

Superannuation
Productivity Commission
Locked Bag 2, Collins St East
Melbourne
VIC 8003

27 April 2016

Subject: Superannuation Efficiency and Competitiveness

Dear Karen and Angela

Mercer welcomes the Productivity Commission's invitation to make a submission responding to the Commission's Issues Paper of March 2016 entitled *Superannuation Efficiency and Competitiveness*.

We recognise this is not a straightforward topic and has many aspects that can be considered. Within the tight timeframe it has not been possible for us to consider every issue raised in the Issues Paper but we have identified the following topics which we believe will be helpful for the Commission in its ongoing considerations. Our comments in respect of each topic are in a separate attachment to this letter, as follows:

1. Objectives for the superannuation system: pages 3-5 (refer p8 of the Issues Paper)
2. Assessing operational efficiency – global benchmarks: pages 6-20 (refer p10 of the Issues Paper)
3. Assessing competitiveness: pages 21-28 (refer p15 of the Issues Paper)
4. Assessing operational efficiency – insurance: pages 28-31 (refer p19 of the Issues Paper)
5. Allocative efficiency: pages 32-33 (refer p22 of the Issues Paper)

Who is Mercer?

Mercer is a global consulting leader in talent, health, retirement and investments. Mercer helps clients around the world advance the health, wealth and performance of their most vital asset – their people.

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Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over \$50 billion in funds under administration locally and provide services to over 1.3 million super members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 213,000 members and more than \$20 billion in assets under management.

We would be delighted to meet with you during your Inquiry to discuss the above topics or other related matters where we may be able to provide you with additional insights into the Australian superannuation industry and operations. Please contact me on 03 9623 5464 or by email if you would like to arrange a discussion.

Yours sincerely,

Dr David Knox
Senior Partner

Attachment 1: Objectives for the superannuation system

As noted on page 8 of the Issues Paper, Step 1 of the Commission's approach will be to impute the objectives for the superannuation system. As is well known, the Financial System Inquiry (FSI) recommended that the primary objective for the superannuation system should be:

To provide income in retirement to substitute or supplement the Age Pension

Defining clear objectives is important both in the short and longer-term if the overall system is going to provide an adequate and secure retirement income for Australians.

Mercer believes it is critical that the objectives are defined with a total retirement income perspective. To do this properly we recently recommended to Government that defining the objectives of both superannuation and the age pension should be conducted simultaneously, with a key factor being the inclusion in the objective of a desired level of total income from both superannuation and the age pension.

With this approach in mind, we have recommended that the objective for the overall retirement income system should be:

to provide the vast majority of Australians¹ with an income throughout their retirement that enables their pre-retirement living standards to be maintained.

Furthermore, we do not believe it is appropriate to state that superannuation should substitute or supplement the Age Pension. It is too vague. Whilst recognising that supplementation and substitution will occur, we need a clear and sensible line in the sand as to when superannuation income should move from supplementing the age pension to becoming a substitute for it. For the development of sound future policies, it is important that agreement is reached on the objective of the overall retirement income system as well as the objectives of each pillar within the system, together with an agreed understanding of the integration and relationships between each pillar.

We are concerned that the FSI Objective does not provide any indication of, or reference to, the desired outcome, namely the level of income which superannuation (or superannuation plus the age pension, for those eligible) should provide. Arguably any level of superannuation would meet the FSI Objective. It therefore provides little guide to policy makers as to the level of superannuation savings which should be compulsory (i.e. the SG requirements) or the level of incentives to encourage people to voluntarily save through super.

¹ This objective deliberately uses the term "the vast majority of Australians" and not "all Australians" as we do not believe that the Government should support, either through superannuation tax concessions or the age pension, the maintenance of lavish or expensive lifestyles.

Therefore from the Productivity Commission's perspective it is important to recognise that the objective of superannuation goes beyond the substitution or supplementation of the age pension. It is noteworthy that the Treasurer, Scott Morrison, in an address to the 2015 ASFA National Conference suggested that the objectives of superannuation can be distilled into three main aims:

- to promote better standards of living in retirement by supplementing or replacing the age pension
- to curb the rising cost of the Age Pension
- to improve the national savings pool

Although these three objectives go beyond the single objective suggested by the FSI, it is also fair to comment that even these objectives are high level and somewhat vague.

Within the superannuation system, an important obligation for all trustees is to act in the members' best interests. Using this perspective, the objectives of superannuation become much more member-focussed and could include any or all of the following objectives:

- to provide a level of retirement income that enables retirees to maintain their previous standard of living during retirement
- to provide death and disablement insurance during the pre-retirement years at a cost lower than available to most individuals (Note: Insurance is often ignored when superannuation objectives are discussed even though it is a compulsory component of MySuper products.)
- to provide education to the member so they understand more about their superannuation, its purpose and the options available
- to provide a range of appropriate retirement products, recognising the diversity of risks faced by retirees

In the broader industry, it should also be recognised that members of SMSFs may have slightly different objectives from members of APRA-regulated funds, given that their balances tend to be much larger. For example, many SMSF members would be expected to receive little, if any, age pension payments during retirement.

Whilst the previous paragraph concentrated on the objectives from the members' perspectives, it is also worth recognising that the Government is likely to have slightly different objectives. For example, the Government may wish to see:

- reducing costs of the age pension in future years as the superannuation system matures
- increasing provision of insurance related products, both in the accumulation and retirement periods, thereby reducing future costs to Government of supporting those in financial need
- the ongoing development of deep and sophisticated capital markets, thereby promoting some export opportunities

- the development of well-resourced regulators to ensure that there is appropriate protection for consumers; a level playing field for product providers; and appropriate disclosure of relevant information in a cost-effective manner

Traditionally superannuation began with the objectives of the employer which was to attract and retain quality staff. While this purpose is still important in several countries, Australia's compulsory SG system for employees has meant that most employers have very limited involvement in the superannuation of their employees. In effect, they pay the required contribution and leave it to the superannuation fund to engage with the member. Nevertheless, it must be recognised that some employers, including some multi-national companies who operate in Australia, continue to recognise the benefits provided by superannuation represent an important part of the employer-employee relationship. Examples include:

- the provision of additional employer-paid insurance for employees in riskier industries eg mining
- the payment of superannuation administration fees by some employers
- the provision of financial seminars in the workplace

The above discussion highlights that there exist a variety of objectives for superannuation depending on the position of different stakeholders. It is also feasible that different objectives may lead to conflicting outcomes. For example, the provision of group insurance may provide very valuable protection to members and their households during the working years. However higher levels of insurance inevitably lead to lower retirement benefits which reduces the future age pension saving. Similarly, some superannuation funds with higher fees may provide a larger range of services to their members which result in a stronger level of member engagement and understanding. Of course, the higher fees would also reduce the ultimate retirement benefits.

