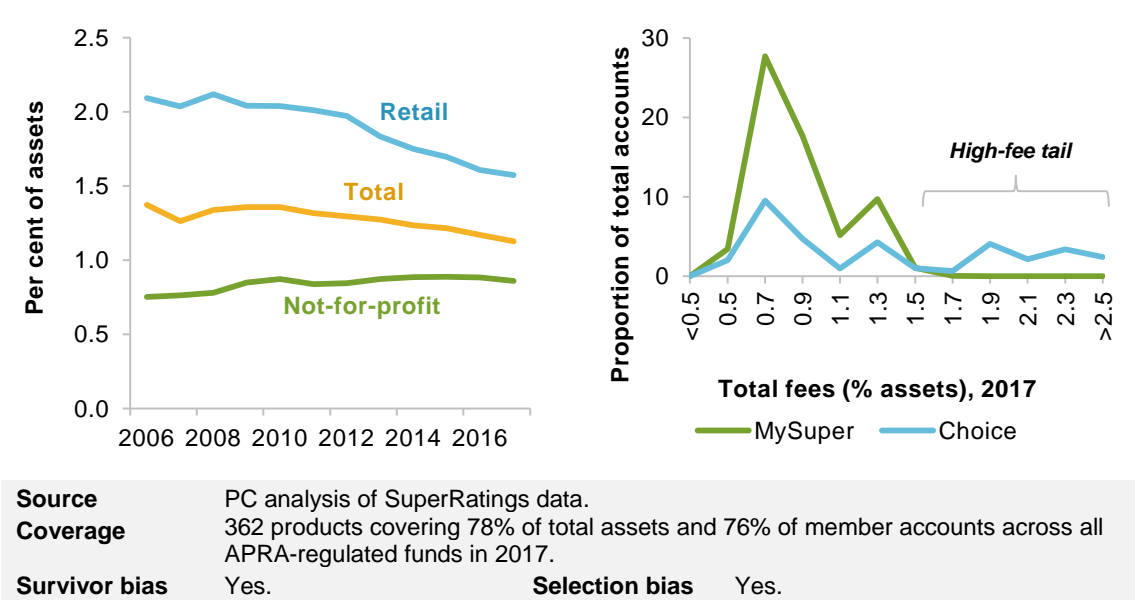
Our analysis reveals that significant economies of scale have been realised in the super system over the past 13 years, particularly for administration expenses. Holding constant other cost drivers, increases in scale are estimated to have generated cost savings of about \$340 million each year (on average), amounting to \$4.5 billion in incremental gains since 2004. But there is little evidence that these cost savings have been systematically passed through to members in the form of lower fees, and only tentative evidence (and only for

not-for-profit funds) that scale benefits have manifested as higher net returns. Data limitations mean it is difficult to tell precisely how members have benefited from greater scale.

As a percentage of balances, the reported fees members pay have fallen since the global financial crisis — from 1.3 per cent in 2008 to 1.1 per cent in 2017 (figure 7). This downward trend is apparent across most of the system, but is most pronounced in the retail segment, where average administration fees have fallen materially. By contrast, average fees charged by not-for-profit funds have been largely flat over time, but remain well below the fees charged in the retail segment.

The decline in retail segment fees may partly be due to the MySuper reforms, which led to many retail funds moving their default members to lower-fee MySuper products. It could also be a competitive response to members leaving retail choice products to open SMSFs.

Figure 7 Products by segment: retail and choice products have materially higher fees



Nevertheless, a tail of high-fee products remains entrenched. Annual fees exceed 1.5 per cent of balances for an estimated 4 million member accounts (holding about \$275 billion). Almost all of these accounts are in choice products offered by retail funds. While some may be receiving exceptional investment returns or member services, the evidence indicates that funds that charge higher fees tend to deliver lower returns, once both investment and administration fees have been netted off. High fees also persist over time.

Other types of fees can also harm members. High exit fees in some choice products can create a barrier to member switching, across both the accumulation and retirement phases. Fees for financial advice appear excessive in parts of the choice segment. In 2017, 10 retail

funds collected about \$1.4 billion of advice fee revenue, charging their members about \$341 per account in that year alone.

Further, at least 2 per cent of member accounts are still subject to trailing adviser commissions — despite such commissions being banned since 2013 for new accounts by the Future of Financial Advice laws. Eleven retail funds identified in data published by the Royal Commission are estimated to have collected in excess of \$400 million in such trailing commissions in 2017 alone. While largely a legacy problem, these commissions can materially erode member balances.

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

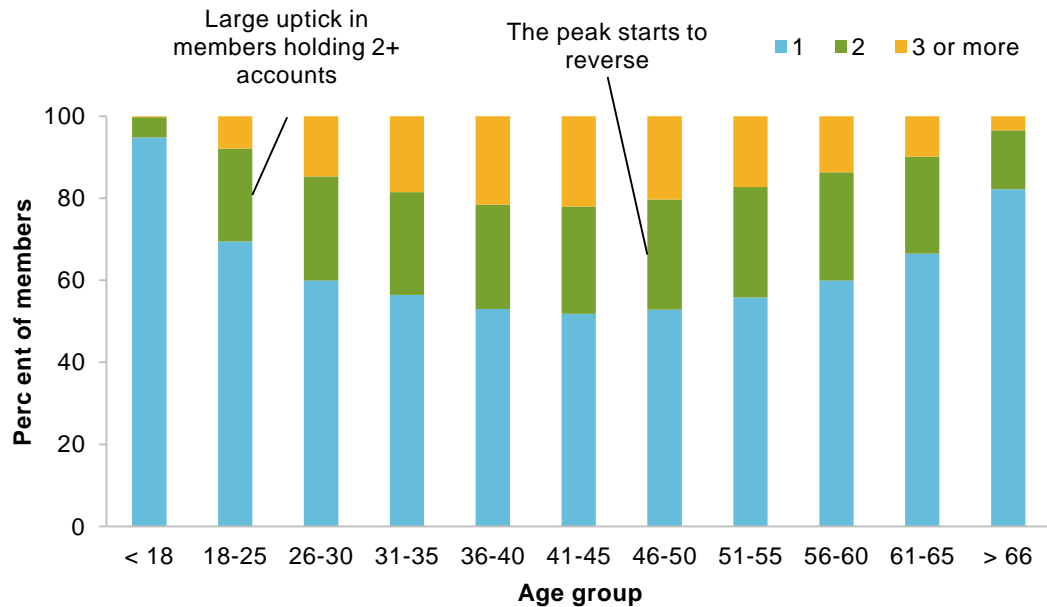
There are too many unintended multiple accounts

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 roll over their existing balance. Much of this account proliferation appears early in adulthood and persists well into middle age (figure 8).

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 to unnecessarily erode their 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, affecting younger and lower-income members the most.

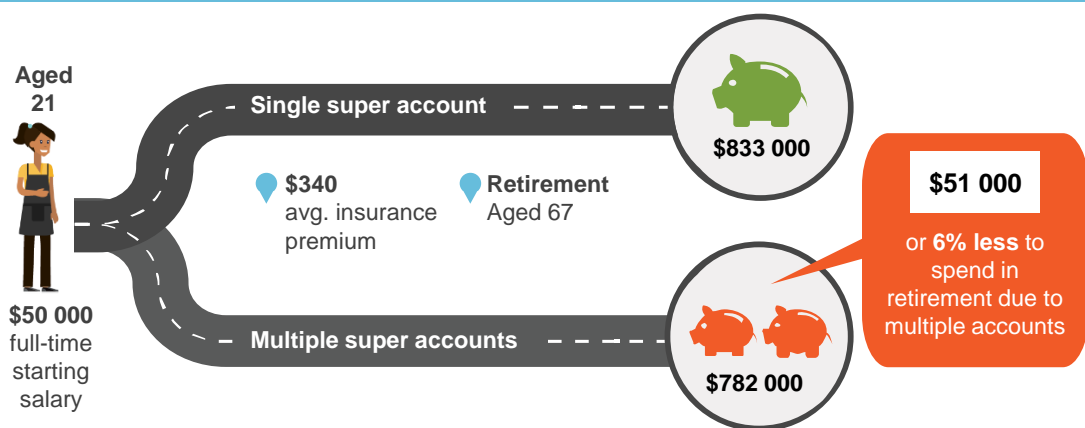
This absurdity of unintended multiple accounts has arisen because defaults are anchored to the job or the employer, not the member (discussed below). It is an avoidable system failure that has hurt members since the inception of compulsory super. Recent initiatives have made it easier to find and consolidate accounts in the system, but progress has been slow and a large stock of unintended multiple accounts remains — about 10 million. These initiatives will never amount to more than ‘mopping up spilt milk’ while unintended multiple accounts continue to be created. The problem is unlikely to abate given ongoing changes in the workforce (including multiple job holding and more job mobility across occupations and industries). Government and the regulators could and should have acted earlier to identify this costly systemic problem and taken decisive policy action.

Figure 8 **Account proliferation happens early, and persists**



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 make decisions. It would also direct those who do not make a choice to good

defaults. While a large diversity of products exist, many members struggle to find the right product for them.

In the accumulation phase, most members have fundamentally simple needs: high net returns, low fees, well-managed risks and transparent product features. ‘No-frills’ products can meet their needs well, and many default (MySuper) products fall into this category (though their insurance offerings are often too complicated, as discussed below).

But most MySuper products fail to strike the right balance between high net returns and protecting members from the risk that asset prices will fall as they near retirement (crunching their retirement balance). Well-designed life-cycle products can address this sequencing risk by moving members into more defensive (but lower-growth) assets as they approach retirement. In practice, however, many life-cycle products have simply ended up leaving members with lower retirement balances than they would otherwise have got in a fixed-strategy product. This is a combination of failing to adequately take account of members’ personal characteristics — as not all members will need to de-risk ahead of retirement — and of dialling down risk too early in the life cycle (in some cases as early as 30 years of age). Almost a third of MySuper member accounts and assets are in such life-cycle products.

In the choice segment, a proliferation of little used and complex products — some tens of thousands — increases fees without boosting net returns, and makes effective decision making elusive for most members. There is evidence that some members who use these products are unwittingly buying a degree of control over their super at the price of materially lower retirement incomes.

In retirement, members’ needs are no longer as straightforward. The large diversity of household preferences, incomes and other assets means that no single product can meet everyone’s needs. Pre-retirees need to navigate an increasingly complex maze. The range of retirement products on offer — including account-based pensions, annuities and new hybrid annuities — does not appear to be deficient. The bigger issue is whether people are choosing the product that is best for them. The Government has announced a new Retirement Income Covenant that will require funds to offer a risk-pooled product to members when they retire, but the exercise has been beset by design challenges and implementation has been (sensibly) delayed to 2022.

A broader underlying problem 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 members 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 simpler information to help them find and compare products and, if necessary, switch.

Access to information and affordable, credible and impartial financial advice is crucial — especially in the retirement phase — and its importance will only grow as the system matures. 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 received. Despite the Future of Financial Advice reforms, conflicted financial advice remains an egregious problem (especially within vertically integrated organisations).

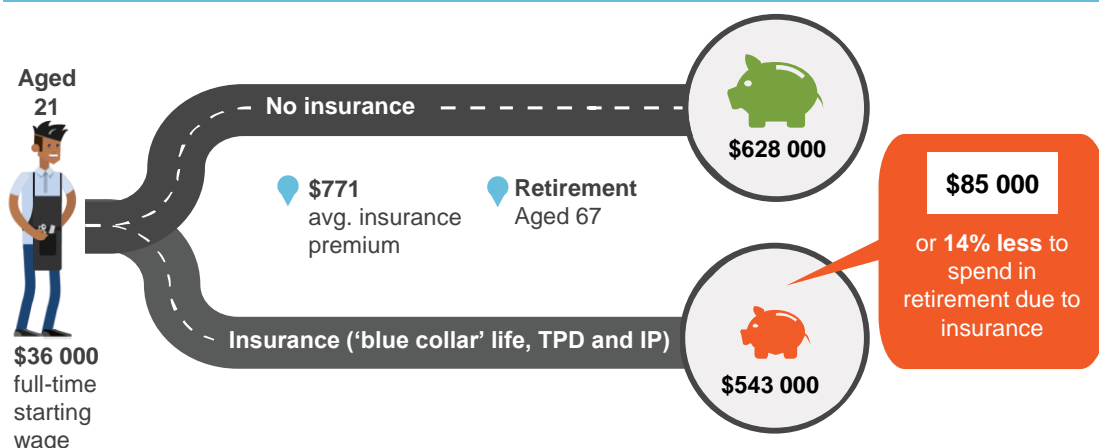
Insurance is not delivering value for all members

About 12 million Australians have insurance (life, total and permanent disability and/or income protection cover) through their super. Group insurance arrangements deliver many of them much more affordable insurance than they would be able to get through individually written cover outside of super. 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, though we have not assessed this issue as part of this inquiry.

But not all members receive good value from the insurance in their super. The premiums that come out of members' accounts erode their retirement balances. The effects are worse for members on low incomes and those with intermittent labour force attachment, who continue to have premiums deducted from their accounts while not contributing to their super (while, at the same time, often facing more onerous criteria for an insurance claim to be accepted). The retirement balance erosion for these members could reach 14 per cent (\$85 000) (cameo 5), and as much as 28 per cent (\$125 000) for some disadvantaged members with duplicate insurance policies.

