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Productivity Commission
4 National Circuit
Barton ACT 2600

By email: super@pc.gov.au

To whom it may concern

Response to Productivity Commission's draft report into the efficiency and competitiveness of the superannuation industry

This submission is in response to the Productivity Commission's (PC) draft report for Stage 3 of its inquiry into Superannuation: Assessing Efficiency and Competitiveness. Given our previous submission, our attendance at the recent public hearings, and our support for submissions lodged by other parties, we have not in this submission sought to add greatly to the volumes of work and analysis already done. We have focused on three items:

- We have sought to provide the commission with a response to the requests for further information in the draft report.
- We have expanded on some comments from our statement at the public hearing.
- We direct your attention to some additional comments that we have prepared for the Financial Services Council (FSC) as well as some additional comments on fees and Choice.

We applaud the PC on the extensive work it has done. Regardless of whether all your recommendations are legislated, the report has provided a thorough assessment of the superannuation system and will guide all parties to refine and improve the superannuation system.

We agree with your analysis of the many deficiencies in our complex superannuation system, particularly the issue of multiple accounts and under-performing funds. However, we are optimistic that many of these issues can be remedied with some key changes. For example, we note the changes made in the recent Federal Budget which address the issues of unnecessary life insurance and multiple accounts.

We understand the reasoning behind your *best in show* concept, as this shifts the onus of selecting a fund from employers to employees. However, we are concerned about some of the potential outcomes of this major change to the system. If introduced, we would not restrict such a structure to ten funds but would have a longer list to maintain a competitive marketplace, particularly for boutique funds.

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Yours sincerely

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Response to information requests

INFORMATION REQUEST 2.1

Are the assumptions underpinning the Commission's benchmark portfolios sound?

If not, how should they be revised, and what evidence would support any revisions?

Our main concern with the analysis is that it does not allow for the fact that the asset allocation is ultimately more important (for default funds) as it will largely drive the investment outcomes for members to a greater degree than individual security selection. Consequently, we would urge that should a *best in show* model be implemented that investment strategies are measured on the suitability of the asset allocation and strategy rather than simply past performance vs. benchmark portfolios.

We also note that there are some limitations in the quality of the data that the PC has used in its analysis. In particular, the consistency of the classification of assets in the APRA data for the 12-year period considered could impact results. This may be especially true for alternative assets which may have been lumped into the 'other' category e.g. infrastructure, private equity.

INFORMATION REQUEST 2.2

Aside from administration fees, asset allocation and tax, what other factors might explain differences in investment performance against benchmark portfolios of the superannuation system, as well as segments such as for-profit and not-for-profit?

Over long periods of time, investment performance will vary by the proportion of growth assets held. A fund's liquidity position will influence this percentage. For example, a fund with a high number of pensioners may have more of the portfolio in cash to provide liquidity for pension payments.

Funds with strong cash flow and liquidity can invest in unlisted assets which are illiquid. These have an illiquidity premium, paying a higher return over longer periods. Consequently, the ratio of unlisted to listed assets is a factor which will influence performance.

Scale is also a factor. In some for-profit funds, a proliferation of investment choices will dilute the average size holding, so the full-scale benefit is not realised.

What evidence is available to test the influence of such factors?

There is limited evidence to test this in the superannuation industry without gathering asset class level returns. We understand the PC is currently seeking to obtain this data.

INFORMATION REQUEST 4.1

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

Rice Warner is supportive of lifecycle investment options continuing to be allowed as part of MySuper.

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

We have concerns with the design of lifecycle products that begin to reduce exposure to growth assets at an early age.

We refer the PC to research performed for AIST by Rice Warner in 2016 (http://www.aist.asn.au/media/860083/lifecycle_mysuper_product_fees.pdf). This research showed that these types of portfolios can reduce member retirement outcomes.

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

Lifecycle products could be designed to segment members according to their likely retirement outcomes. Members who will receive a full Age Pension could be treated separately to a member likely to receive a part pension or none at all. This segmentation is likely to be done within the five years prior to retirement and not before.