Such tensions are inevitable and highlight the fact that superannuation has a range of objectives which may compete with each other. This outcome is not surprising as the ultimate objective of providing retirement income should be able to be modified or adjusted to reflect the needs of the actual members. For example, the retirement and insurance needs for those living in outback Australia who are members of a mining-based superannuation fund are likely to be quite different from white-collar finance professionals living in Sydney or Melbourne.

Attachment 2: Assessing operational efficiency – global benchmarks

As noted in the Issues Paper, one approach to assess operational or productive efficiency is to minimise the costs for a given level of output. A commonly-used measure of costs in the pension industry is to measure costs as a percentage of the assets within a fund or within a country's system.

This broad approach is adopted by the OECD which publishes operating costs as a percentage of total assets². Submissions to the Financial System Inquiry from Treasury and the Reserve Bank, as well as the Grattan Institute, relied heavily on the published OECD data relating to the operating costs of pension systems in many countries. However with many commentators relying heavily on this single data set, it is important that the significant shortcomings of this data source are well understood.

Hence this attachment will:

- Review the OECD data
- Highlight some of the variations that can occur between countries
- Consider some of the unique features of the Australian system
- Comment on the data used in respect of five well known systems and highlight its limitations

A review of the OECD data

The OECD publishes operating expenses for pension systems expressed as a percentage of total pension assets in each country. These operating expenses include both administrative costs and investment management costs in most cases. As a starting point for an international comparison this approach seems reasonable.

Furthermore, the OECD data recognises the significant differences in pension systems around the world and classifies pension arrangements into the following three main types:

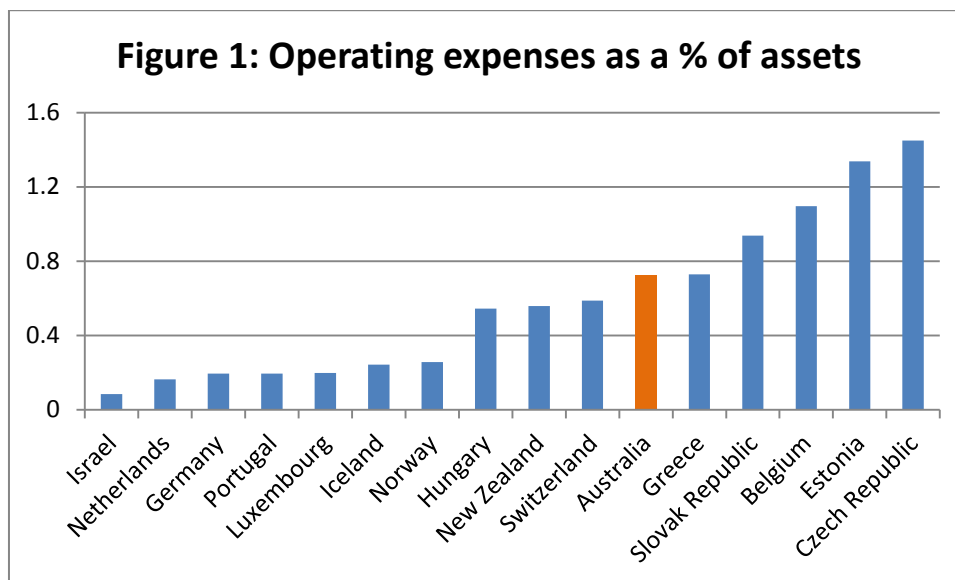
- Autonomous pension funds
- Non-autonomous book reserves
- Pension insurance contracts

In respect of Australia, virtually all the data is classified as autonomous pension funds whereas many countries have unavailable data in respect of one or more of their pension arrangements.

² OECD, Funded Pension Indicators, http://stats.oecd.org/Index.aspx?DatasetCode=PNNI_NEW

Indeed when the OECD publishes the operating expenses in respect of all pension funds, only half of the 34 OECD countries, including Australia, have data that is published. This lack of data across the whole pension industry hinders the validity of the international comparisons that are often made.

Figure 1 shows the expenses for 16 of the 17 countries listed for 2014. The excluded country is Slovenia which has a very high expense cost of 4.28%.



It should be noted that the Australian data published by the OECD excludes the costs associated with the SMSF sector of the industry. That is, it is based on APRA data only and thereby excludes about one third of the assets in the Australian industry, where the average member balance is much higher than in the APRA funds.

Notwithstanding the limitations of the data, the Australian system is shown as the seventh most expensive of these 17 countries (including Slovenia), and is shown as being slightly more expensive than New Zealand and Switzerland.

This outcome is broadly consistent with the assessment of costs in the 2015 Melbourne Mercer Global Pension Index (MMGPI) Report which ranked Australia as the eighth most expensive of 25 countries in terms of costs. Due to the unavailability of comparable cost data for all countries, the MMGPI does not use the OECD data but considers the following two questions in its assessment of costs:

1. What percentage of the total assets is held by various types of pension funds? These types include employer-sponsored funds, multi-employer (or industry) plans, insurance arrangements, retail funds and government-administered central funds. Different levels of cost are assumed for each type of fund.
2. What percentage of the total assets is held by the largest ten pension funds or providers? This question is designed to identify the presence of scale.

The OECD also notes that³:

Countries with defined contribution schemes and those with large numbers of small funds appear to have higher operating costs than countries with only a few funds offering defined benefit, hybrid, or collective defined contribution arrangements.

This comment highlights that the operating costs of each system will be affected by the characteristics and features of that system which may be very different from other pension systems. It is therefore essential that we understand and appreciate the consequences of these fundamental differences as we consider the available data.

Variations in the data

Although the general OECD approach seems reasonable, the following factors affect the results in different ways for each country and therefore should be appreciated when the results are used for comparative purposes.

- In all pension systems there are lower administration expenses for members in the pension phase than in the accumulation phase. The reason is simple. During the accumulation years, the administration system is dealing with a range of transactions, including contributions from employers, the self-employed and employees, insurance, as well as constant changes to employment and contribution levels. The pension phase is simpler to administer and therefore cheaper. In addition, the assets held for the average pensioner is generally higher than for the average working member. Hence it would be expected that countries, where the system is still maturing and most of the assets are in the accumulation phase or where pensions are relatively unimportant, would have higher administration costs as well as higher investment management costs due to a stronger emphasis on growth investments in the accumulation phase. The following table summarises some of these differences.

³ OECD (2013), Pension Markets in Focus, p17.

	Accumulation phase	Pension phase
Administration costs	Higher costs due to more transactions and lower balances	Lower costs with pension payments
Investment costs	Higher costs with more growth oriented investments	Lower costs with more defensive assets (eg fixed interest)

Australia is an example of a system that continues to mature with lower average balances and a smaller proportion of the assets in the pension phase, particularly when compared with many European systems. It is also worth noting that flexible account-based pensions with a range of investment options are more expensive to administer than defined benefit pensions or annuities where the retiree has no choice.