Cameo 5 Insurance policies erode balances for low-income workers

Super problem: Insurance = 2.5 years' lost pay



More fundamentally, wide variation in the types and levels of default cover (as well as premiums) across funds does not seem warranted based on inherent differences in each fund's membership cohort. In many cases, member circumstances and needs vary more within than across funds — but funds typically collect little data to tailor default insurance to their members. Which insurance policy members end up in is often determined by which default product their employer has chosen — the luck of the draw.

Even worse, some members end up with insurance policies that are simply unnecessary. About 17 per cent have duplicate policies across multiple super accounts — eroding their retirement balances by over \$50 000. And some members are being defaulted into insurance products they are ineligible to claim on, with income protection cover being the chief and costly culprit for such 'zombie policies'. Typically, a member can only claim against one income protection policy and only when they are working (although only a small share of members are likely to be affected). 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 with 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 act as barriers to account switching and consolidation, and can derail fund mergers
- member difficulties in interacting with funds, particularly to opt out of insurance and to make a complaint
- the bundling of life and disability insurance, meaning that some members without dependants are unable to opt out of life cover while retaining their disability cover
- poor application of risk premiums in default insurance, for example, for occupation or smoking status.

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 much Government prompting — the industry developed a voluntary code of practice. This is a small first step at addressing some of the most egregious problems, such as excessively high premiums for some members. Many funds have committed to adopting the code, but how rigorously they will comply with the rules in practice remains unclear. The code is unenforceable, falls well short of what is needed, and does not reflect 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 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?

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, and the effectiveness of regulation and regulators. Many members do reasonably well, as evidenced by the number of funds and products with strong long-term 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 — actively comparing products or opening SMSFs. But most are not. Many members simply default, and rely on their fund to manage their super for them (whether out of trust, a lack of interest or an inability to compare products themselves). 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 attention and engagement varies over the life cycle.

In general, rates of switching between funds and products are modest — historically, fewer than 10 per cent of members switch funds each year and only a third have ever changed their investment option. (Recent data suggest an uptick in switching to industry funds associated with the Royal Commission, but this is likely to be a temporary phenomenon absent system reform.) Close to 60 per cent of members do not understand their fees and charges, and about 40 per cent lack an understanding of basic investment options (such as growth, balanced and conservative). This reflects broader trends: about 30 per cent of Australians have low financial literacy, and a quarter do not understand basic financial concepts.

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. Indeed, 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 rules), a lack of easy to understand information, and challenges in finding where to go to get help have made it hard for members to engage. These factors also make it harder for members who do engage to get the best outcomes, with evidence of poor decision making by some. This 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 — by 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 looks competitive. The retail level is characterised by many funds, low concentration, a contestable choice segment and competitive tension from SMSFs. Structural features of the system create challenges for new funds but do not constitute high barriers to entry. While some wholesale markets appear relatively concentrated (such as for administration services), those few providers are likely realising economies of scale.

But a closer look reveals problems. Muted competitive pressure from the demand side — members and their advisers — means that competition is not playing the corrective role that it does in other, less complex markets. In the choice segment, poor comparability of products (due to poor data and product proliferation), the charging of fees for no service, the entrenched tail of high-fee products and persistent underperformance by some funds all point to an absence of healthy competition. Evidence suggests that funds are competing to provide increasingly tailored products and administrative services (such as smartphone apps), but are putting less effort into delivering the highest net returns to members.

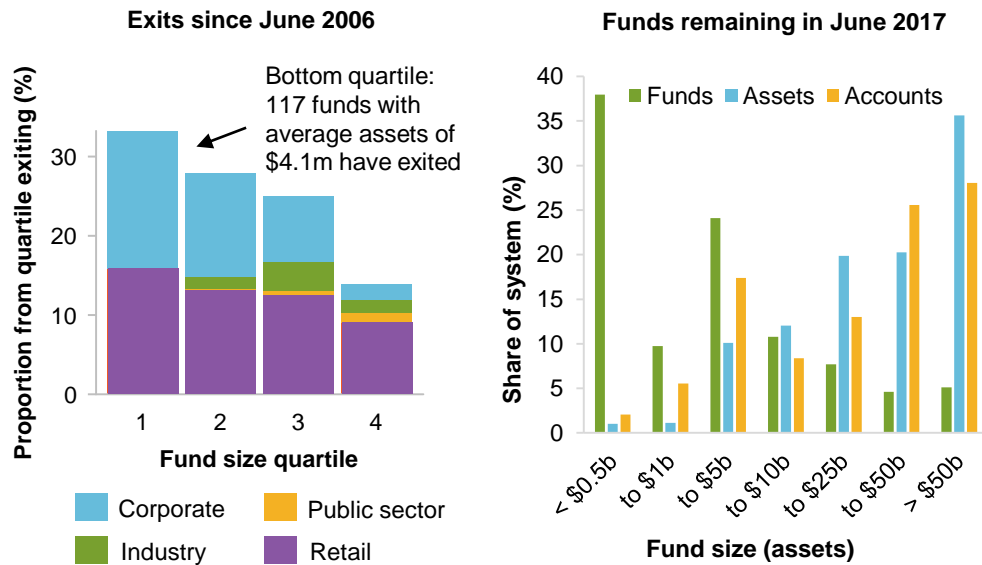
In the default segment, competition is at best superficial. Members who default are typically disengaged and exert no competitive pressure — there is limited or no competition *in* the market. As a result, competitive pressure has to come from competition among the funds authorised to provide default products — competition *for* the market. But this is not happening either. Default policy settings mean that competition is muted. In particular, those funds that have gained access to the default market face no systematic pressure to compete strongly. The stalled process for listing default funds in modern awards has acted to keep new entrants out of the default segment, and there is currently no process in place to remove from awards funds that are not performing well (discussed below).

At the wholesale level, evidence suggests that investment managers have some market power, even though market concentration is low. As a consequence, smaller funds, in particular, pay higher fees than would be the case if competition was more robust. Some larger funds have responded by bringing some of their investment management in-house, thereby putting competitive pressure on external investment managers.

Further, our analysis of economies of scale reveals that substantial cost savings from greater scale remain to be made, especially from further consolidation in the super system. Many small funds (with high average expenses) have exited the system, but a large tail remain (figure 9). About half (some 93) of all APRA-regulated funds have less than \$1 billion in assets, and many underperform. We have (conservatively) estimated that cost savings of at least \$1.8 billion a year could be realised if the 50 highest-cost funds merged with 10 of the

lowest-cost funds — benefitting an average member in the system by \$22 000 at retirement. That this potential exists reflects a lack of effective competition.

Figure 9 **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. The design of the system results in up to two-thirds of members defaulting when starting a new job. About half of all member accounts are in MySuper (default) products, representing 24 per cent (\$595 billion) of total system assets. Current arrangements — comprising workplace determination of default funds and a requirement for the funds that provide them to hold MySuper authorisation — have worked well for many funds and industrial parties (such as employer groups and unions). And many members have ended up in default funds that have demonstrated good investment performance.

But current arrangements are clearly not putting members first. Member outcomes are too variable. Policy settings have created an ‘unlucky lottery’ for members by failing to ensure they are placed in the very best funds — over 5 million member accounts are in funds experiencing serial underperformance. This has significant consequences for members’ balances and ultimately their wellbeing in retirement.

As noted above, a lack of healthy competition for the market means poor-performing funds are not being weeded out. Tying defaults to the employer rather than the member has led to the absurdity of members accumulating unintended multiple accounts (and paying multiple sets of fees and insurance premiums). And policy settings have enabled restrictive clauses

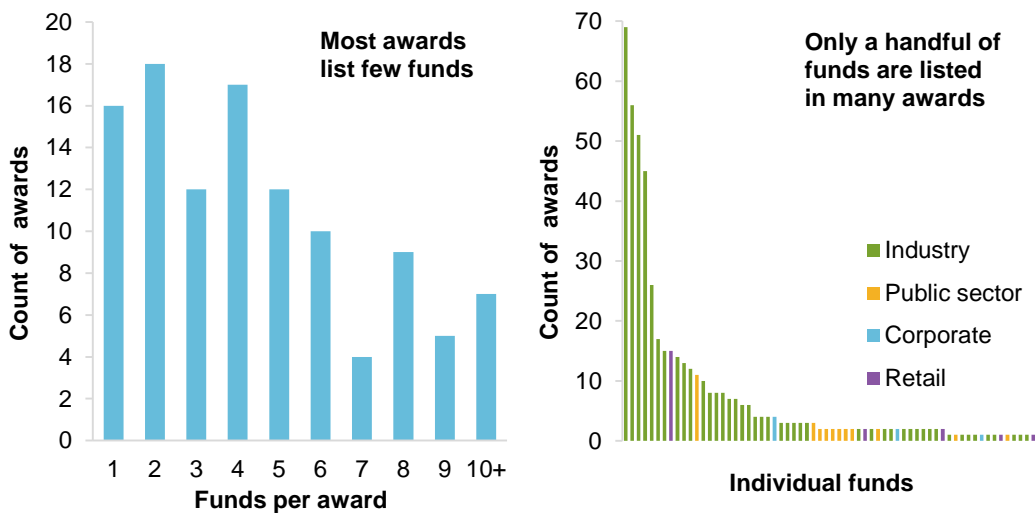
in workplace agreements that prevent an estimated 1 million members from exercising choice should they want to.

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 is evidence that some funds offer benefits to influence employers’ choices — a problem that is both hard to observe and to 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. Where bound by an award (and not all employers are), employers could face a choice of anywhere between 1 to 15 funds, depending on which of the 122 awards is relevant (figure 10). Only a handful of funds are listed in more than 10 awards.

Figure 10 **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 have generally been able to have themselves considered by the FWC — but these industrial parties have themselves sponsored the joint development of funds, and so have not been unhindered by conflicts of interest when reviewing other funds' requests to be registered.

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 by, on merit. But a legal challenge derailed the first attempt to appoint an expert panel, 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 underperforming funds to be removed (albeit APRA is now pressuring some poorly performing funds to justify their MySuper authorisation). 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 the default segment by requiring all funds to obtain MySuper authorisation to be allowed to offer a default product (and thus be 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, performance and fees.

In the context of ongoing changes in the workforce (including multiple job holding 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 appear to be mainly owed to trustee and employer goodwill. Yet wide variation in performance is inevitable, given the large number of funds and the current way of allocating defaults. Sustaining a high level of performance, and spreading it to more members, is only achievable by providing incentives to innovate and meet new needs.

Governance falls short of best practice

High-quality governance is integral to a super 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, governance (and its regulation) matters.

Over the past 30 years the governance of super funds has improved, yet governance practices lag contemporary best practice. Some trustee 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. The Royal Commission has revealed evidence of conflicts of interest directly resulting in member harm, including many instances where trustees in vertically integrated retail groups have preferred the financial interests of related-party shareholders over those of their members.

Best practice governance would require the trustee boards of *all* super funds to avoid conflicts of interest wherever possible, and then manage any unavoidable conflicts that remain. Trustee boards should also have a good mix of knowledge, skills and experience. Evidence from our governance survey suggests that not all funds employ satisfactory practices for appointing adequately skilled and qualified directors and for assessing board performance. Little more than half of CEOs firmly believed that their board has the right mix of capabilities, and only three in five firmly believed that their board has effective recruitment practices or seeks to improve its 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 sometimes actual) conflicts of interest. Indeed, one recent study estimated that nearly 80 per cent of directors on retail fund trustee boards are affiliated with related parties.

Vertical integration is not a problem per se, and can deliver benefits when competition and regulators are both fully effective — but neither are in the current super system.

Moreover, disclosure and trustee diligence are often lacking when it comes to outsourcing to related-party providers (a key source of conflicts of interest). APRA has voiced concerns that some funds may not be achieving value for money in their outsourcing arrangements. Our survey data and research by others suggest that funds that outsource administration to related parties pay more, but the poor quality of the data (especially on investment) makes it challenging to robustly analyse outsourcing practices.

Evidence of unrealised economies of scale, persistent underperformance and a large number of small funds — all imposing large costs on members — raises the question of why more funds have not merged. Little is known about mergers that have been broached but not completed. Some impediments to mergers are still evident, despite recent changes in regulatory guidance to funds (on successor fund transfers). Self-interest of board members is one, with the Royal Commission revealing clear evidence that board composition decisions have scuppered some merger discussions. The temporary nature of capital gains tax relief for funds that merge could also be a factor.

Conduct regulation appears to be missing in action

Regulation is essential for a compulsory and complex system holding large amounts of money and characterised by many disengaged members and potential conflicts of interest.

Regulation has evolved and improved over many years, and there is already a cornucopia of regulation aimed at trying to ensure members' best interests are met. Recently proposed reforms to boost the regulators' powers and regulatory levers will increase this further. 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 the new product intervention powers put forward for the Australian Securities and Investments Commission (ASIC) will strengthen its ability to guard against upselling.

But steadfast and confident enforcement of the existing rules seems lacking. In particular, strategic conduct regulation appears to be largely missing in action — especially when it comes to public deterrence. Ideally, a regulator would proactively identify actual or potential instances of material member harm, investigate the underlying conduct and take strategic enforcement action in a way that provides a valuable public deterrent to future poor conduct. But the requisite data analytics (akin to those in this report) and consequential strategic surveillance have fallen short.