Relevant factors other than age to achieve optimal outcomes for members could include:

- balance (or expected retirement balance)
- life expectancy
- marital status (and the amount of super held by the spouse)
- assets outside of superannuation.

We note funds do not collect or hold this information. However, should they be able to obtain data on members, it would allow tailoring of solutions to a degree which best manage risks related to retirement.

INFORMATION REQUEST 7.1

What are the main types and quantum of costs involved in fund mergers? How do these vary depending on the size of funds involved?

The typical costs types involved in a merger are set out below (in a rough order of magnitude).

These include the costs of switching administrators, costs of breaking contracts early, marketing, project costs and consulting costs:

- costs of administration
- custodian/investment contracts
- marketing and communication
- project resourcing
- SME resource
- external consultants
- contingency costs
- project expenses
- licences
- staff.

In analysing baseline merger costs, we typically assume that the lower bound for the costs of a merger is $1.75 million and the upper bound is $5.25 million. A typical merger might have costs of 0.02% of the combined FUM of the merged entities.

INFORMATION REQUEST 7.2

What evidence is there that funds are passing through economies of scale to members in the form of lower fees, or through other channels? Why has the pass-through of scale benefits occurred as it has?

We refer the PC to research performed by Rice Warner for the Financial Systems Inquiry which looked at the reduction in fees over a period of ten years and the extent to which scale benefits had been passed through.

The full report can be found on the FSI website:

http://fsi.gov.au/files/2014/12/Superannuation-fees.pdf

We also include our recent *Superannuation Fees Report* which shows that average fund fees continue to reduce as a percentage of assets. As this is a commercial product, we ask that it not be published with this submission. Note this report shows that the industry fees now total $22 billion and not the $30 billion quoted in your draft report (see page 9 of our submission).

INFORMATION REQUEST 8.1

What is the case for bundling life and total and permanent disability insurance together, as is done by some superannuation funds?

Are there funds that offer these separately, and if so, do many members of these funds elect to have one type of cover but not the other?

Data on which funds offer Death and TPD insurance separately is available on the Rice Warner Group Insurance Comparator.

Rice Warner's *Super Insights* database contains information at a member level, on the type of insurance elected by members. In summary:

- Out of the 115 products reviewed (offered by 54 unique funds) from the Rice Warner Group Insurance Comparator, 24 products offer TPD cover without death cover or offer a level of TPD cover exceeding their death cover for some ages.
- For four of these 24 products, TPD cover can only be obtained separately to the death cover if the standard/default TPD cover amount is elected (I.e. members cannot select additional levels of cover).
- Most products (around 80%) only offer TPD cover if death cover is obtained and the level of TPD cover is less than or equal to the level of death cover. Based on Rice Warner's *Super Insights* data, there are few members (less than 1%) who take one type of cover but not the other.

INFORMATION REQUEST 8.2

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

We refer the PC to our previous comments on default income protection benefits within superannuation contained in Rice Warner's report *Superannuation: Assessing Competitiveness and Efficiency (Insurance Aspects)*.

https://www.pc.gov.au/__data/assets/pdf_file/0008/221201/sub046-superannuation-assessment.pdf

Public hearing comments

We comment on four aspects of your report:

1) Setting the bar for MySuper.

2) The role of employers in a system based on wages.

3) The role of life insurance.

4) Our views on "best in show".

Setting the bar for MySuper

Your report makes some suggestions which we fully support. The key one is that the original MySuper hurdle was set too low, and the requirements to maintain a MySuper licence should be elevated.

In setting this standard, we caution against using past performance as a key mechanism for eliminating all non-performing products. Your 12-year analysis of annual net returns covered the pre-FOFA and Stronger Super environment and is not representative of the MySuper world. To illustrate, many retail funds allowed employers to select default investment strategies pre-MySuper, and these could vary significantly. Further MySuper has led to the removal of commission and the reduction of other fees since its introduction.