- There are very different structures of pension systems around the world. This makes direct comparisons extremely difficult. For example, in countries where employer-sponsored (or corporate) pension plans are traditionally the norm, such as in Canada, the UK, and the USA, it is common practice for the employer to pick up some of the costs of administering the pension plan (for example, no rental or technology costs) as well as support from the Finance and HR departments. Clearly such support reduces the cost for these employer-sponsored schemes. At the other extreme, is the unique Australian fund type of self-managed super funds (SMSFs) where the individual member often bears much of the cost through their own time commitment. In addition, the presence of SMSFs in Australia means that the average balance in APRA-regulated funds is much lower thereby increasing the average cost per member (expressed as a percentage of assets) than would be the case if SMSFs did not exist.
- Investment management costs are very difficult to obtain on a comparative basis. For example, pension funds that have an in-house investment department will bear the direct costs of their investment management and show it as part of their operating costs. On the other hand, pension funds that outsource their investments to fund managers and other third parties may show limited costs as the investment management costs may be absorbed into the unit prices or crediting rates provided by the fund manager. That is, there may be significant indirect costs. It is therefore likely that the operating costs quoted by the OECD will underestimate the true costs of investment management. This effect will vary between countries and is likely to depend on many factors, including the relative importance of major financial institutions where the investments may be carried out within their overall operations.

- The OECD approach assumes a fully funded system; that is, where the assets bear some relationship to the liabilities. However, many countries have components of their system that are partly funded which means the quoted costs (as a percentage of assets) will be overstated. For example, most of the public sector defined benefit funds in Australia are only partly funded and the shortfall is in the order of \$200 billion. Yet the administrative costs of these funds are not affected by their funding status. If these funds were fully funded, the Australian cost percentage (expressed as a percentage of assets) would be 8-10% lower.

Some unique features of the Australian system

There are some unique features of the Australian superannuation environment that need to be taken into account when comparing the operating costs and outcomes of our system with those in other countries.

The **first** unique feature is the presence of SMSFs where all members of these funds are also trustees of their fund. It is well known that SMSFs have become more popular in recent years and as at December 2015 represent 29.1%⁴ of all superannuation assets. These funds also have a much higher average balance than APRA funds. As noted above, the OECD operating expenses for Australia exclude SMSFs.

It is well known that within any financial services industry the operating expenses per dollar are higher for smaller balances. That is, there is always a fixed cost component. The size of this component is very difficult to estimate due to the variety of arrangements that exist within the superannuation industry. However the removal of SMSFs from the OECD data means that the operating expenses per dollar of assets for Australia will be higher than if the expenses and assets relating to SMSFs had been included. In all other countries (ie where SMSFs do not exist), higher balances remain in the system thereby reducing overall costs when expressed as a percentage of assets.

The **second** unique feature is the prevalence of choice. Most Australian workers have the opportunity to choose both their superannuation fund and the asset allocation within their fund. The availability of investment choice is in contrast to many European funds where there is a single diversified fund. The availability of fund choice has also provided an important impetus for the growth of SMSFs. However it is not only with SMSFs where the implications of choice are evident.

⁴ APRA (2016), Quarterly Superannuation Performance, December 2015.

Fund choice has also contributed to multiple accounts. For example, some members may remain in a fund so that they can continue to receive group insurance, whether their future contributions are being made into another APRA-regulated fund or to a SMSF.

Within APRA-regulated funds, about 35%⁵ of assets are within the MySuper products. That is 65% of funds are invested outside MySuper. After allowing for SMSFs, this means that members make investment decisions in respect of approximately 75% of the assets in the Australian superannuation system. With this evidence pointing to a strong participation in investment choice, it would be very difficult to reduce the level of choice currently available.

An implication of this investment choice, whether for APRA-regulated funds or SMSFs, is that members are also selecting the corresponding fees. For example, if members select increased allocation to investment options such as overseas equities, private equity or infrastructure, the costs will be higher than the default strategies. This will be reflected in higher costs for the overall industry. However members have selected these options in the hope or expectation of extra returns over the longer term.

The **third** unique feature of the Australian system is the strong regulatory system operated by APRA and ASIC. Within a compulsory superannuation system such as Australia's Superannuation Guarantee, there is no doubt that the regulator is able to be stronger than in most voluntary pension systems. This strong regulatory setting and the associated requirements mean that Australia received the second highest score for the Integrity sub-index in the 2015 MMGPI. This sub-index covers regulation, governance requirements, member communication and protection.

Inevitably stronger regulation also leads to higher compliance costs. Of course, stronger regulation should also lead to fewer failures and a better outcome for members, but it must be recognised that the introduction of prudential standards and other requirements inevitably raises costs. It should also be noted that Australia is the only country which requires all funds to hold an operational risk reserve. This will raise the level of expenses for some funds by up to 0.1% of assets for a period of 3 years to 30 June 2016 to fund the reserve or to provide a return on capital to shareholders who provide the capital.

In addition to the unique features discussed above, other features of the Australian system add to the complexity and cost relative to some other system. Two examples are tax and insurance.

⁵ Ibid.

Most countries adopt an EET⁶ approach to pension taxation. This means that pension funds are not involved in the tax system. In contrast, the complex taxation of the Australian superannuation system is unique and adds considerable operating expenses. A few simple examples in respect of taxed funds illustrate the point:

- Taxation is paid by funds on concessional contributions but not on non-concessional contributions
- Funds are required to pay additional tax on behalf of the member or repay contributions, if requested by the member, should contributions exceed prescribed limits
- Taxation is paid by funds on investment income from assets in the accumulation phase but not in respect of assets in the pension phase
- Funds are able to claim taxation deductions in respect of most, but not all, their expenses;
- Benefits are subject to tax if received prior to age 60 or paid to a non-dependant on death but not if paid after age 60
- Different tax rates apply to benefits paid to a departing non-resident or if the member has not submitted a Tax File Number
- The extra communication costs to members to explain the complicated tax rules
- Funds must prepare and submit Business Activity Statements and tax returns
- Most of the services purchased by superannuation funds are subject to the GST. Some are entitled to Reduced Input Tax Credits while others are not

Finally, the Australian superannuation system requires funds to offer life insurance cover to their members. In most cases, this insurance also includes disablement cover. Whilst this offering means that many Australians receive insurance cover at a competitive price based on group arrangements, there are also significant additional costs for the superannuation funds. These include ongoing negotiations with insurers, provision of material to members, assessment of claims and, in some cases, the need for legal advice to defend decisions. These insurance arrangements are also impacted by economic conditions and decisions by some State Governments to restrict the scope of workers compensation.

In summary, the Australian superannuation system has many features that are not replicated anywhere in the world. It is a system with more choice, very strong regulation, a most complex taxation system and compulsory insurance. Inevitably these features add costs to the system.