The Royal Commission's hearings have highlighted the deficit, to date, of public exposure of poor conduct (and associated penalties) to demonstrably discourage similar behaviour by others — now and in the future. The hearings have also revealed failures in both the detection and deterrence of poor conduct, by both APRA and ASIC.

In part, this is attributable to confusing and opaque arrangements for regulating trustee conduct, with significant overlap and no clear delineation between the roles of APRA and ASIC. There is a very real and ongoing risk that regulatory breaches 'fall through the cracks' as a result of divided responsibilities — with each regulator believing the other should be dealing with a matter, and neither being held accountable for not doing so. It has also led to heavy reliance on cooperation between the regulators.

Regulator culture and practice also matter. APRA steadfastly regulates through a prudential lens — focused primarily on 'accounting for the money' — when super is not a market characterised by prudential risk (most members and taxpayers underwrite the risks) nor one of 'caveat emptor' (buyer beware). The regulators appear focused on funds and their interests, and not on whether members' needs are being met and their interests unharmed.

There are yawning gaps in data

Super has been a large and compulsory public policy endeavour, yet there is remarkably little publicly available data on the outcomes that individual members are actually experiencing — in terms of the returns they earn, the fees they pay, the insurance they hold and the outcomes they receive over time.

The regulators' data collections are largely focused on funds and (only recently) on MySuper products, with a deficiency of member-based data. Despite regulator awareness, there are also major gaps and inconsistencies in these data collections, including in key drivers of

member outcomes and in areas prone to potential conflicts of interest. Among other things, APRA fails to collect reliable data on funds' true investment expenses, with pervasive non reporting and under reporting by funds. It also fails to collect robust data on funds' outsourcing arrangements with related parties. Poor-quality disclosure by funds appears to go unchecked and unpunished. 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. Progress has been glacial in some areas. Regulators appear to be hamstrung by industry opposition (on the misplaced basis of short-term compliance costs). And the absence of a strong member voice to give impetus to change means there has been no countervailing influence.

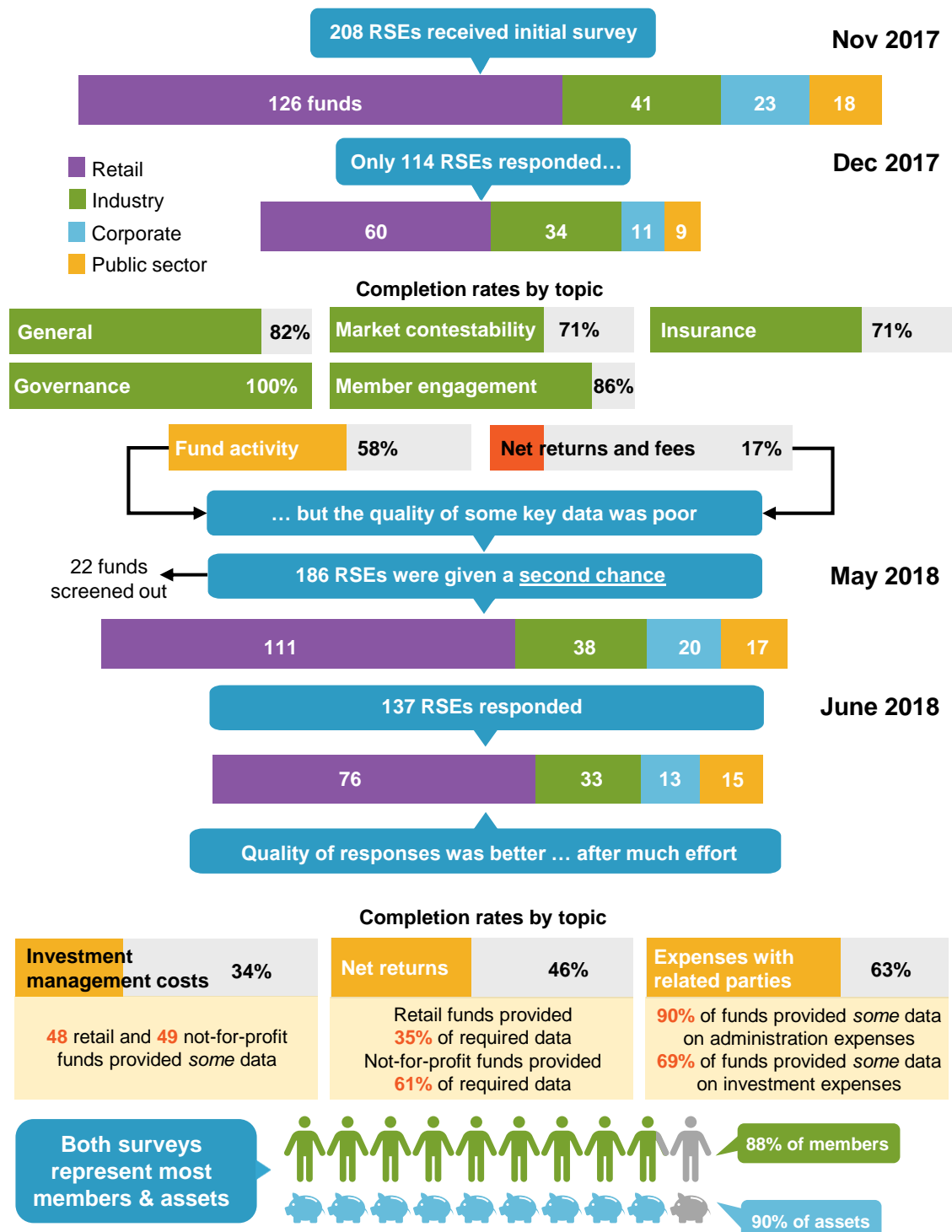
While our surveys were designed to fill some of the data gaps we faced in this inquiry, the overall quality of responses was symptomatic of a concerning disregard (on the part of many, but not all, funds) for transparency and members' best interests (figure 11). Only about half of super funds chose to participate (although notably they represented the overwhelming majority of member accounts and system assets). And of those that did participate, many skipped questions or provided incomplete data, especially on outcomes that matter most to members.

This prompted a supplementary survey of funds on a subset of topics, which had better response rates (after much follow up by us). Even then, this revealed that some funds do not comprehensively undertake performance attribution analysis or due diligence on their underlying products — must-haves for a trustee board to satisfy themselves that they are acting in members' best interests.

Poor data result in poor transparency, which leaves regulators and ultimately 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. Poor data also suppress competitive pressure on the supply side, as any fund seeking to assiduously benchmark against its peers would struggle to do so.

The continued absence of regulators confidently collecting and analysing data also precludes their effective supervision, enforcement and ultimate protection against member harm. The analysis in this inquiry highlights the value of data analytics in identifying member harm, which should have always been core business for a regulator.

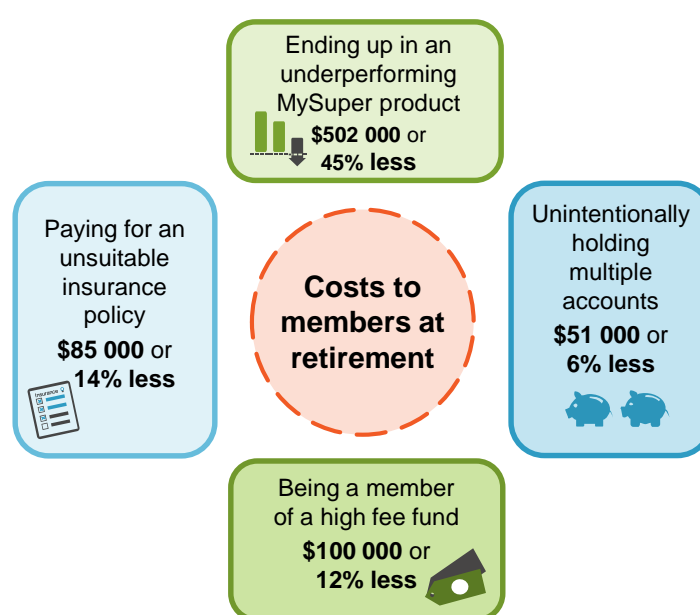
Figure 11 Responses to our super funds survey: not so super



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. Subpar 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 by about 6 per cent (\$51 000) and an underperforming MySuper product can reduce a typical member's balance by 45 per cent (\$502 000) by the time they retire (figure 12).

Figure 12 **The character of member harm**



The payoffs from fixing some of the worst problems in the super system would be significant. We have estimated that members would have collectively been in the order of \$2.6 billion better off each year if there were no unintended multiple accounts. And members would have collectively gained a further \$1.2 billion each year had all bottom-quartile MySuper products delivered returns in line with the median product in the top quartile. While these figures may appear immaterial across a \$2.7 trillion system, being defaulted into a single top-quartile MySuper product would lift the retirement balance of the median 55 year old by up to \$79 000 when they retire, compared with being defaulted into two bottom-quartile products. For a new workforce entrant today, the gain would amount to \$533 000 by the time they retire in 2064. This unlucky lottery needs to end — and the first line of defence is and should always be the policy settings.

The remainder of this overview sets out our recommendations to modernise the super system and make it work better for all members. These recommendations span the whole system: default and choice, accumulation and retirement, institutional funds and SMSFs. Collectively, they will harness healthy competition to make the super system work better

for all members, bringing it into line with the needs of the modern workforce and diverse retirees.

There is a rare and welcome alignment of inquiry endeavour whereby the Government's superannuation policy deliberations can be informed by both the recommendations of this inquiry and those of the Royal Commission.

A modern approach for default super

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 defaulting into an underperforming product. In the course of this inquiry and the stage 2 inquiry that preceded it, we have developed a modern approach for default super.

As a starting point, members should no longer be defaulted into a new super fund whenever they change jobs or industries. Members should only be defaulted once, if they do not have an existing super account and fail to make a choice of their own. Members 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. In other words, once members are in the super system, they — not someone else — should choose when they switch funds or open a new account.

A 'best in show' shortlist

Our approach is one of employee (rather than employer) choice. At its centre is a safer and simpler choice architecture to help all members choose their own super product — regardless of whether they are default members. This consists of a single shortlist of 'best in show' products for all members. Members should be empowered to choose their own product from the shortlist or to switch, and this should be safe and easy to do. The shortlist is thus an essential accompaniment to employee choice in a world of complexity and compulsion.

This new approach will support member engagement by 'nudging' members towards good products without forcing them to pick one. Members will retain the option to choose from the wider set of MySuper and choice products (or establish their own SMSF), and elevated 'outcomes tests' will help to weed out persistently underperforming products from the system (described below). In this way, choosing a super product will become much safer and simpler than it is today. Members will also still be able to join corporate or job-specific products, as long as they actively consent.

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. Employers would no longer be tasked with selecting default products for their workers. Most do not feel equipped to do so and do not wish to continue to do so. Further,

evidence reveals that some employers fall to the temptation of inducements offered by super funds (at the expense of their employees).

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 clear criteria that are focused on the fund’s likelihood of delivering strong long-term outcomes for members. Only MySuper products would be eligible for shortlisting. A high weight would be placed on investment strategy and performance, though the panel would also consider the fund’s track record on fees, governance and innovation, as well as how well its default insurance arrangements can cater to new members of all occupations.

This task would be broad in scope and the expert panel could draw on similar types of analysis to that of this inquiry (albeit with access to better data). But the specific analysis in this inquiry, and in particular the investment performance assessment, was undertaken to inform our system-level assessment of how the super system has been performing — it is distinct from the selection criteria we are proposing for the expert panel, and should not be conflated.

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 all members who join the fund should also receive the same benefits as existing members.

Following feedback on our draft report, we have further advanced and prescriptively articulated the shortlisting criteria and principles. While some inquiry participants were concerned funds may be able to ‘game’ the process by taking excessive short-term investment risks, the panel would be able to detect this by requiring funds to share data on their investments. Other participants argued that the process could harm competition if the benefits of being on the shortlist lead to the same funds becoming entrenched on the list. This overstates the importance of default flows in the system: all funds would remain free to compete for members and build scale. The expert panel should also be explicitly required to create a competitive dynamic each time it selects funds for the shortlist.

The age-old adage that past performance is no guarantee of future performance is only true of investment markets in a narrow sense. The expert panel would have a remit to consider a much wider range of criteria than historical investment returns. The adage is also incongruent with the evidence in this inquiry that good long-term performance is associated with low fees, good governance, and sufficient scale. That is not to say that judgment will not be required — and thus an expert panel is much better placed to identify *likely* future outperformers than employers (as under current arrangements) or individual members themselves (particularly default ones).

But good judgments can only be made if free of bias. The best in show panel should be comprised of experts and be independent of — but accountable to — government. Appointed panellists should be free of direct conflicts of interest, and be seen to be so by the public. Panellists should be appointed through a robust selection process, and chosen by a selection committee comprising the heads of respected, independent government agencies (such as the Reserve Bank) and a consumer representative. To further ensure independence, the panel appointment procedures should follow those used to appoint the Parliamentary Budget Officer, whereby appointments are made by the presiding officers of the Parliament and a Parliamentary committee must approve the appointment. The panel's decisions would be subject to judicial but not merits review.

Based on our three years of endeavour, consultation and analysis on the super system, we are confident there are many suitable, expert candidates who are free of conflict and well placed to assess and determine relatively superior funds for listing.