We believe that the MySuper system needs to be measured over a longer period to prove its worth in delivering value for money outcomes for default members. Of course, none of this should delay APRA in removing licences from those who are under-performing and show no signs of improvement.

While we accept your view that member circumstances are too different to set up a homogenous MyRetirement product, we consider MySuper should also be extended into retirement. It is possible to set up a simple structure of bucketing various investment strategies, so members can vary the amounts placed in each bucket. This provides flexibility without unnecessary complexity.

We also believe the standards for Choice products need tightening. Many of these products provide relatively poor value and consumers will not always understand this due to the known problems of knowledge asymmetry and lack of financial literacy.

It would be worthwhile considering the range of Choice options to see if any further recommendations could be made. For example, like you, we question whether Eligible Rollover Funds have a role given the consolidation of lost accounts.

The role of employers in a system based on wages

We agree that the FWC process to allocate default funds imposes constraints on the ability of funds to compete for employers and members. If the bar is set higher for MySuper products, we believe this process should be removed.

Many larger employers are well equipped to choose a default fund for their employees. However, they can only secure discounts and tailored insurance if the employer plan remains the default. If your recommendations were fully put in place, we could see the demise of employer plans to the detriment of many employees.

The role of life insurance

What is the role of life insurance? It is not part of the *Objectives of Superannuation,* yet group insurance through superannuation is the largest life insurance segment and provides the best value of all insurances when measured by claims as a percentage of premiums.

We support a formal review of whether insurance should be funded through superannuation funds and what structure the benefits should take. It would be useful for the superannuation industry were there to be an Objective of Insurance within Superannuation.

We also support the Insurance in Super Voluntary Code being turned into binding and enforceable rules, noting that the Government's Budget measures will achieve aspects of this.

We further note the 2018 Budget changes will remove some of the inequities in the system, and address some of your concerns.

Our views on Best in Show

If introduced immediately, the *best in show* shortlist of 10 MySuper products could:

- Stifle innovation, as a differentiated strategy may not be rewarded.
- See the 10 initially selected funds have a significant liquidity and scale advantage over other MySuper funds, making it difficult for another MySuper fund to be chosen in the future for the list.
- Potentially encourage funds to chase returns with potential risk if they believe they need a good short-term return to make the list of 10.
- Prevent new entrants from establishing products that can obtain default status.

We note the number of MySuper products was initially much fewer than anticipated when the Stronger Super legislation was passed, and that the number of MySuper products continues to decline through continued fund mergers. Indeed, the number of MySuper products that can be selected by public offer and are not employer specific is already only around 65 and trending lower. Rice Warner's *Superannuation Market Projections report* last December suggested that the number of funds is likely to halve in the next five years.

We consider that it is worthwhile strengthening the MySuper standards and letting the market settle for a period of five years before considering the merits of the *best in show*. This will be less disruptive and will allow the industry to address the many issues raised in your report.

In five years, if it is still determined that *best in show* needs to be introduced, we would recommend allowing more than ten funds to be considered. This would allow specialist funds, such as those operating in a small State, to continue receiving cash flow from young members.

Additional commentary

We have kept our comments brief and have limited them to the PC's recommendations on the best in show model, lifting the bar for MySuper, insurance and superannuation fees.

A new default system – the best in show model and lifting the bar for MySuper

We refer the PC to our comments prepared for the Financial Services Council (FSC) which supplemented its submission as summarised below:

- The draft PC report assessing the efficiency and competitiveness of the Superannuation Industry has many sensible proposals that will drive improved member outcomes:
  - Requiring members to default into a superannuation fund only once when they enter the workforce will reduce the number of inefficient multiple accounts in the system.
  - Elevating the bar for MySuper will drive improved member outcomes and fund performance over time.
  - Rationalisation of the number of superannuation funds over time will be a positive as many under performing funds will be removed from the system.
  - Prompting the employee to select their own fund could drive an increase in member engagement in superannuation which would improve member outcomes.
- Though the proposed *best in show* list of 10 default provides some improvements over the current system, it also has the potential to cause significant and sub-optimal disruption throughout the Superannuation Industry as it could possibly:
  - Stifle innovation, as a differentiated strategy may not be rewarded.
  - See the 10 initially selected funds have a significant liquidity and scale advantage over other MySuper funds, making it difficult for another MySuper fund to be chosen in the future for the list.
  - Encourage funds to chase returns with disregard to risk if the funds believe they need a good short-term return to make the list of 10.
  - Discourage new entrants from establishing products that can obtain default status.
  - There is still a risk that most members will remain unengaged and will fail to monitor the first fund they join.
- It will be difficult to rank a list of up to 10 funds based on multiple criteria:
  - For example, it will be challenging for the panel to fill the last remaining places on the list if many funds on the cusp of making the best in show list have similar ratings against many of the criteria.
  - The PC needs to clarify what would happen in such a circumstance and indicate whether the list would be expanded to accommodate additional funds.
- The PC's proposed *best in show* model removes employers from the process of allocating default members. However, many larger employers are well equipped to choose a default fund for their employees. In many cases they can only secure discounts and tailored insurance if the employer plan remains the default. The lack of flexibility in the PC's proposed *best in show* model (to allow employers to select a default for their employees) could see the demise of employer plans to the detriment of many employees.
- Strengthening of the MySuper authorisation benchmarks will likely result in rationalisation and merging of funds over time without creating the significant disruption to the industry that the *best in show* model would cause. We note that this does not shift choice of default fund from employers but consider this can

be achieved by nudging all young members for SME employers to make a fund selection from the full MySuper list.

- Should these reforms fail to succeed in achieving the required objectives Government could then look to implement another model such as *best in show* to achieve the required changes.

- We recommend any *best in show* process refrain from relying on past performance as the key determinant for selecting the shortlist, though we note it may be useful for eliminating the bottom non-performing products from the process.
- A significant reduction in the number of default superannuation funds may have flow on impacts to the Australian economy, including the liquidity of the Australian equity market. In some scenarios, superannuation funds will be dominant participants in the marketplace, potentially reducing competition for assets through partnerships and joint ventures.
- Evaluation of the success of the MySuper system needs to be conducted over a longer period to prove its success in delivering value for money outcomes for members. If some form of the *best in show* list is to be implemented, delaying implementation until 2025 will allow for a reasonable comparison of the impact of MySuper on the system.

In addition to comments made in the FSC submission, we also note that there is the potential that funds will seek to shift MySuper members to Choice investment products. While it is desirable that members become more engaged with their superannuation, shifting to a Choice product is not always positive.

Our research shows that Choice members:

- tend to pay more in fees for the wider range of services provided
- often under-perform the default investment selection
- join funds which lack the scale of default funds
- require financial advice which again adds to the cost of their superannuation and reduces funds available at retirement.

Superannuation Fees

We note some technical inconsistencies in the presentation of analysis of fees in the draft report.

In 2016, Group Insurance premiums for APRA regulated funds totalled approximately $8.4 billion[1] (the corresponding figure for 2017 was $9 billion). Adding this to the $22 billion in fees and expenses for 2016 (from the Rice Warner *Fees Analysis Report*) gives total fees and premiums of $30 billion. Rice Warner believes that this is the number provided in the PC report, and that the $30 billion figure stated in the PC report does in fact include insurance premiums. The PC Report Draft Supplement 5[2] states that Rainmaker research was used for the $30 billion p.a. figure. On inspection, this figure includes Group Insurance premiums.

The Rice Warner *Fees Analysis report (2017)* showed fees (excluding insurance premiums) to total approximately $22 billion or 1.03% of assets for the year to 30 June 2016 (aligning for the corresponding period in the PC's report). Since then we have updated our report and the corresponding figure from the *Fees Analysis report (2018)* is $22.4 billion or 1.00% of assets at 30 June 2017.

[1] APRA Super Bulletin June 2016
[2] https://www.pc.gov.au/__data/assets/pdf_file/0008/228248/superannuation-assessment-draft-supplement5.pdf