⁶ This acronym means that contributions are tax exempt (the first E); fund investment income is exempt (the second E); but that benefits are fully taxable (the capital T). In contrast, Australia taxes contributions at a concessional rate, taxes investment income at a concessional rate but benefits after age 60 are tax exempt. Hence the Australian system is sometimes referred to as ttE.

Some comments on the OECD data for particular countries

To highlight the impact of different systems, this section considers the retirement systems and the associated costs in five countries which have very different systems but which are often cited as being leaders in pension reform or having a very good retirement system.

Canada

Canada has a long-established pension system which comprises a universal age pension with a means-tested supplement, a national earnings-related pension based on revalued lifetime earnings (i.e. the Canada Pension Plan or the Quebec Pension Plan), voluntary occupational pension schemes and voluntary personal retirement savings.

The quoted OECD figure for operating expenses in 2014 for autonomous pension funds in Canada is 0.40% of assets. Operating costs, as collected by Statistics Canada, are intended to reflect both investment and administration costs. However, these costs exclude some investment expenses that have been netted from investment income. The quoted OECD figure would also exclude any administrative costs paid directly by an employer sponsor rather than from plan assets.

Furthermore this data provided by Statistics Canada is in respect of Trusteed Pension Plans only and therefore excludes individual registered retirement saving plans. This definition also excludes pension funds held under an annuity insurance contract.

The assets of employer-based pension plans (which are mainly Trusteed Pension Funds) at the end of 2014 were \$C1,873.3 billion compared to \$C1,114.1 billion of assets in individual registered saving plans⁷. The exclusion of the costs relating to these individual plans means that the Canadian data cannot be compared with the Australian data, which includes the costs for both occupational and personal plans. As noted earlier, individual retirement saving plans typically have higher fees than occupational pension schemes due to the extra costs that arise from dealing with individuals instead of groups of employees through an employer.

Therefore the quoted Canadian cost of 0.40% in the OECD data for autonomous pension funds cannot be compared with the Australian cost of 0.74%, which includes personal retail funds regulated by APRA. In fact, if one assumes a cost of 1.5% of assets for the individual plans (which is probably conservative), the Canadian cost for the whole industry figure becomes 0.81%, slightly higher than the Australian figure.

⁷ <http://www.statcan.gc.ca/daily-quotidien/151216/t001c-eng.htm>

Chile

Chile led the pension reform program in Latin America in the 1980s and has often been discussed as a country with a solid pension program. Similar to Australia, it has a three tier system with an income-tested first tier, a mandatory second tier with individual DC accounts and a voluntary third tier.

The contribution rate is 10% of earnings paid by employees with administrative fees levied on top of these mandatory contributions. Employers are not involved. At retirement, the accumulated benefit can be used to buy an immediate annuity, a temporary income with a deferred annuity, programmed withdrawals or a combination.

The Chilean system has six providers (or AFPs) with fees ranging from 0.77% to 2.36% of salaries for contributors (amounting to a total contribution by employees ranging from 10.77% to 12.36% of gross income). As the fees are paid in addition to the mandatory contributions, it is understandable that they are expressed as a percentage of salaries. However such an approach means that the fees are not related to the assets held for each contributor. The same services are provided for all contributors.

In 2008 the Chilean government introduced major pension reform which had a significant effect on the level of operating expenses as reported by the OECD. The quoted expenses decreased from 1.205% of assets in 2008 to 0.642% in 2011, the latest figures published by the OECD.

The major causes of these reduced expenses were:

1. The government introduced a tendering program every two years for new employees. That is, all new workers entering the labour market enter the AFP with the lowest fees and must remain with that AFP for at least 24 months. This fee must apply to all contributors within that AFP and not just the new entrants. The successful tenderer in 2008 in the first auction was a new provider (Modelo) to the market. Modelo won again in 2010 and grew to 1.2 million members due to the mandatory arrangements of receiving contributions from all new employees. A small AFP won the tender in 2012.
2. The new arrangements after the first tender were very different from the previous structure as the new AFP had fewer offices around the country, a different and cheaper service structure and limited investment in education. Commission for sales staff was also removed as there was no competition.
3. The insurance arrangements, covering both life and invalidity insurance, were also tendered in the marketplace. Previously these arrangements represented half the operational costs. This tender process reduced these fees by 15-20%. Importantly,

increased efficiency was also introduced as employers are now responsible for paying this insurance whereas previously it was the responsibility of each worker.

In addition, the quoted OECD expenses exclude any expenses relating to pensioners as the annuity price includes the life company's allowance for expenses.

It should also be noted that the public perception of AFPs in Chile is poor even though the real returns (net of price inflation) have been good. One of the reasons for this outcome is that wages have risen considerably in the last 20-30 years so that the value of the final retirement benefit is low when compared to the final salary. Also, some members have had interruptions to their contributions.

Although new workers have had their contributions paid into the cheaper providers, existing contributors have tended to remain with their existing providers, highlighting the presence of inertia in all pension systems.

The Chilean experience highlights some important lessons for Australia. These include:

- The removal of commission reduces costs. As commission is not allowed to be paid in respect of SG contributions, there is no opportunity to use this change in Australia.
- A concentration on fees alone will inevitably reduce services to members and is also likely to affect investment decisions.
- Providing group insurance will often provide better value for members than individual insurance. This is already common place in Australia.
- A biennial tender with the potential for a new single provider every two years may reduce fees to members but would also generate significant disruption, especially where employers make the contributions as occurs in Australia.

Denmark

Denmark has a highly regarded pension and receives the highest score in the 2015 MMGPI. It has a multi pillar system with a basic universal pension, a means-tested supplementary pension, a statutory fully-funded DC arrangement and quasi-mandatory occupational schemes.

The OECD reports the operating costs for Denmark's pension system in 2014 as 0.082% for autonomous pension funds, although there is no figure shown for the total system (ie all funds). That is, it ignores pension insurance contracts which comprise about two-thirds of the assets held in Danish pension system.⁸

⁸ OECD (2015), Pension Markets in Focus, Figure 1.

However it is also important to note that these operating expenses reported by the Danish FSA for autonomous pension funds do not include investment costs. That is, the direct administration expenses are shown but the indirect investment expenses are not reported.

The investment expenses typically range from 0.1% of assets for some indexed funds to 3.5% of assets for special risk funds with external investment management. In most cases, the indirect investment fees are normally much higher than the direct administration fees. For example, data for 2013 shows that the combined administration and investment fees for the seven commercial pension providers in Denmark range from 1.2% to 1.7% of assets. In each case, the investment costs represent more than half the total costs.

Hence, the apparently very low cost of the Danish pension system of 0.1% is misleading as it is only in respect of administration costs for autonomous pension funds, excluding investment costs and the more common pension insurance contracts.