Although the current legislated (but not implemented) default model includes a panel within the FWC, the best in show expert panel proposed here should not sit within that body. This is because widespread acceptance by the community (including members and industry) of the legitimacy of the body housing the expert panel would be desirable. Such acceptance is problematic when the FWC process has become mired in controversy. Further, the FWC is not a technocratic decision-making body — and that is what is required for a member-focused panel with widespread public credibility. In any case, the selection of best in show products should give no weight to workplace relations and industrial precedent, the FWC's core areas of expertise.

How should the shortlist be implemented?

The Australian Taxation Office (ATO) should be the lead agency in implementing the new default model. An online service should be set up so that members can easily pick from the shortlist or nominate a new super fund, whether they are new to the workforce, changing jobs, or simply wishing to engage with their super. This could build on work already underway to provide super 'standard choice' forms through myGov. The system should facilitate simple choice, easy account consolidation and universal participation by employers and employees. It should be configured in a way that gives a clear nudge to support and encourage member decision making and engagement.

In parallel, the legacy stock of existing multiple accounts in the system needs to be cleaned up. The Government has legislation before Parliament that would empower the ATO to do this by automatically consolidating inactive accounts with low balances (under \$6000) where a member already has another super account (with the balance staying with the ATO, and incurring no fees, where no other account exists). This should be enacted without delay, with the threshold for such auto-consolidation increased over time to allow more accounts to be captured.

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. This would be much less than the number of members being defaulted each year under the current arrangements. It would represent a large reduction in ‘churn’ in the system, as members would not be 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.

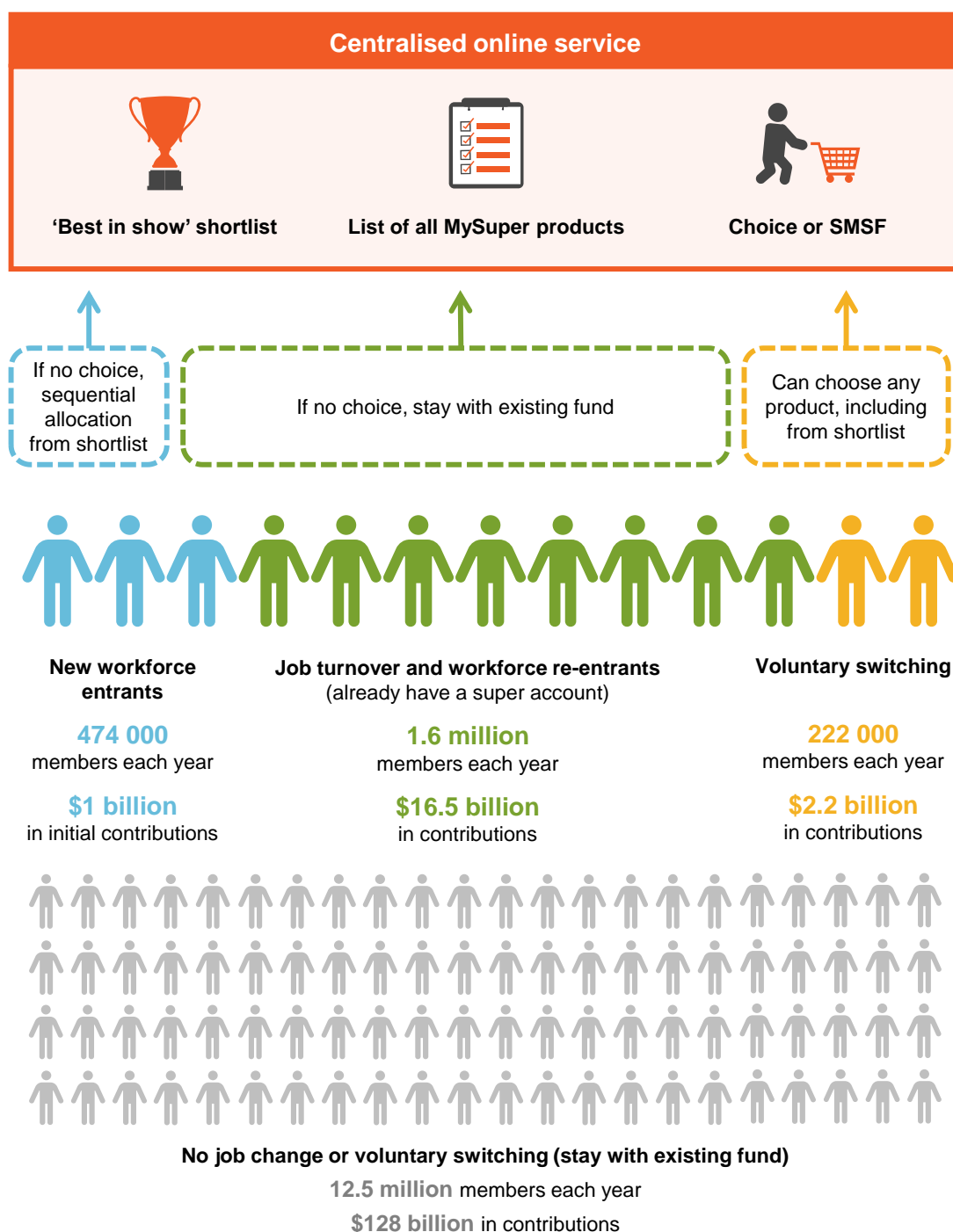
Modelling we undertook, and that was reviewed by APRA, suggests that even if many existing members chose to switch to a best in show fund, and other funds needed to exit or merge in the first few years, this should be manageable for APRA. It would induce much-needed consolidation and thus advance (not compromise) members’ interests.

How will members benefit?

A best in show process will be more than a step change from today’s system of confusing product comparisons and workplace-specific defaults. It is a ‘must have’ for making the super system work better for all members. In particular, it would bring five unique benefits that are over and above the gains that would arise from simply cleaning up the long tail of underperformers in the system, or from introducing ‘default once’ in isolation. It would:

1. support simple member choice, as well as safe choice, by making it easy for members to compare and select from a set of good products
2. stimulate competition between funds to get on the shortlist, and thus drive healthier competition to deliver for members
3. present clear ‘role models’ for other funds to emulate
4. accelerate desirable industry consolidation
5. serve as a discernible point of reference for financial advisers and their customers, and thereby strengthen the application and enforcement of financial advice laws by ASIC.

Figure 13 Where will members go?



New workforce entrants would be the immediate beneficiaries, as most would end up in a fund on the shortlist — one that is likely to deliver the best outcomes, with a potentially large impact on their balances at retirement. Existing members would benefit by being able to simply and safely choose a new super product, and from not being re-defaulted (and accumulating unintended multiple accounts) when they change jobs.

To illustrate this distinct benefit of best in show, conservative estimates suggest that the best in show process in and of itself could deliver a new workforce entrant an extra \$165 000 by the time they retire — nearly doubling the gain for millions of members compared to only removing persistent underperformers from the system (through the proposed elevated outcomes test discussed below).

All members would benefit from healthier competition. The new model will harness competition (and the innovation that flows from it) to deliver for members, rather than funds and providers — in other words, competition *for* the market. The competitive dynamics generated by wanting to get onto, or remain on, the shortlist will drive funds to deliver strong investment performance for their members, pass through the benefits of greater scale, and innovate to better meet their needs. The shortlisted funds will effectively serve as ‘role models’ for other funds that miss out, who will have a clear incentive to beat their competitors the next time around. In the course of doing so, existing default members in these funds will benefit just as much as prospective new members. And those funds that are not well placed to serve a broad cohort will be encouraged to better define and serve their niche cohort (or, if they cannot, to wind-up and merge).

Over time, the member-centric nature of the process would also see greater competition *in* the market, 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. While this may see some uptick in switching rates, any costs of switching would be considerably outweighed by improvements to member engagement and ultimately member outcomes. Indeed, greater member engagement does not always take the form of switching. It can simply be better member awareness — knowing which fund they are with, what their balance is, what long-term returns they are getting and whether they have insurance.

Further benefits will arise from moving to ‘default once’, in conjunction with the best in show shortlist. It will halt the generation of unintended multiple accounts that are currently causing much member harm. It will also avoid members being automatically shifted in and out of multiple funds over their working lives as they change occupations or industries, which members are increasingly likely to do in the modern workforce. And default once will avoid the additional costs to members (at least \$45 million a year) and disengagement an ‘auto-rollover’ approach would bring — a proposal put forward by some industry participants that would see members’ existing balances being automatically transferred to a new default super fund when they start a new job.

Linking defaults to the member and not the job — and thereby removing employers from the process — will also sidestep the potential conflicts of interest that go hand in hand with the current system. And it will extricate default selection from workplace relations and likely see a long-overdue increase in average scale, to the benefit of millions of members. Employers can still play a role, such as by negotiating with super funds to secure group discounts or tailored insurance for their employees, and corporate funds will remain in the

system. Members will need to actively choose these products themselves, and employers and unions would be well placed to guide them to relevant information.

Elevated outcomes tests

MySuper authorisation was intended to play 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 was meant to make products more comparable, and thus to help members to make decisions about their super and to exert competitive pressure on funds to meet their needs. At the same time, MySuper authorisation 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 annual outcomes test whereby trustees must determine whether their MySuper product is meeting the best interests of their members, and must compare their MySuper product against others in the market based on fees, returns, risk and other metrics. APRA would have increased powers to revoke the MySuper authorisation of funds that do not comply, and 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.

But the MySuper outcomes test needs to be further elevated. Funds should be required to obtain independent verification — to an audit-level standard — of their outcomes test assessment at least every three years. They should also be required to compare their MySuper performance to a benchmark portfolio tailored to their asset allocation — as we have done to examine the super system’s performance in this inquiry. The results should be published.

Elevated outcomes testing should also be extended to the choice segment. APRA has already taken steps in this direction by setting regulatory standards for a fund-wide outcomes assessment to apply from January 2020 (which would sit above the MySuper outcomes test). These assessments should also be subject to independent verification, and supplemented by more prescriptive requirements for comparing each of a fund’s choice investment options to a tailored benchmark portfolio and publishing the results (as per the elevated MySuper outcomes test).

The investment benchmarks should serve as a clear test for the right to remain in the super system. MySuper products and choice options that persistently underperform the benchmark would fail this ‘right to remain’ test. This should be assessed over a rolling eight-year period, with a margin of 0.5 percentage points. The fund would then have 12 months to remediate (such as by cutting fees) or to withdraw the investment option and move the affected members somewhere more suitable. Where neither of these occurs, APRA should direct the fund to withdraw the investment option, or revoke the fund’s MySuper authorisation. APRA would then need to oversee the transfer of members to a superior fund, such that those members are likely to be better off in the long term (even if their exact ‘bundle of rights’ differs).

The elevated outcomes tests would also require funds to rigorously assess their fees and the member services, insurance and financial advice they provide. Trustees would need to justify to APRA that their MySuper product has an appropriate investment strategy for the member cohort, and be able to justify to ASIC that their choice investment options are appropriate for the relevant target market.

It can be expected that elevated outcomes tests would result in many funds seeking to lift their game, rationalise their products or merge with another fund. Many underperforming and grossly inappropriate products should disappear, and the benchmarking will give APRA a clear lever to make this happen. This would weed out the underperformance that infiltrates all corners of the super system (including among legacy products — which hold an estimated 3 million member accounts), thereby affording a much more targeted approach than blanket prohibitions on particular types of funds or service providers. It would also see much-needed consolidation in the super system and better outcomes for millions of members.

Elevated outcomes tests will also promote clearer accountability. As funds are vessels for members' assets, the onus should be on funds to justify why they should remain in the system. Basing this 'right to remain' on a clear and objective benchmark will make it harder for trustees to game or work around by selectively choosing their own methods of performance comparison. It would also act to both counter and deter poor conduct (that results in poor performance) and make the enforcement task easier for regulators by providing greater clarity and certainty about when regulator action can be expected — and thus will also help to hold the regulators to account.

Products and information that meet member needs

Simpler and more comparable disclosure

Making it easier for members to get engaged, compare products and make decisions is an essential prerequisite (alongside our 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. Clearer, simpler and more widely applied product dashboards are needed to help members compare the returns, fees and risks 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 the end of 2019 — with exceptions only granted on a truly exceptional basis. 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, ASIC should make them available on a single website. They should also be accessible via the new centralised online service for the best in show shortlist. Members should be prompted to compare their current product with those on the shortlist to see how their product is performing and, if desired, to easily switch.

Better advice

Not all members will need financial advice. But more can be done to help those who do to access advice that is impartial, affordable and meets their needs. A significant body of evidence has emerged through the Royal Commission and work by ASIC that conflicted and unsuitable advice pervades the super system. This must be fixed.

The best in show shortlist will help by serving as a discernible (and unavoidable) point of reference. It will help advisers (in recommending products), their customers (in putting pressure on advisers to explain why any product advice diverges from the list), and also the regulators (in enforcing financial advice laws).

Stronger regulatory oversight of financial advice is overdue. Advisers should be required to disclose which products are on their approved product lists, as we recommended in our parallel inquiry on *Competition in the Australian Financial System*. Steps are in train to lift the qualification requirements of financial advisers, and this should be extended to require specialist training for those advising on SMSFs. And when a member is being advised to set up an SMSF, the adviser should be required to give them a document that clearly explains key issues they need to consider (‘red flags’) in deciding whether an SMSF is right for them. A minimum balance is too blunt an instrument, but advisers should be prepared to justify to ASIC why they are recommending any SMSF be established with a balance remaining under \$500 000 beyond the initial establishment years.