The Netherlands

The Netherlands has a highly regarded pension system which ranks second in the 2015 MMGPI. It comprises a flat-rate universal pension and quasi-mandatory earnings-related occupational pension schemes linked to industrial agreements. The basic principle in most plans is that a member can accrue a pension of about 70 per cent of their average career income, based on 40 years' employment.

As shown in Figure 1, the OECD reports the operating costs for the Dutch pension system as 0.165%. However this data appears to exclude either administrative expenses or investment costs. An overview of costs published by the Dutch central bank for 2010-12 shows that the administrative expenses were 0.14% of assets and the investment expenses were 0.17% of assets. That is a total of 0.31% of assets which is double the figure currently quoted by the OECD for the Netherlands. As with Denmark, the investment costs are higher than the administrative costs.

The regulations require pension funds to have a minimum level of assets and to have a buffer above the expected liabilities. Indeed when the asset coverage is less than 105 per cent, the benefits will be reduced. Hence, although most pensions are described as defined benefit, some may be more accurately defined as "collective defined contribution". In other words, contributions can be increased or pension indexation adjusted, as may be required. Solidarity is an important feature of the Dutch system with all members of a pension plan paying the same contribution for the same benefit.

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In 2011 the Dutch pension system consisted of 459 pension funds; 354 of these funds were single-employer funds and covered 12% of the workforce; 85 were industry-wide funds (of which 67 were mandatory) and covered 76% of the workforce; and 12 funds were for professional groups.

The Dutch pension system is well respected around the world and is efficient, in terms of costs. However it is worth noting that it has a much higher exposure to bills and bonds (42.5% of assets) than the Australian system (8.8% of assets)⁹ and has a strong collective DC approach rather than individual DC accounts, which would reduce administration costs.

The United Kingdom

The United Kingdom (UK) has a long established pension system with several components including a flat-rate basic pension supported by an income-tested pension credit; an earnings-related pension based on revalued lifetime earnings; and voluntary occupational and personal pension arrangements. The UK is also introducing the National Employment Savings Trust (NEST) where employees are automatically enrolled into a DC arrangement, although individuals may opt out.

The OECD does not report the operating costs for the British pension system in 2014 although the OECD website shows an operating expense of 0.219% of assets for 2013. Data available from the Office for National Statistics (ONS)¹⁰ shows that the administration costs paid by self-administered pension funds in the year to 30 September 2015 was £3,971 million¹¹ compared to total assets for these funds at 31 December 2014 of £1,784,104 million¹² which gives an operating expense of 0.22% of assets.

Although the ONS definition includes investment management fees, it is doubtful that this includes all investment fees. For example, it is common practice for an investment management cost to be included only when an investment invoice is received by the fund. Where costs are met via the unit price without a direct invoice to the pension fund, the investment costs will not be separately disclosed.

In the case of pure DC schemes for employees, the employer would often meet invoiced investment manager and administrative expenses directly, and no “expenses” would be shown in

⁹ Ibid., Figure 10

¹⁰ Office for National Statistics (2016), MQ5: Investment by Insurance Companies, Pension Funds and Trusts, Q3 2015.

¹¹ Ibid, Table 4.3

¹² Ibid, Table 4.2

the scheme accounts – that is, the underlying investment expenses would only appear as a drag on asset performance. Therefore, expenses shown in the scheme accounts represent only a fraction of the expenses incurred.

A recent report by the Department for Work and Pensions¹³ showed that the average Annual Management Charge for trust-based DC schemes was 0.75% of assets whereas the average Annual Management Charge for contract-based DC schemes was 0.84% of assets. In each case, there were lower fees for the larger schemes (i.e. for those employers with more employees). It is also worth noting that this survey excluded schemes where there were less than six members for whom the employer made a contribution. In other words, it excluded individual or personal arrangements where the fees would be expected to be higher.

The UK data shows that the actual operating costs vary greatly depending on the pension arrangements including structure of the benefits (DB or DC), the involvement of the employer, the structure of the scheme (self-administered or outsourced) and the size of the scheme which can generate economies of scale.

Summary

In four of the five countries discussed above, the actual costs of the total pension system are higher than the numbers quoted by the OECD. This finding highlights the great difficulty in obtaining comparable international data and thereby making valid comparisons of quite different pension systems.

Some concluding remarks

There is no doubt that a reduction in operating costs is desirable as lower fees should lead to increased benefits and better outcomes. However lower fees are not the full story. It is preferable to focus on the desired outcomes, namely higher retirement benefits and better decisions by members. In some cases, improved outcomes will arise from the payment of higher fees in respect of some investments (e.g. long term infrastructure) or improved decision making processes by retirees through the provision of financial advice or web-based information. A focus on fees alone without considering the ultimate outcomes is ill-advised.

As indicated above, the Australian system is unique with its many features relating to compulsion for most employees, choice, insurance, taxation and regulation. Therefore we believe there is not another pension system in the world which provides an appropriate benchmark.

¹³ Department of Work and Pensions (2013), Charges in defined contribution pension schemes, November.

For this reason, as well as the other comments made above, we suggest that the published OECD data on operating expenses does not provide a valid benchmark to assess operational efficiency within the Australian superannuation industry. Naturally this conclusion leaves open the question as to the best measure of operational efficiency.

One solution may be that we do not consider the whole system. For example, where individuals make a deliberate choice, such as setting up a SMSF, then they should be allowed to conduct their SMSF with freedom and to operate it in a manner that suits them, including the payment of any costs.

Similarly, if an individual selects an investment choice they should be allowed to receive the consequences, including both costs and investment return.

Of course, in both these cases, it would be appropriate to ensure that they receive some information and education before they make their decision; a modified health warning, if you like. However, we should not restrict them from making decisions that may be appropriate for their personal circumstances.

This leaves the MySuper products. The objective of this product was that it should be low cost for the default member. Whilst the additional services offered by a fund may vary, it is reasonable to suggest that the net outcomes from these products over a reasonable time period (say 5-10 years) should be above a prescribed minimum benchmark. Of course, this benchmark cannot be defined in advance as it will depend on economic circumstances and investment markets, as well as changes in asset allocation. However it may be possible to develop a benchmark that could be used by APRA to test the outcomes arising from each MySuper product. Where a particular product does not meet the benchmark, it would be appropriate for the regulator to investigate further, before making any judgement call. After all, there may be valid reasons why a particular fund in a particular time period has delivered what may be considered to be sub-optimal results.

A comment on the Melbourne Mercer Global Pension Index

Page 12 of the Productivity Commission's Issue Paper references several composite indexes comparing pension systems across countries. The first example quoted in Box 2 is the Melbourne Mercer Global Pension Index (MMGPI) which compares retirement systems in 25 countries representing about 60% of the world's population.

The MMGPI focuses on measurable outcomes (eg adequacy and assets) and the current requirements within the legislation. That is, it adopts an evidence-based approach with the use of

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very limited subjectivity. It's also worth noting that the provision of data and comparable information is problematic in the pension space, particularly when one is comparing 25 countries with a range of languages, legislative backgrounds and societal expectations. In addition, the use of pension terminology is not consistent around the world.

The only indicator that the MMGPI uses that considers efficiency or competition is the assessment of costs which was discussed earlier in this chapter. However, the two proxies used for this indicator are not perfect and are merely indicative. Obtaining hard, reliable and truly comparative data for the pension industry around the world is very, very difficult.

Attachment 3: Assessing competitiveness

As the Issues Paper notes, the superannuation system is very complex and it is important to consider and understand the diversity of the system in developing and applying efficiency criteria. In this section we make some comments on the structure of Australia's superannuation system, the level of competition and barriers to competition.

Australia's superannuation system – structure and competition

The 'map of the superannuation system' which appears as Figure 3 of the Issues Paper has 5 types of superannuation funds, consistent with APRA's statistics. We have set out below some brief comments on each of the types of funds.

- Corporate funds are essentially standalone funds established by employers to provide superannuation for their own employees. This group comprised most superannuation funds until the 1990s, but now represent a small percentage of the total assets as most employers have now outsourced their superannuation arrangements
- Industry funds are multi-employer funds and began with a focus on employees within a particular industry. However this specific industry focus is reducing as funds merge and some individuals stay with a single fund throughout their career.
- Retail funds are operated by financial institutions and may seek investors (or members) from the general public or through employers. This important distinction will be further discussed below.
- Public sector funds were originally for all employees of the Commonwealth, State and local governments and related organisations. However, the default fund for many public servants is now an industry fund which may have a focus on public servants, whilst also being a public offer fund. It is also worth noting that many of the larger public sector funds are not fully funded as they represent pay-as-you-go defined benefit schemes.
- Self-managed superannuation funds (SMSFs) have grown significantly in the last two decades as more individuals take personal control of their superannuation. However, as is noted in the published data, the asset allocation of these funds is quite different from the other "pooled" superannuation arrangements.

As indicated above, the APRA classification of retail superannuation funds comprises both superannuation arranged by individuals for themselves and those arranged through employers for their employees. These employer arrangements often operate through a corporate master trust. In many cases, the employer transferred their original corporate fund into a master trust thereby taking advantage of the services and economies offered by the provider. As such, most master

trusts are offered on a wholesale basis thereby providing significant cost savings to these members.

The corporate master trust market is highly competitive, particularly for large employers who can use their size and purchasing power to get the best deal possible for their employees, often with the assistance of independent tender managers.

As a result, in many cases, the fees charged for customised arrangements through the corporate master trust are lower than available through a relevant industry fund.

However the decisions arising from this particular competitive process are not solely price driven, though they do drive down price. In our experience with large corporate tenders in which the Mercer Super Trust has competed, the key criteria for making these decisions are, in order of importance:

- Investment arrangements and expected investment returns: The fact that these criteria are paramount is backed up by the requirement under APRA SPS 530 to undertake an annual investment strategy health check which is required to ensure that the investment objectives are consistent with the investment strategy. This includes the design and quality of the default (MySuper) investment option, where Mercer's innovative 'SmartPath' investment option has been very well received by the market. SmartPath is a life-cycle investment option where the life-stages are managed in cohorts so, for example, sequencing risk can be managed for each cohort separately taking into account the investment experience leading into the retirement years. The range and quality of options available to members who wish to exercise investment choice is also a key consideration.
- Quality of member services: Help-line services including availability of limited advice at no additional fee; website and on-line resources such as retirement income calculators and member education material and services such as webinars. Note that the more successful a fund is in engaging members, the greater use will be made of help-line facilities and member options (such as voluntary insurance options), leading to higher costs and hence, if measured only on the level of fees, an apparently less cost-efficient fund;
- Fees – evaluated against breadth and quality of services, including investment arrangements
- Insurance premium rates and terms and conditions – customised to suit the make-up of the employer's workforce as these rates and conditions can vary considerably
- Administrative capability – track record of delivery, depth of resources
- Governance quality – including trustee and policy committee arrangements

Ultimately these criteria are all about generating the best possible outcomes for members, not fee minimisation. From a purely efficiency perspective, Mercer is very concerned that, because fees can be objectively measured and aspects such as service and product quality are difficult to measure objectively, inappropriate weight will be attached to fees when assessing efficiency. The 'product' of superannuation has many possible features and therefore it should not be considered to be a commodity and assessed on price alone.

For example, funds may have higher investment fees due to sophisticated arrangements including selective use of active management and alternative assets such as direct property, infrastructure and private equity. Over the long term it is expected that these investments would lead to higher risk-adjusted returns than funds with lower fees due to, for example, use of passive management and 'nil fee' investment such as bank deposits. However even results over reasonably long time-periods such as 5-10 years may not always demonstrate the expected out-performance as a result of the economic or market experience over that particular period.

It is critical to 'look behind the numbers' at how the performance was achieved rather than simply focussing on the performance number. It is too much to expect that formulaic risk-adjustment approaches can satisfactorily achieve this. That is not to say that measures such as volatility of returns and the Sharpe ratio are not valuable and important; rather they only tell part of the story and need to be interpreted with care.

An unsophisticated approach to measuring efficiency based predominantly on the level of fees is likely to lead to a small group of very large funds dominating the industry, with fewer and lower quality member services, little choice and extensive use of passive investments – that is, low cost but not necessarily better outcomes for members.

Investment fees

Mercer is both a leading asset consultant for major superannuation funds and a major buyer of investment services for the Mercer Super Trust and our unit trust arrangements. The following observations reflect our experience from these standpoints:

- The Australian market for superannuation funds management is highly competitive and overseas fund managers frequently need to discount their rack rates to compete with the Australian market.
- Chief Investment Officers of many superannuation funds are under significant pressure from their trustees to keep investment fees down.
- As funds have increased their assets under management they have been able to push down manager fees due to their increased scale. However in many cases funds have re-

invested part or all of the savings to improve the quality of the offering by increasing exposure to higher cost assets such as alternatives that are expected to improve risk-adjusted returns. As a result we believe that, while headline overall investment fees may not have reduced significantly due to scale, the quality of investment portfolios of many major funds has improved significantly over time, so that the value per dollar of investment fees has improved due to increased scale.

- Stronger regulation of fee disclosure has resulted in more investment fees and costs being disclosed over time. These apparent (but not real) fee increases have also hidden the real fee reductions due to increasing scale.

We strongly support the separate measurement and disclosure of fees and costs relating to administration and bundled advice from those relating to investment management, so that the cost and value provided by the two services can be evaluated independently.