Conflicts of interest in the provision of financial advice would also be reduced by banning trailing commissions and lifting the quality of products across the board via elevated outcomes tests, which would remove the risk of members switching to persistently underperforming products.

More broadly, a clearer distinction is needed between financial advice (that takes account of a member’s individual circumstances) and information (that can help them to make their own decisions). All advice in relation to super is arguably personal, and the term ‘advice’ should not be used where members are only being provided with product information or marketing material (which we also recommended in our parallel inquiry).

Impartial advice will be especially important for many members in the retirement phase, where diverse needs, preferences and non-super assets mean one size can never fit all. There are real risks in nudging many members into risk-pooled products that may not suit their needs and are costly to get out of. Trustees do not always want to offer these products, and forcing them to do so may conflict with their obligations to act in members' best interests. The Government should thus reassess the benefits and costs of its proposed Retirement Income Covenant, and abandon it if the flaws cannot be sufficiently remediated (by the now deferred date of 1 July 2022).

In conjunction with this reassessment, the Government should also consider extending the existing Financial Information Service (provided by the Department of Human Services) to offer members at or near retirement impartial information to help them navigate complex retirement income decisions and, where relevant, seek out impartial financial advice. In time, digital ('robo') technology could potentially be incorporated. In the meantime, the Government should prompt pre-retirees (when they reach age 55) to online information to help them make decisions about their retirement.

Smarter use of data

There is much scope for super funds to better harness data and technology to provide advice (including digital advice) and to design super and insurance products. This includes collecting and analysing more data about their members, as well as drawing on cost-effective imputed data that are not fund specific. In particular, there are good prospects for further personalising life-cycle and retirement products to better match them to diverse member needs. To accelerate progress, the Government should roll out the new Consumer Data Right to super, and automatically accredit super funds to be eligible to receive information that banks hold on members (with their consent).

Fees charged on a cost-recovery basis

Evidence abounds of excessive and unwarranted fees in the super system — a particular focus of evidence to the Royal Commission. Because super funds are legally obliged to act in members' best interests, the fees they charge should not exceed cost recovery levels. The Government should enforce this across all MySuper and choice products, and prohibit funds from cross-subsidising between members — which would see an end to excessive fees (such as some percentage-based administration fees) while also ruling out scope for some members to bear the cost of other members' decisions.

The Government should also, as soon as practicable, ban trailing commissions. These commissions remain in the system despite being grandfathered over five years ago as a transitional arrangement. The time for transition is over.

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. But this is not enough. 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. While a small minority of under-25s might benefit from opt-out insurance, exemptions should only be granted to funds that can convincingly demonstrate to APRA that this exception should apply for specific cohorts of their members.

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 help to remove some unintended multiple policies and thus also reduce the risk of members holding ‘zombie’ insurance policies they are unable to claim on.

The Government is in the process of legislating changes along these lines, together with making insurance opt in for accounts with balances less than \$6000. This legislation should be passed without delay.

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, along with a simple calculator that members can use to estimate how insurance premiums would affect their balances at retirement. In addition, funds seeking inclusion on the best in show shortlist should articulate this trade-off for prospective members, and demonstrate how their default cover could cater to new members of all occupations.

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. ASIC and APRA should work together to monitor and report on adoption and implementation of the code, and to direct the industry to strengthen the code’s provisions such that it meets ASIC’s definition of an enforceable code of conduct. Standardising key definitions and provisions is a priority, but this cannot be left to the industry alone. The industry should be given a hard two-year deadline to make the bolstered code binding and enforceable on all signatories, at which point adoption of the code should become a licence condition for all funds that offer insurance.

This inquiry has not asked the broader question of whether insurance *should* be funded through super. That question should be answered by an independent public inquiry into insurance in super, which should commence within four years from the completion of this current inquiry report. This inquiry should also evaluate the effectiveness of policy initiatives to date, examine the intersection of insurance in super with other schemes (such as worker’s

compensation), and consider whether opt-out insurance through super is the most efficient and equitable way to provide assistance to people in the event of illness and injury.

Best practice fund governance

Members' outcomes — more than process or intent — must be the key focus of governance arrangements and trustee endeavour. The interests of the fund and the member are not interchangeable concepts. Super funds exist solely as a vessel for members' assets. What is in the best interests of the fund need not automatically be in the best interests of the member.

We are recommending a set of amendments to governance rules to lift the performance of boards and make trustees more accountable to their members. Trustees of all super funds should be required to have, use and disclose a process to assess their board's performance relative to its objectives and to assess the performance of individual directors (at least annually). 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. At least every three years, an external third party should be engaged to evaluate the board's performance and capability against the skills matrix, with a copy to be provided to APRA. This would better align super funds' governance with best practice for companies listed on the stock exchange.

Best practice also means that all new board appointees have a professional understanding of the super system and investment decision making, gained either through industry experience or formal training. This should be a regulatory requirement.

A focus on skills would likely lead to more independent directors as boards recruit from a wider 'gene pool'. Tightening the definition of 'independence', as the Government has proposed, will help by putting a stronger focus on recruiting genuinely independent directors. But the debate over mandating independent directors has become highly polarised. Arguing only about the number of independent directors on a board loses sight of what matters: getting the right mix of knowledge, skills and experience, and managing conflicts of interest.

Stronger disclosure is needed to shine a light on conflicts of interest and put pressure on trustees to first avoid conflicts and then better manage (unavoidable) residual conflicts. APRA should require funds to conduct formal due diligence of their outsourcing arrangements at least every three years, with a copy of the assessment to be provided to APRA. Funds should also publicly disclose to current and prospective members the proportion of their costs paid to related-party service providers.

Further rigour is also needed in the contracts that trustees sign with outsourced providers. APRA should require trustees to include in all material service contracts a clause that obliges the service provider not to do or take any action that adversely affects members' interests. Good trustees should already be doing this, along with monitoring contract performance. But

the Royal Commission has revealed evidence that some have taken a very lax approach towards oversight of their 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 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 would assist APRA in facilitating or compelling mergers as it applies the elevated outcomes tests (discussed above). APRA should also be empowered to prevent mergers that are not in members' best interests. At the same time, ASIC should proactively investigate questionable cases where mergers between super funds stalled or did not proceed, and the Government should ensure ASIC has the powers it needs to pursue action against directors in the event of failed mergers that should have proceeded. This would dovetail with a greater focus on strategic conduct regulation (discussed below).

More generally, it has become evident that funds do not always act in the best interests of their members. It would appear that this reflects not only trustee misconduct but a lack of clarity around what is expected of trustees under the best interests duty in legislation — as has become apparent in the evidence emerging through the Royal Commission. The best interests duty should really be about achieving what an informed member might reasonably expect. More clarity could be achieved by re-articulating the definition in legislation, by providing clearer guidance in regulation, and/or by regulators confidently pursuing 'test cases' through the courts. The Government should consider these options in light of the outcomes of the Royal Commission.

Regulators that are member champions

Confident regulators that champion the member are essential in a compulsory super system. Regulatory arrangements need to support this. A clearer articulation of the roles of APRA and ASIC is needed to more closely align these roles with each agency's 'regulatory DNA'.

APRA is best placed to focus on licensing and authorisation to promote high standards of system and fund performance. The elevated outcomes tests should be central to its regulatory approach, by helping to detect poor performance — whether caused by a failing of competence, conduct or a combination of both — and thus informing how APRA prioritises its supervisory effort. The Government should provide APRA with a more explicit 'member outcomes' mandate to replace its traditional (and here misplaced) prudential mandate, and clarify that 'outcomes' should be synonymous with actual member outcomes, not adherence with processes. APRA will also need an exponential uptick in dedicated expertise and resources to deliver on what is expected of it. An independent and expert capability review of APRA is now overdue. Recently announced and completed reviews are no substitute.

ASIC is best placed to regulate the (mis)conduct of trustees and advisers, and to oversee the appropriateness of products (including to particular target markets) and disclosure. In principle, it should be the primary strategic conduct regulator for the super system. This

entails both the detection and deterrence of misconduct. ASIC will need to work closely with APRA to share data and identify areas for closer scrutiny (with the elevated outcomes tests thus also assisting ASIC). They will also need to coordinate enforcement action. ASIC is well suited to undertaking *public* enforcement activities that provide a strong deterrent effect to all trustees.

We are mindful that these matters are subject to consideration by the Royal Commission. Ultimately, and with the benefit of this report and that of the Royal Commission, the Government should clarify the precise allocation of roles between APRA and ASIC. At the same time, it should comprehensively examine whether APRA and ASIC need stronger powers and whether penalty provisions should be strengthened, especially in relation to trustee misconduct.

In any case, it is clear that many of the accountability mechanisms for regulators that already exist — such as ministerial and Parliamentary oversight, performance reporting, and Statements of Expectation and Intent — have been left largely dormant or at best underutilised by Government. The Government needs to set much clearer expectations of APRA and ASIC and proactively hold them to account for the outcomes they deliver. This should include requiring them to jointly publish a *State of Superannuation* report every two years to report on member outcomes in the super system and progress in identifying, stemming and remediating member harm.

The regulators also need to confidently and systematically collect more data relevant to assessing member outcomes, make these data public, and analyse the data to inform and prioritise their regulatory activities. There should be a prioritised and ongoing endeavour by APRA, ASIC, the ATO, the Australian Bureau of Statistics 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. As part of this, APRA should collect more data on actual member outcomes on an ongoing basis (including product-level reporting), tackle inconsistencies and misreporting by funds head on, and work more closely with ASIC to advance data analytics. It cannot be overstated how fundamental data analytics are to strategic and effective conduct regulation of the super system. The data gathered (and the analysis) in this inquiry are a good starting point. Better data would also make it easier for the Government to hold the regulators to account (including through their *State of Superannuation* report), and to fulsomely evaluate policy interventions over the long term.

Regulators should not be left to champion member interests on their own. They will always struggle in a system where debate is dominated by the interests of funds and their service providers rather than the interests of members. To balance this, the Government should provide ongoing funding for a new organisation to understand, promote and give voice to member interests — and to provide assistance to members themselves.

Implementation

Implementing the package of recommendations in this report will modernise the super system, harness healthy competition and make the system work better for all Australians into the future (table 1). These recommendations also offer enduring policy solutions to the sorts of poor conduct that have occurred under current policy settings. But the industry and its structure will need to change.

We have designed a transition timetable that will allow for a considered implementation that reduces disruption to members, and is manageable for the regulators to oversee and for industry to digest (figure 14). The transition should be achievable within three years following the passage of legislation. The first stage is to remove underperforming funds and products from the system (by phasing in the elevated outcomes tests). Once the risk of new members being defaulted into underperforming funds has been removed, employee choice (guided by the best in show list) and default once can be introduced. This will also allow time for an expert panel to be appointed, a shortlist to be developed and the requisite online systems to be set up and tested.

These policy changes are of significant import to future national wellbeing. Their timely and effective implementation should be overseen by a Steering Group comprising the Secretary of the Department of the Prime Minister and Cabinet, Secretary to the Treasury, Chairs of APRA and ASIC, and the Commissioner of Taxation.

Beyond the specific recommendations in this inquiry, further changes in enforcement practices or new regulation in some areas may also prove to be warranted, pending the final findings and recommendations of the Royal Commission. Any such changes will need to be incorporated into the implementation strategy.

This is not the first inquiry on the super system, and will not be the last. Nor should it be. In a compulsory system, it is incumbent on the Government and regulators to ensure ongoing accountability and review. This is essential for the super system to remain fit for the future and deliver the best possible outcomes for members in retirement.

Table 1 Modernising the super system to work better for all members

<i>Causes</i>	<i>Recommendation(s) (numbers)</i>	<i>How members will benefit</i>
Problem: Balances are eroded by fees and insurance		
Default allocation directly results in unintended multiple accounts	Members default once and retain existing account for new jobs (1) ATO to clean up stock of low-balance inactive accounts (5)	In time, all members will pay a single set of fees and insurance premiums (unless they choose otherwise)
Excessive fees and trailing commissions	Require all fees (including exit fees) to be cost recovery and ban trailing commissions (14)	Less undue balance erosion Greater member switching to better products
Problem: Persistently underperforming funds and products		
Poor performing funds and products remain in the system	Elevated outcomes tests (4) Remove impediments to mergers (20, 21)	Members get better returns as funds lift their performance, transfer members to a better fund, or merge
Problem: Poor investment performance for some default members		
Lack of simple and safe choice	A single best in show shortlist of products (2, 3) Centralised online service (1)	Easier for members to engage by choosing their own product, and to compare products and switch
Default allocation means some members are not defaulted into high-performing funds	A competitive and independent process to select 'best in show' products (3) Replace employer selection of defaults with sequential allocation from best in show shortlist (2)	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 Employers no longer pick defaults
Poor performing funds are retaining their MySuper authorisation	Elevated outcomes tests (4)	Members get better returns as funds lift their performance, transfer members to a better fund, or merge Safer choice for members
Economies of scale are not fully realised	Elevated outcomes tests (4) Remove impediments to mergers (20, 21)	Better net returns for members of currently underperforming funds
Problem: Poor outcomes in the choice segment		
Lack of quality, accessible and comparable information on products	Simple and comparable dashboards for all products (6), with comparisons to a member's current product and best in show shortlist (7) More meaningful product disclosure (24) Consumer data right for super (13)	Easier for members to compare options and switch products, and to benchmark the quality of financial advice Safer choice for members
Proliferation of complex and high-fee products in the choice segment	Elevated outcomes tests (4) Require all fees (including exit fees) to be cost recovery (14) APRA review of legacy products (23) Best in show shortlist (2, 3)	Closure of poor performing products (including legacy products) Easier for members and their advisers to evaluate available products and compare to current product
Limited data on products and member outcomes	Dashboards for all products (6) Publish product-level data (23) Improve data collection and release, with focus on member outcomes (27)	High and low performing funds are clearly identifiable to members Accountability to members that the system is performing in their interests

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Table 1 (continued)

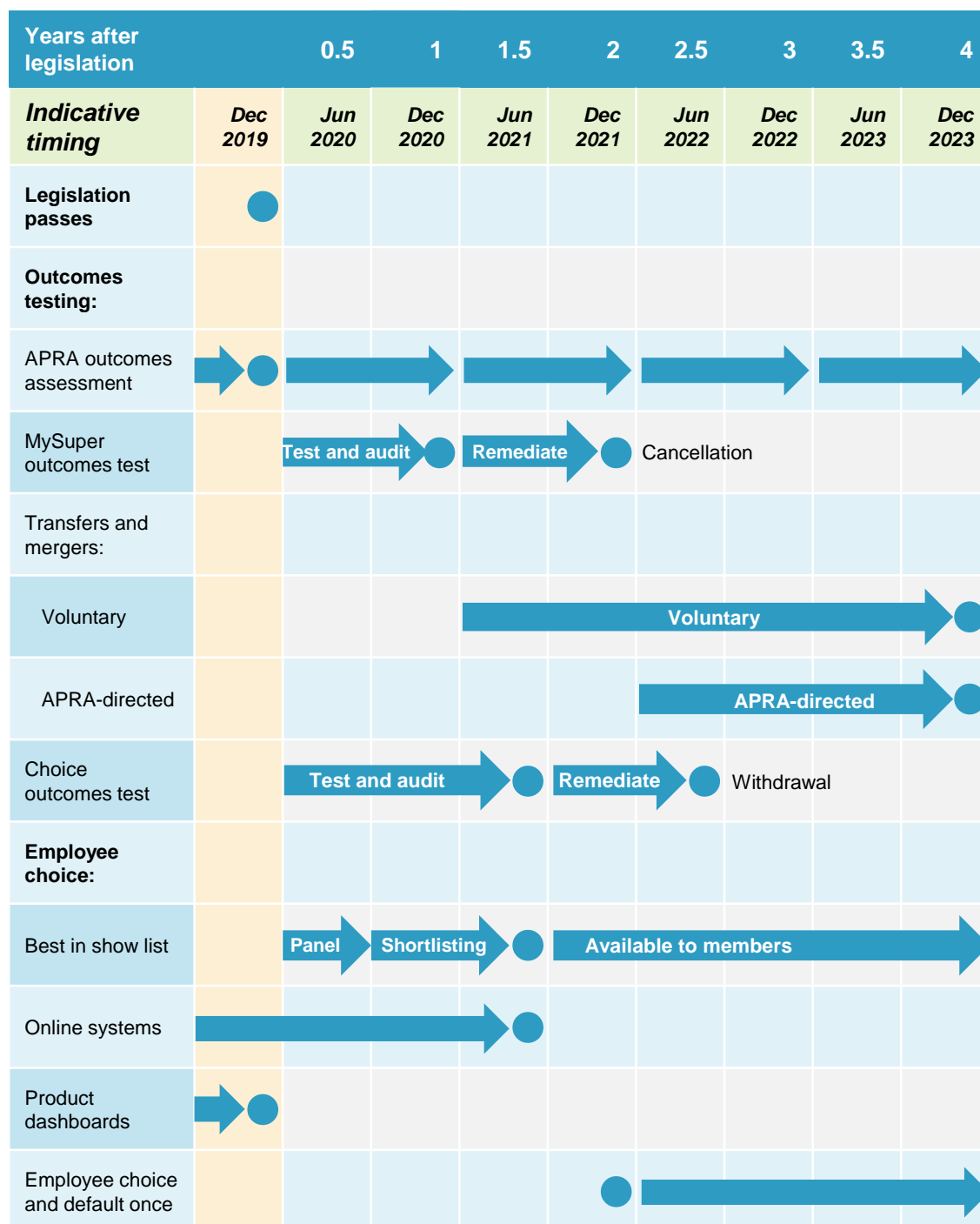
<i>Causes</i>	<i>Recommendation(s) (numbers)</i>	<i>How members will benefit</i>
Problem: Members do not always end up in the right products		
Funds do not make full use of data in designing products (including life-cycle products and insurance)	Improve data collection and release (27) Consumer data right for super (13) Elevated outcomes tests (4)	Stronger competitive dynamic to push funds to design better products Investment strategies and product features are better tailored to member needs
Members struggle to find the right retirement products	Guide pre-retirees to online information (11) Consider funding information sessions for retirees (10) Delay Retirement Income Covenant (10) Independent member advocacy body (28)	Easier to access impartial information to make decisions Members approaching retirement are more aware of their options
Problem: Member engagement is often low		
Products are complex and hard to compare	Simple and comparable dashboards for all products (6), with comparisons to a member's current product and best in show shortlist (7)	Easier for members to compare options and switch products, and to benchmark the quality of financial advice
Low levels of financial literacy	Evaluate financial literacy programs to target funding to those that work (9)	Greater levels of financial literacy
Many members do not know where to get help	Independent member advocacy body (28) Guide pre-retirees to online information (11) Consider funding information sessions for retirees (10)	Independent information and assistance easier to access Members approaching retirement are more aware of their options
Problem: Financial advice is expensive or conflicted		
Members struggle to gauge the quality of advice they receive	Best in show shortlist (2, 3) A 'red flags' document for members advised to establish an SMSF (12)	Easier for members to question the advice they receive and benchmark its quality
Weak enforcement of financial advice laws	Disclosure of approved product lists (8) Stronger safeguards on SMSF advice (12) Best in show shortlist (2, 3) Greater conduct regulation role for ASIC (24, 25)	Greater transparency of adviser behaviour to members and regulators, allowing for stronger enforcement of advice laws Less scope for conflicted advice
Confusion of what constitutes advice	Ensure the term 'advice' can only be used where personal advice is given (8)	Less scope for members to be misled or for entities to circumvent advice laws
Problem: Insurance is not delivering value for money for all members		
Unsuitable insurance, including default insurance members cannot claim on	Opt-in insurance for young and inactive members (15) Clearer articulation of balance erosion trade-offs (16)	Removal of unsuitable insurance policies and, over time, greater value for members
Inconsistent standards and poor practices across industry	Strengthen and enforce insurance code (17) Inquiry into insurance in super (18)	Removal of unsuitable insurance policies and, over time, greater value for members

(continued next page)

Table 1 (continued)

<i>Causes</i>	<i>Recommendation(s) (numbers)</i>	<i>How members will benefit</i>
Problem: Poor conduct by fund trustees		
Poorly managed conflicts of interest	Stronger contract terms with outsourced providers, formal due diligence by funds (23), and greater disclosure of outsourcing costs to members (24) Stronger definition of independent director (19) Elevated outcomes tests (4)	Lower fees and/or higher net returns Conflicts of interest are more transparent Products with poor performance due to related party conflicts are improved or withdrawn
Some trustee boards lack sufficient skills, expertise or independence	Lift standards for boards, including independent skills assessments (19)	More capable boards that ultimately deliver higher net returns and products that better meet member needs
Self-interest appears to stymie mergers	Elevated outcomes tests (4) Greater disclosure of merger activity (20) APRA reporting on merger activity (23) ASIC investigation of stalled mergers (24)	Underperforming funds exit the system or merge Trustees are deterred from stymieing beneficial mergers
Varying interpretations of best interests duty	Clarify definition of best interests duty (22)	Stronger trustee focus on delivering outcomes that benefit members
Lack of strategic conduct regulation	See below	
Problem: Absence of strategic conduct regulation		
Unclear regulator roles and powers, especially for conduct regulation	Clarify regulator roles and powers (25) Capability review of APRA (26)	Confident regulators actively deter misconduct and promote member outcomes
Inadequate data	Publish product-level data (23) and develop more consistent, member-relevant data across system (27)	Accountability to members that the system is performing in their interests Regulators better able to monitor conduct and outcomes
Strong member voice is lacking	Independent member advocacy body (28)	Greater championing of member interests in policy debates and regulation development
Insufficient regulator accountability	Regulator reporting on activities and outcomes to government and the public (29) Clarify regulator roles and powers (25) Elevated outcomes tests (4)	Accountability to members that the system is performing in their interests Easier to hold regulators to account for delivering what is expected of them

Figure 14 Implementation: a transition road map



Findings and recommendations

Investment performance

FINDING 2.1

The Commission's funds survey suggests that superannuation funds on average outperformed a market index benchmark in most individual asset classes over the 10 years to 2017. Not-for-profit funds outperformed retail funds on average within most major asset classes over this period.

However, these survey results are positively biased due to missing data for funds that have exited the system (survivor bias) and that did not provide the requested data (selection bias).

While international comparisons add further data issues, compared with large pension funds in other developed countries, Australian superannuation funds appear to have achieved comparable returns on individual asset classes.

FINDING 2.2

APRA-regulated funds have delivered investment returns to members over the past 21 years (net of all fees and taxes) of 5.9 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 that is not fully explained by differences in asset allocation.

Not-for-profit funds, as a group, have systematically outperformed retail funds. This outperformance cannot be fully explained by asset allocation, tax or expenses. Much of it is likely due to differences in asset selection (within asset classes) between the segments.

FINDING 2.3

There is wide variation in performance at the fund level. About 5 million member accounts and \$270 billion in assets are in 29 funds that underperformed conservative benchmarks tailored to each fund's own asset allocation over the 13 years to 2017. About 77 per cent of member accounts and 72 per cent of assets in underperforming funds were in retail funds, even though retail funds represented just 9 of the underperforming funds. Of the other underperforming funds, 14 are industry funds, 3 are corporate funds and 3 are public sector funds.

While asset allocation is the largest determinant of returns at the fund level, most of the variation across funds cannot be explained by asset allocation, tax or expenses. Rather, it is most likely primarily due to differences in asset selection (within asset classes) between funds.

FINDING 2.4

There is wide variation in performance in the default segment. About 1.6 million member accounts and \$57 billion in assets are in MySuper products that underperformed conservative benchmarks tailored to each product's own asset allocation over the 11 years to 2018. This suggests that many members are currently being defaulted into underperforming products and could be doing better.

If all members in bottom-quartile MySuper products received the median return from a top-quartile MySuper product, they would collectively be \$1.2 billion a year better off. Being in the median bottom-quartile product means that, on retirement, a typical worker (starting work today) is projected to have a balance 45 per cent lower (or \$502 000 less to retire with).

FINDING 2.5

There is wide variation in performance in the choice segment that is not fully explained by differences in asset allocation. Almost \$25 billion in assets are in investment options that underperformed conservative benchmarks over the 13 years to 2017. Many choice members could be doing a lot better.

FINDING 2.6

The SMSF segment has delivered broadly comparable investment performance to the APRA-regulated segment, but many smaller SMSFs (those with balances under \$500 000) have delivered materially lower returns on average than larger SMSFs.

Fees and costs

FINDING 3.1

Superannuation fees in Australia are higher than those observed in other OECD countries. This may be partly because Australian funds face higher expenses. While international comparisons are not straightforward, there is evidence (by asset class) that Australian investment management costs are generally high by international standards, including for significant asset classes (such as equities and international fixed income).

FINDING 3.2

In aggregate, total fees in APRA-regulated funds (for administration and investment management services) have been trending down as a proportion of assets over the past decade, from 1.3 per cent in 2008 to 1.1 per cent in 2017.

FINDING 3.3

Fees have fallen for retail funds, albeit remaining higher (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 possible competitive spillover to choice products), although this is difficult to attribute directly given the impact of other fee drivers.

FINDING 3.4

While financial advice can benefit members, excessive advice fees in choice products and all trailing commissions erode member balances. Ten retail funds collected about \$1.4 billion of advice fee revenue in 2017, charging their members about \$341 per account in that year alone. Separately, members of 11 retail funds identified in data from the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* are estimated to have paid in excess of \$400 million in (grandfathered) trailing adviser commissions in 2017.

In contrast, advice fees are closely regulated in MySuper products (with funds only permitted to recoup the cost of intrafund advice from fee revenue), thereby protecting members from undue balance erosion. The disparate regulation of fees and costs in the choice and MySuper segments is in part contributing to poor member outcomes in the choice segment.

FINDING 3.5

There is a 'tail' of choice products with high fees (exceeding 1.5 per cent of balances), offered by retail funds. This tail accounted for about 17 per cent of assets and 15 per cent of member accounts in APRA-regulated funds in 2017. Retail legacy products account for almost half of all products in the high-fee tail.

The share of member accounts in the high-fee tail has been declining over time, particularly since 2013 and the introduction of MySuper, but today still accounts for an estimated 4 million member accounts holding \$275 billion in assets. Further declines are likely to hinge on the effectiveness of regulator efforts to shift members out of retail legacy products.