Barriers to competition – default fund restrictions

It is important to note that the ability of employers to negotiate the best deal on superannuation arrangements for their employees will, in many cases, be removed if the selection of default funds by the Fair Work Commission proceeds as currently legislated. It will be very difficult for a corporate master trust to achieve listing under an award as a default fund under these arrangements. Further details are set out below.

Currently funds not listed in a Modern Award are unable to compete for new default members. Similarly, employers currently using a default fund listed in an Award may be unable to move to a more competitive product because it is not listed in the relevant Award.

Changes to the Fair Work system, currently on hold because of the lack of a Fair Work Expert Panel, will see further adverse outcomes as many members of competitive and efficient funds currently allowed to be used under grandfathering provisions may need to be transferred to higher cost and less effective funds when the current grandfathering rules are abolished.

The current grandfathering arrangements have generally enabled large employers who are concerned about their employees to continue using funds which are more effective for employees than those listed in the relevant Modern Award. As mentioned, such employers have generally gone through a tendering process to ensure employees receive the “best” deal.

The Fair Work system is also flawed as the removal of a fund from a list in a Modern Award will effectively result in the need to transfer some members of that fund to another fund. This is likely to have severe adverse outcomes for the fund as well as its other members. Such outcomes may

limit the willingness to remove funds from the relevant lists. This too will create a barrier to ongoing competition.

Removing default fund requirements from Modern Awards will avoid a number of adverse outcomes which are likely to arise if the legislation is not amended. Research by Rafe Consulting (the Rafe Report¹⁴) for the Financial Services Council has estimated 1.25 million new accounts may need to be established because the current employer default fund is not listed in the relevant Modern Award resulting in:

Higher fees

In some cases, fees in the new default fund will be higher than those in the previous fund. (This could be particularly significant in relation to employees of a large employer which may have been able to negotiate significant “large employer” fee discounts in their existing fund.)

Multiple fees

Unless an employee “chooses” their existing fund, future contributions will be paid to the new fund. Past contributions are unaffected and remain in the previous fund unless action is taken to merge the accounts. The employee will potentially become a member of two superannuation funds (the new default fund in respect of future contributions and the previous default fund in respect of past contributions) and incur two sets of administration fees (until the accounts are merged). As most employees are not engaged with their superannuation, we expect many will not make any decisions and by default, could end up in two funds paying double fees.

Merging the accounts will generally trigger the payment of a withdrawal or exit fee in the account being closed. Unless sufficient notice is provided, some contributions may be paid to the new default fund before the employee can advise they wish to choose their existing fund.

Insurance

Insurance arrangements in the new default fund are likely to be different from the previous default fund. Premium levels and levels of cover may be higher or lower. Whether the new arrangements are more, or less, appropriate for an individual member will depend on the individual’s particular circumstances. However, unless the employee’s accounts are merged, there may be two sets of insurance premiums providing, in some cases, unnecessary insurance cover and a reduction in the amount of contributions financing the employee’s

¹⁴ Impact Of Changes To The Fair Work Act On The Australian Superannuation Sector, Employers And Their Employees (16 June 2014)

retirement. Further, members may not be eligible for insurance in the new fund (for example if they were not at work on the day of joining) and may eventually lose their insurance cover in their existing fund if the account balance is no longer sufficient to pay premiums.

Other

If the accounts are not merged and one becomes inactive, after five years, such accounts (up to a threshold currently \$4,000 and increasing to \$6,000 from 31 December 2016) may be classified as an inactive account and transferred to the ATO (incurring a withdrawal fee). Following the transfer to the ATO, the account will only earn interest at the rate of CPI, potentially significantly lower than would have been earned if it had been retained in the superannuation fund. Once transferred to the ATO, members will also lose valuable death and disability insurance.

Impact on employers

Employers will be subject to additional costs and red tape in choosing a new default fund, advising employees and processing requests from employees who wish to retain their existing fund. The Rafe Report estimates 80% of 117,000 employers currently using Master Trusts will need to choose a default fund listed in a modern award which is not their existing fund.

Further costs and red tape will arise for employers who have employees covered by more than one Modern Award where it may be necessary to have different default funds for different groups of employees and potentially change an individual employee's default fund each time the employee changes roles and becomes subject to a different Modern Award. In such cases the adverse impacts on the employee will be repeated each time.

Employers with employees covered by different Modern Awards may need more than one default fund to cover all of its employees adding further to costs and red tape.

Impact on superannuation funds and members

Significant costs will be incurred by superannuation funds in applying to the Fair Work Commission for listing under more than 100 Modern Awards.

We also expect many existing funds that do not obtain listing in a significant number of Modern Awards (and consequently see a major fall in their contribution income as well as losing assets to other funds) will not have sufficient scale. This may result in adverse outcomes for existing members of these funds.

The Fair Work provisions may also promote the survival of homogenous vanilla products and result in less competitive products with poorer long term outcomes for consumers.

Mercer believes the superannuation default fund requirements in Modern Awards should be removed. This would free up competition. Legislation already mandates the use of a MySuper product for default members (at least in respect of contributions from 1 January 2014 with existing default balances to be transferred to a MySuper no later than 1 July 2017). Hence this ensures all default members will be in a fund which has satisfied APRA's filtering requirements.

Despite this, some people have raised concerns that the repeal of the Fair Work default fund provisions will enable employees to remain in an unattractive default fund even though it is a MySuper. This is unlikely to occur in relation to large employers who often have the resources to assess the best fund for their employees' welfare. However it is possible that this adverse outcome could occur in relation to some smaller employers who originally chose a default fund where the fees charged by the default fund's MySuper are too high. If such concerns are valid, a possible solution is to limit the grandfathering arrangements for employers with, say less than 100 employees, to cases where:

- The MySuper has achieved an "appropriate" or better rating from one of the superannuation ratings houses (this approach would enable a more holistic view of a fund including its total service offering as well as its likely investment outcomes); or
- The employer has obtained professional advice in relation to the suitability of the fund for its employees within the previous 5 years.

We consider such an approach to be far superior to the Expert Panel approach in the Fair Work Act with fund assessments being made by those who are independent as well as being experts in the field. This approach would also avoid the arbitrary limitation of the number of funds which could be used by an employer which would apply under the current Fair Work provisions.

Demand-side competition

The removal of the Fair Work default fund provisions as recommended above would greatly enhance default fund competition. In respect of consumer-led competition between funds, our observation is that this largely occurs at a number of trigger points:

- Commencing with a new employer: This leads members to consider making a choice between their existing fund and their new employer's default fund or funds.
- Seeking financial advice: Members who seek personal financial advice (from an adviser outside their existing fund) may change funds on the recommendation of that adviser

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- The most common instance of the foregoing point is members retiring and making a decision about pension products. The influence of financial advisers and brand recognition is apparent in the much higher post-retirement retention rates of some funds which successfully retain more than half the available funds at retirement.