FINDING 3.6

Despite regulator awareness, there remain significant gaps and inconsistencies in how funds report data on fees and costs. Funds that misreport or underreport fees and costs appear, at times, to have gone unpunished. This harms members by making fee comparability and decision making difficult at best, and thus renders fee-based competition largely elusive.

FINDING 3.7

Higher fees are clearly associated with lower net returns over the long term. The material amount of member assets in high-fee funds, 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).

FINDING 3.8

Reported costs for SMSFs (relative to assets) have increased over recent years and, for those with over \$1 million in assets, are broadly comparable with APRA-regulated funds. By contrast, costs for SMSFs under \$500 000 in size are particularly high, on average, and significantly more so than for APRA-regulated funds.

About 42 per cent of all SMSFs (some 200 000 in 2016, with an estimated 380 000 members) have been under \$500 000 in size for at least two years, and appear to persist with high average cost ratios and low average returns. Nevertheless, the proportion 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.

Members' needs

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. Many more members indicate that the performance of funds, including their service quality, has improved over time than those who feel that performance has 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.

FINDING 4.2

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

A low-fee product that, over a person's working life, exposes them to a mix of defensive and growth assets is likely to meet the needs of most Australians during the accumulation phase. A better-designed and modernised default allocation mechanism could act as a trusted benchmark for better member decision making across the entire system.

FINDING 4.3

Well-designed life-cycle products can produce benefits greater than or equivalent to single-strategy balanced products, while better addressing sequencing risk for members. There are also good prospects for further personalisation of life-cycle products that will better match them to diverse member needs, which would require funds to collect and use more information on their members.

Some current MySuper life-cycle products shift members into lower-risk assets too early in their working lives, which will not be in the interests of most members.

FINDING 4.4

In the retirement phase, risk-pooled lifetime income products may meet some members' preferences for a predictable income stream and for managing longevity risk. However, the proposed Retirement Income Covenant may nudge many others into products ill-suited to their long-term needs, may not achieve its desired goal of increasing retirement consumption, and fails to take sufficient account of the diversity in household preferences, incomes and other assets.

The requirement that all funds must offer a 'flagship' risk-pooled product would oblige any fund without a capacity to create such a product to purchase it from a third party — where there are few choices currently on the market. The requirement for a standardised risk-pooled product may conflict with trustees' obligations to act in members' best interests, and many funds do not want to offer them. Their complexity, limited scope for reversibility and major deficiencies in the credibility, independence and affordability of financial advice for retirement products leaves significant scope for member detriment arising from the requirement to supply risk-pooled products.

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 can have the biggest payoffs for members.

Member engagement

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 decision making. Low financial literacy is observed among a sizable minority (about 30 per cent) of members.

FINDING 5.2

Demand-side pressure in the superannuation system is 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.

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, and regulators have left this unresolved.

FINDING 5.4

The quality of financial advice provided to some members — including those with SMSFs — is questionable, and often conflicted.

The need for information and affordable, credible and impartial financial advice for retirees will increase as retirement balances grow with a maturing system, and given the rising diversity and complexity of retirement products.

Erosion of member balances

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.

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.

- Structural flaws have led to the absurdity of unintended multiple accounts in a system anchored to the job or the employer, not the member. These unintended multiple accounts (one in three of all accounts) are directly costing members nearly \$1.9 billion a year in excess insurance premiums and \$690 million in excess 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.

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

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, there is concentration in some service provider markets for outsourcing (like administration). However, a growing ability for larger funds in particular to insource all, or parts, of their service requirements adds to competitive pressure.

While concentration is low in the investment management market, evidence suggests that managers have some market power. As a consequence, smaller funds, in particular, pay higher fees than would be the case if competition was more robust.

FINDING 7.2

Fund-level regulation creates a significant cost of entry and some structural features of the system are likely to create challenges for new entrants (including gaining scale by attracting members). However, these are not prohibitive or even high barriers to entry. Nor does the strategic use of integrated business models to gain members stifle contestability in the choice segment.

In the default segment, regulatory settings limit access to the market (including difficulty being listed in a modern award), competition *for* the market is absent, and competition *in* the market is muted.

FINDING 7.3

There is a high propensity for funds in the system (particularly retail funds) to report using associated (or related) service providers — a form of vertical integration. Use of related parties is associated with higher costs, and weaknesses in contract review processes suggest some funds are outsourcing to related parties ahead of more efficient (but unrelated) service providers — constraining contestability and likely at the expense of member outcomes.

FINDING 7.4

Evidence of economies of scale is compelling — larger fund size is strongly associated with lower average costs in the Australian superannuation system.

Significant economies of scale have been realised over the past 13 years, particularly on the administration side. Holding constant other cost drivers, ‘marginal’ (or incremental) gains in system savings (accruing from increases in scale in any year) totalled an estimated \$4.5 billion between 2004 and 2017. Data limitations rule out estimation of realised ‘cumulative’ savings (scale benefits that persist beyond the year in which gains are first realised), but no doubt they have also been material.

Significant unrealised economies of scale remain. For example, annual cost savings of at least \$1.8 billion could be realised if the 50 highest-cost funds merged with the 10 lowest-cost funds. And a 0.01 percentage point reduction in administration expense ratios for funds with more than \$10 billion in assets could result in annual savings of about \$130 million. The presence of these potential gains, particularly from further consolidation, reflects a lack of effective competition in the system.

Scale benefits also manifest through increasing returns to scale. Net returns are positively related to size for not-for-profit funds. (No corresponding correlation was found for retail funds.) Stronger net returns among larger not-for-profit funds might be due to higher exposure to unlisted asset classes, but data limitations rule out strong conclusions. Larger funds do appear, however, to make better investment decisions within asset classes.

There is little evidence that realised economies of scale have systematically been passed through to members in the form of lower fees. Scale benefits may have been passed through in the form of member services or increases in reserves, or offset by the costs of meeting new regulatory requirements. And not-for-profit funds, on average, might have passed through some scale economies by investing more heavily in (higher-cost) unlisted assets and obtaining higher returns. Data limitations preclude firm conclusions about the form of pass through of economies of scale, and thus how members are actually benefitting and whether they are benefitting in a form they value.

Insurance

FINDING 8.1

The deduction of insurance premiums can have a material impact on member balances at retirement. This balance erosion 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.

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.

FINDING 8.3

The fiscal impact of insurance in superannuation is complex and multifaceted. The effect on Age Pension outlays of the erosion of superannuation balances by insurance premiums is not trivial, and could materially offset any savings to government in social security outlays (that would otherwise have been paid to members that become insurance payout recipients).

Fund governance

FINDING 9.1

Board processes to recruit highly skilled and experienced directors, and to effectively evaluate board performance and capability, are an essential prerequisite for best practice governance. Although there have been improvements to trustee board processes to better ensure boards have the necessary skills and experience, there is still much room to do better. Many boards are not employing effective assessment processes.

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. A focus on skills would likely lead to more independent directors as boards recruit from a wider 'gene pool'.

FINDING 9.2

Contract management processes, along with disclosure and reporting, need much improvement. While vertical integration is not a problem per se, conflicts of interest raised by the use of related parties need to be better managed by trustees and, where left poorly managed, redressed decisively by confident regulators.

A better definition of the term independent director is needed. Trustee directors are not independent if they are affiliated with parties related to a fund.

FINDING 9.3

Many funds mimic (at least to some degree) the investment 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.

FINDING 9.4

Robust and independently assessed performance attribution is needed for a trustee board to satisfy itself that it has acted in members' best interests. But trustees have considerable room for improvement in the use of performance attribution. Indeed, some even appear to have 'outsourced' their best interests duty for members using platforms and wrap accounts to financial advisers and product providers.

FINDING 9.5

Benefits provided to employers by some funds unduly influence some employers' choice of default fund.

FINDING 9.6

Considerable evidence of trustees acting in ways that are inconsistent with members' best interests suggests that trustees and regulators adopt a broad and at times inappropriate interpretation of members' best interests.

System governance

FINDING 10.1

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

In particular, the proposed MySuper outcomes test (a good first step) should better enable APRA to de-authorise poorly performing products and better promote fund consolidation. But the test needs to be strengthened, extended to choice investment options and then fully and transparently enforced by APRA.

Introducing civil and criminal penalties for trustee directors, and giving APRA more power to deal with ownership changes of superannuation funds, are policy 'must haves' to better protect members.

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 inevitably lead to poor accountability and contribute to the lack of strategic conduct regulation, especially public deterrence through enforcement action, with poor outcomes for members.

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.

FINDING 10.4

The relatively small number of SMSFs with some form of limited-recourse borrowing arrangement (about 7 per cent of SMSFs representing 5 per cent of SMSF assets) means such borrowing does not currently pose a material systemic risk. However, active monitoring (along with public reporting and discussion by the Council of Financial Regulators) is warranted to ensure that SMSF borrowing does not have the potential to generate systemic risks in the future.

Concerns about SMSF borrowing arrangements being utilised by members that lack the requisite financial literacy to properly understand the risks associated with them (or for whom such arrangements are unsuitable for other reasons) are best dealt with through measures to improve the quality of SMSF-related advice.

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.

Overall assessment

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 bottom-quartile MySuper products had instead been in the median of the top-quartile performing MySuper products they would collectively have gained an additional \$1.2 billion a year.

Competing for default members

FINDING 12.1

While the default segment has *on average* provided better outcomes for members than the system as a whole, it fails to ensure members are placed in the very best funds and places a sizeable minority in funds delivering poor outcomes. For example, focusing on investment performance (an important aspect of member outcomes), products that performed above their benchmark generated a median return of 5.5 per cent a year in the 11 years to 2018, whereas the 17 underperformers generated a median return of 3.8 per cent a year (and represented about 1.6 million member accounts and \$57 billion in assets).

Current arrangements also lead to unnecessary account proliferation, rely heavily on third-party decision making and deny some members any ability to choose their own funds. Default arrangements need to be modernised and recrafted to harness the benefits of competition *for* default members. The interests of members (not funds) should be paramount.

FINDING 12.2

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

Modernising the super system

RECOMMENDATION 1 **DEFAULT ONCE: ONLY DEFAULT MEMBERS WITHOUT AN ACCOUNT**

Default superannuation accounts should only be created for members who are new to the workforce or do not already have a superannuation account (and who 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 on 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 MySuper account) for the Government.

There should be universal participation in this process by employees and employers. It should be fully in place by no later than the end of December 2021.

RECOMMENDATION 2 **A 'BEST IN SHOW' SHORTLIST**

A single 'best in show' 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. The shortlist should also be easily accessible to all members at any time, including when starting a new job.

Members should not be prevented from choosing any other fund (including an SMSF). Terms in enterprise and workplace agreements that restrict member choice should be invalidated.

Any member who does not have an existing account and who fails to make a choice of fund 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.

The first 'best in show' shortlist should be in place by no later than the end of June 2021.

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

The Australian Government should establish an independent expert panel to run a competitive process to develop the 'best in show' shortlist. This panel should select from products submitted by funds that meet a clear set of criteria (established and published beforehand by the panel) and that are judged as likely to deliver the best outcomes for members over the long term, with high weight placed on investment strategy and performance. All APRA-regulated superannuation funds should be free to participate in the 'best in show' selection process, regardless of ownership or sponsor (including government-owned funds).

In setting the criteria and selecting products, the expert panel should be guided by three legislated guiding principles.

- Products should be chosen based on the fund's likelihood of providing the best outcomes for members in the accumulation phase, taking account of risk.
- Products chosen should be particularly suitable for members who have typically defaulted but should also be highly suitable products for all members.
- The panel should always seek to ensure a competitive dynamic exists between funds, without compromising the integrity of the 'best in show' list.

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 strong competitive dynamic between funds for inclusion on the shortlist.

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

The process should be repeated, and the panel reconstituted, every four years. No more than half of expert panel members should carry over from one selection period to the next, and no individual member should remain on the panel for more than two terms.

RECOMMENDATION 4 ELEVATED MYSUPER AND CHOICE OUTCOMES TESTS

The Australian Government should legislate to require all APRA-regulated superannuation funds to undertake annual outcomes tests for their MySuper and choice offerings. These outcomes tests should include:

- a requirement for funds to obtain independent verification, to an audit-level standard, of their outcomes test determination, at least every three years (starting with the first test)
- clear benchmarking requirements for all MySuper and choice investment options.

This benchmarking should include a requirement for all investment options to be compared with a listed investment benchmark portfolio tailored to their asset allocation (with exceptions only to be granted on an 'if not, why not' basis). APRA should issue clear and specific guidance on the construction of these benchmark portfolios (drawing on the methodology established by this inquiry). Options that fall short of this benchmark portfolio by more than 0.5 percentage points a year, on average, over a rolling eight-year period should be subjected to a 12-month period of remediation or, if remediation is not possible, withdrawn from the market, with members transferred by funds to a better performing option. Any remediation or transfer activity should be subject to close oversight by APRA.

The Government should provide APRA with the power to stop a fund from launching new investment options or accepting new members into existing options subject to remediation until that remediation is complete.

APRA should also be given the power to revoke the fund's MySuper authorisation or direct the fund to withdraw the choice option where remediation is not successful in the required timeframe or a voluntary withdrawal of the product from the market does not occur. In these circumstances, APRA should oversee a process of transferring the affected members to another suitable fund, including on a temporary sub-fund basis where necessary, provided that APRA has determined that the transfer is, on balance, likely to be in the best long-term interests of the members of both funds. Should no fund be willing to accept the members, APRA should appoint an independent acting trustee with a remit to wind-up the fund.

The outcomes tests should form part of the new APRA standard to require fund-wide assessments of member outcomes.

Funds should be required to complete their first (annual) elevated outcomes tests by no later than the end of December 2020 for MySuper products, and no later than the end of June 2021 for choice investment options.

RECOMMENDATION 5 CLEANING UP THE STOCK OF UNINTENDED MULTIPLE ACCOUNTS

The Australian Government should seek the passage of legislation to require the auto-consolidation of superannuation accounts with balances under \$6000 and 13 months or more of inactivity. Trustees should be required to transfer these accounts to the ATO for auto-consolidation with a member's matched active account.

The Government should make explicit that this process should capture accounts held in Eligible Rollover Funds. These funds should be wound up within three years, with APRA oversight.

The Australian Government should increase the balance threshold for auto-consolidation over time, unless there are compelling reasons not to. The Government should also review the policy framework for lost and unclaimed superannuation accounts with the aim of streamlining the framework and ensuring it works in harmony with the auto-consolidation mechanism.

RECOMMENDATION 6 A MEMBER-FRIENDLY DASHBOARD FOR ALL PRODUCTS

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

ASIC should:

- prioritise the implementation of these dashboards for choice investment options to achieve full compliance by the end of 2019
- only grant an exemption for an option or set of options from the dashboard requirement on the basis of evidence under the principle of 'if not, why not'
- revise the dashboards to simplify the content and provide more easily comprehensible metrics (drawing on robust consumer testing) by the end of 2019
- immediately publish all available MySuper and choice dashboards on its MoneySmart website, with the information clearly and readily accessible from the area of myGov that allows for consolidation of accounts.

The Australian Government should also require all superannuation funds to provide their members with the corresponding dashboards when a member requests to switch from a MySuper product to a choice option within the fund.

RECOMMENDATION 7 DELIVERING DASHBOARDS TO MEMBERS

The Australian Government should require the ATO to provide a link to the relevant (single page) product dashboard(s) on a member's existing account(s) via its centralised online service. Links to each single-page product dashboards for the 'best in show' products should also be presented on the centralised online service.

RECOMMENDATION 8 A CLEARER DEFINITION OF ‘ADVICE’ AND DISCLOSURE OF APPROVED PRODUCT LISTS

The Australian Government should immediately amend the *Corporations Act 2001* (Cth) to ensure that the term ‘advice’ can only be used in association with ‘personal advice’ — that is, advice that takes into consideration personal circumstances.

The Government should also immediately require Australian Financial Service Licensees to disclose to ASIC, in relation to superannuation products:

- the number of products on their approved product list (APL)
- the proportion of in-house products on their APL
- the proportion of products recommended that are in-house
- the proportion of products recommended that are off-APL.

ASIC should publish this information annually.

ASIC should also conduct selected audits of the information received to facilitate assessment of the effectiveness of advisers in meeting clients’ best interests.

RECOMMENDATION 9 EVALUATION OF FINANCIAL LITERACY PROGRAMS

The Australian Government should comprehensively and systematically evaluate the programs it funds that aim to improve the financial literacy of Australians. Such a review would help to better target funding to those programs evaluated as effective and to defund those that are not. This could be done through a review of the National Financial Capability Strategy, which could also include State and Territory Governments evaluating such programs in their own jurisdictions.

RECOMMENDATION 10 REASSESS THE NEED FOR A RETIREMENT INCOME COVENANT

The Australian Government should reassess the benefits, costs and detailed design of the Retirement Income Covenant — including the roles of information, guidance and financial advice — and only introduce the Covenant if design imperfections (including equity impacts) can be sufficiently remediated.

In conjunction with this reassessment, the Australian Government should also:

- consider cost-effective options, including possibly extending the Financial Information Service to provide retirees with access to a one-off, impartial information session to help them navigate complex retirement income decisions
- explore the business case for investing in digital technology that assists people’s financial decision making.

RECOMMENDATION 11 MORE USEFUL INFORMATION FOR PRE-RETIREEES

The Australian Government should prompt all superannuation members when they reach 55 years of age to visit the:

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

RECOMMENDATION 12 STRONGER SAFEGUARDS ON SMSF ADVICE

The Australian Government should:

- require specialist training for persons providing advice to set up an SMSF
- require persons providing advice to set up an SMSF to give prospective SMSF trustees a document outlining ASIC's 'red flags' prior to establishment
- extend the proposed product design and distribution obligations to SMSF establishment.

RECOMMENDATION 13 ROLL OUT THE CONSUMER DATA RIGHT FOR SUPERANNUATION

The Australian Government should automatically accredit superannuation funds to be eligible to receive (following member consent) information held by banks under the Open Banking Initiative. The Government should also roll out the new Consumer Data Right to superannuation in parallel with implementation of the elevated outcomes tests (recommendation 4).

RECOMMENDATION 14 LIMIT ALL FEES TO COST RECOVERY AND BAN TRAILING COMMISSIONS

The Australian Government should require that all fees charged by APRA-regulated superannuation funds are levied on a cost-recovery basis. Using fees to cross-subsidise between members should be prohibited. These rules should be implemented and enforced by regulators in such a way that avoids gaming by funds and does not pose new barriers to member switching.

The Australian Government should ban trailing financial adviser commissions in superannuation, to take effect as soon as practicable.

RECOMMENDATION 15 **OPT-IN INSURANCE FOR YOUNG AND INACTIVE MEMBERS**

The Australian Government should seek the passage of legislation to make insurance through superannuation opt-in for members under 25 years of age, and to require trustees to cease all insurance cover on accounts where no contributions have been made for the past 13 months (unless the member provides express permission that the cover is to be retained).

In addition to these proposed legislative changes, exemptions to the under-25 opt-in restriction should only be granted if the trustee can demonstrate to APRA that opt-out disability or income protection insurance would be in the best interests of a specific cohort of younger members.

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 affect their balances at retirement.

RECOMMENDATION 17 **A BINDING AND ENFORCEABLE INSURANCE CODE OF CONDUCT**

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
- direct and monitor enhancements to strengthen the code, particularly implementation of standard definitions and moving to a short-form annual insurance statement for members
- direct the industry to take further steps for the code to meet ASIC's definition of an enforceable code of conduct, and to give ASIC an enforcement role under the code.

Both ASIC and APRA should be members of the taskforce, with ASIC taking the lead. The taskforce should annually report findings on industry progress on the code.

The code owners should be given two years to strengthen the code and make it binding and enforceable on signatories. At this point, adoption of the code should become a condition of holding a Registrable Superannuation Entity Licence for all superannuation funds that offer insurance.

RECOMMENDATION 18 **INDEPENDENT INQUIRY INTO INSURANCE IN SUPER**

The Australian Government should commission an independent public inquiry into insurance in superannuation. This inquiry 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 more prescriptive regulation is required. It should also look at the intersection of insurance in super with other schemes (such as workers' compensation) and consider how best to provide assistance to people in the event of illness and injury, including whether opt-out insurance through superannuation is the most efficient and equitable way to do so.

This insurance inquiry should be initiated within four years from the completion of this inquiry report.

RECOMMENDATION 19 **REGULATION OF TRUSTEE BOARD DIRECTORS**

APRA should amend its prudential standards to be prescriptive in:

- requiring trustees of all superannuation funds to have and use a process to effectively assess their board's performance relative to its objectives and the performance of individual directors, and to disclose this process annually
- requiring all trustee boards to maintain a skills matrix and annually publish a consolidated summary of it, along with the collective skills of the trustee directors
- requiring trusts 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
- requiring all trustee board directors to have a professional understanding of the superannuation system and investment decision making, gained either through industry experience or formal training
- defining what constitutes an 'independent director', based on the definition currently in the Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017.

The Australian Government should ensure that there is no legislative impediment to APRA defining what constitutes an 'independent director', or to superannuation funds appointing independent directors to trustee boards (with or without explicit approval from APRA). It should also give APRA powers to interpret and enforce the definition of an independent director.

RECOMMENDATION 20 **DISCLOSURE OF 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. APRA should also be empowered to prevent mergers that are not in members' best interests.

The Australian Government should also legislate new powers and penalties to explicitly enable ASIC to pursue action against trustee directors for misconduct in relation to mergers.

RECOMMENDATION 21 **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.

RECOMMENDATION 22 **DEFINITION OF THE BEST INTERESTS DUTY**

The Australian Government should pursue a clearer articulation of what it means for a trustee to act in members' best interests under the *Superannuation Industry (Supervision) Act 1993* (Cth). The definition should reflect the twin principles that a trustee should act in a manner consistent with what an informed member might reasonably expect and that this must be manifest in member outcomes. In clarifying the definition, the Government should decide whether to pursue legislative change, greater regulatory guidance, and/or proactive testing of the law by regulators. It should be informed by the findings of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*.

RECOMMENDATION 23 AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

APRA should focus more on matters relating to licensing and authorisation, ensuring high standards of system and fund performance. It should (in addition to recommendations 4, 16 and 19):

- supervise and enforce the obligations of the licences and authorisations it grants
- 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)
- require all APRA-regulated superannuation funds to include a clause in material service contracts with outsourced providers that obliges the provider not to do or take any action that adversely affects members' interests
- report annually to the Council of Financial Regulators on funds' progress with implementing the elevated outcomes tests and on fund merger activity
- 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.

The Australian Government should set an explicit 'member outcomes' mandate for APRA in its regulation of superannuation.

RECOMMENDATION 24 AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

ASIC should focus more on the conduct of superannuation trustees and financial advisers, and on the appropriateness of products (including for particular target markets) and disclosure. It should (in addition to recommendations 6 and 8):

- 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, and report to the Council of Financial Regulators on its enforcement against trustee directors who breach their duties by not pursuing a merger when it would be in their members' best interests
- undertake recurring thematic reviews on financial advice in superannuation, including advice in relation to choice platform products and SMSFs.

RECOMMENDATION 25 CLARIFY REGULATOR ROLES AND POWERS

The Australian Government — with the benefit of this inquiry report and that of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* — should clarify the roles of APRA and ASIC in relation to superannuation. In doing so, it should consider the suitability of each regulator's powers, the suitability and strength of penalty provisions for misconduct, and whether there are any undesirable constraints on either regulator engaging in strategic conduct regulation.

RECOMMENDATION 26 APRA CAPABILITY REVIEW

The Australian Government should immediately initiate the independent capability review of APRA, which it had previously agreed to do. This review should also examine how efficiently and effectively APRA operates to achieve its strategic objectives in relation to superannuation, including:

- the capability of APRA to adequately supervise and regulate the superannuation system in line with its current responsibilities and those proposed in draft legislation (as well as future responsibilities arising from the implementation of recommendations in this inquiry), including a focus on capability in enforcement
- identification and analysis of immediate and forward-looking priorities and risks
- the use of legal powers and enforcement tools, including the pursuit of test cases and effective coordination with ASIC and other regulators in this regard
- the skills, capability and culture of the organisation, including the number of staff dedicated to regulating superannuation and their capabilities
- internal governance and accountability mechanisms
- engagement and information sharing with other regulators, especially ASIC
- the use of data collection and analytics
- future resourcing needs.

The review should be completed and published during 2019.

RECOMMENDATION 27 SUPERANNUATION DATA WORKING GROUP

The Australian Government should establish a permanent superannuation data working group, comprised of APRA, ASIC, the ATO, the ABS, the Commonwealth Treasury and the new member advocacy body (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.

RECOMMENDATION 28 AN INDEPENDENT MEMBER ADVOCACY BODY

The Australian Government should, as a priority, provide adequate ongoing funding to support an independent superannuation members' advocacy and assistance body.

RECOMMENDATION 29 **ONGOING REVIEW OF THE SUPER SYSTEM**

The Australian Government should:

- require APRA and ASIC to jointly produce a *State of Superannuation* report every two years on the performance of the superannuation system, including outcomes relating to investment performance, fees, low-balance inactive accounts, merger activity and the elevated MySuper and choice outcomes tests. This report should also detail progress by the industry and regulators to implement Government policy changes and address performance and member harm issues identified in this inquiry report
- commission an independent review, every five years, of the effectiveness of the MySuper and choice elevated outcomes tests at meeting their objectives, and whether they are being suitably applied by APRA to remove underperforming funds and options from the super system
- commission an independent public inquiry, every ten years, of the superannuation system, including a review of the criteria used to assess ‘best in show’ products.

RECOMMENDATION 30 **INDEPENDENT INQUIRY INTO THE RETIREMENT INCOMES SYSTEM**

The Australian Government should commission an independent public inquiry into the role of compulsory superannuation in the broader retirement incomes system, including the net impact of compulsory super on private and public savings, distributional impacts across the population and over time, interactions between superannuation and other sources of retirement income, the impact of superannuation on public finances, and the economic and distributional impacts of the non-indexed \$450 a month contributions threshold. This inquiry should be completed in advance of any increase in the Superannuation Guarantee rate.

RECOMMENDATION 31 **A STEERING GROUP TO OVERSEE IMPLEMENTATION**

The Australian Government should prioritise the implementation of this inquiry’s recommendations by establishing a Steering Group of Departmental and agency heads to oversee the implementation. This group should comprise the Secretary of the Department of the Prime Minister and Cabinet, Secretary to the Treasury, Chairs of APRA and ASIC, and the Commissioner of Taxation.