Attachment 4: Assessing operational efficiency – insurance

The third objective listed on page 19 in the Issues Paper is:

- *minimised cost of ancillary services, such as insurance and financial advice, taking into account the level and quality of those services.*

In Table 2 (p.21) the indicators listed for this measure include ‘ratio of user costs to claims for bundled insurance’.

We presume ‘user costs’ means the premiums members pay and that bundled insurance refers to basic default cover rather than optional cover.

A common and good measure of assessing the efficiency of insurance benefits is the insurer’s “loss ratio”. This is determined as total claims (including allowances for late admittance and reporting of claims) divided by total premiums. It indicates the proportion of premiums returned to members by way of claims. Over the longer term, the loss ratio is typically in the order of 85% for death and total and permanent disablement (TPD) insurance and 80% for income protection (IP) insurance. In our view these levels represent an efficient system and make adequate allowance for the insurers’ expenses and the cost of providing the capital to support any excess insurance claims.

However the loss ratio depends significantly on the pricing cycle. For example in 2013, total claims significantly exceeded total premiums so that overall members received more in claims than the premiums paid and insurers made a loss. As a consequence premiums were increased so that loss ratios are now lower with insurers retaining more for contingencies and profit.

Also it is critical to recognise that, in order to provide meaningful information, loss ratios must be calculated using the full claim payments that relate to the premiums included (and only those claim amounts). This is not straightforward due to the time lags that occur in claims (relating to both notification of the claim and the assessment process), particularly TPD claims where the lags can be many years. Because of these lags, whilst the amount of premiums relating to insured cover for a particular year will be known soon after the end of that year, it may be many years until the actual full amount of claim payments for the year is known. In the meantime, the loss ratio for the year is calculated using actual claims amounts paid to date plus an estimate of outstanding claims.

Hence the ratio of premiums paid by a fund in a year to claims amounts paid in the same year is a very poor measure of efficiency due to the time lag in claims. Claims paid by a fund in a particular year will relate in part to the current year and in part to premiums paid in prior years. The amount of claims which relate to premiums paid in prior years may be much higher or lower than the outstanding claims for the current year that will be paid in future years. Where premiums are growing this will generally result in a claims ratio that looks highly profitable for the insurer, but this is likely to be due to the fact that future outstanding claims incurred which relate to the current year (i.e. claims for the current year which are yet to be paid) are much higher than claims paid in the current year that relate to premiums paid in prior years.

Other areas for consideration in the efficiency of the insurance system are:

Legal fees

Recent media investigations have clearly demonstrated the need for legal representation for claimants in some instances. However many superannuation fund members submit initial claims with legal representation and thereby incur substantial legal fees for claims that would have been paid in any case. This detracts from the size of the net insurance benefit received by the member. In some cases legal intervention can also slow down the claims process, with information requests held up in the solicitor's office. Efficiency could be improved by disallowing legal representation until a claim has been declined, or a certain time frame has elapsed since submitting the claim.

TPD claims

The predominant disability benefit for superannuation in Australia is a lump sum total and permanent disablement (TPD) benefit, as required by the SIS Act. In many cases the disability does not turn out to be permanent. A recent study by SunSuper showed that over 20% of its members who received a TPD benefit had subsequently returned to the workforce and were again contributing to the SunSuper fund. The entire membership pays for these claims by way of increased premiums. One possible solution may be to redirect the emphasis of disability towards income protection, or benefits paid by instalment, rather than lump sum TPD benefits.

Rehabilitation

Many insurers for superannuation funds run their own rehabilitation programs. We have observed that these are not well integrated with existing workers compensation rehabilitation programs and believe there are opportunities to increase efficiency by better integration of these rehabilitation programs.

SIS benefit restrictions can also prevent rehabilitation costs being paid and should be reviewed.

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Stamp duty

Stamp duty represents a leakage from the insurance system and there are inconsistencies and complexities in relation to the different stamp duty regimes in different states. The Victorian state government has substantially increased stamp duty on TPD benefits. There is scope to simplify or remove the stamp duty impost.

Attachment 5: Allocative efficiency

Page 22 of the Issues Paper suggests that allocative efficiency refers to the allocation of resources to their highest value uses. It goes on to suggest that the objective is “to ensure that the outcomes of the superannuation system align with the preferences of members and maximise their well being to the greatest possible extent.”

However such an approach assumes that the preferences of members are both known and consistent. This is not the case. The preferences of members are very diverse. For example, some members will desire a lump sum benefit at retirement to pay off a mortgage or debt or to provide them with greater flexibility or control over their assets during retirement. Alternatively, other retirees will desire a steady and reliable level of retirement income.

Another important factor to bear in mind is that most retirees are risk averse. That is, their investments are more conservative than may be desirable for their maximum ‘financial well being’ in the future. On the other hand, this relative conservatism and reduced exposure to market volatility may provide them with greater ‘emotional well being’.

It is also worth mentioning that whilst many retirees may be wary of market volatility (that is, the risk to the value of their assets in their account based pension), other retirees are more concerned with risks to the value of their regular income or pension payment (from items such as interest payments, rentals from property and dividends) than in the market volatility of the underlying assets. These contrasting requirements and desires means that the optimal asset allocation for retirees (who represent a growing proportion of the superannuation membership) will vary considerably between individuals and that there does not exist a single answer.

A further example of this diversity occurs when retirees behave in a particular manner to maximise their age pension entitlement or to maintain access to the Commonwealth Seniors Health Card. In other words, maximising the investment return or the value of assets may not be perceived by some retirees to be in their best interest. Such behaviour could be considered inefficient when considering the objectives of the system.

While the above examples relate to retirees, superannuation fund members in the accumulation phase also have a range of views in respect of the importance of insurance. There is no doubt that group insurance for death and disablement provides very valuable protection to many Australians. However the premiums paid for this insurance inevitably reduce the ultimate benefit provided at retirement. Some may argue that insurance premiums should be limited to say 1% of salary thereby ensuring that most of the contributions are directed toward retirement benefits. However for some fund members, the provision of affordable insurance is the most valuable component of

superannuation. Hence, there is no single answer to the most efficient allocation of contributions between immediate protection and the longer term provision for retirement.

One final example of the difficulty of allocative efficiency relates to the constraints imposed by the regulators, particularly APRA. There may be very good reasons for most of their general directions and policies but there exist instances where the applications of some of their policies generate additional cost or less efficient outcomes.

The first example relates to the requirement for superannuation funds to obtain third party insurance for virtually all their death and disability risks. This has meant that some large funds, who had been successfully self-insuring for years, were required to take out third party insurance at an additional cost to members.

The second example relates to the requirements for successor fund transfers. The current application of these requirements is that it discourages some potential successor fund transfers which, in turn, restrict fund mergers which could otherwise provide a better outcome to members.