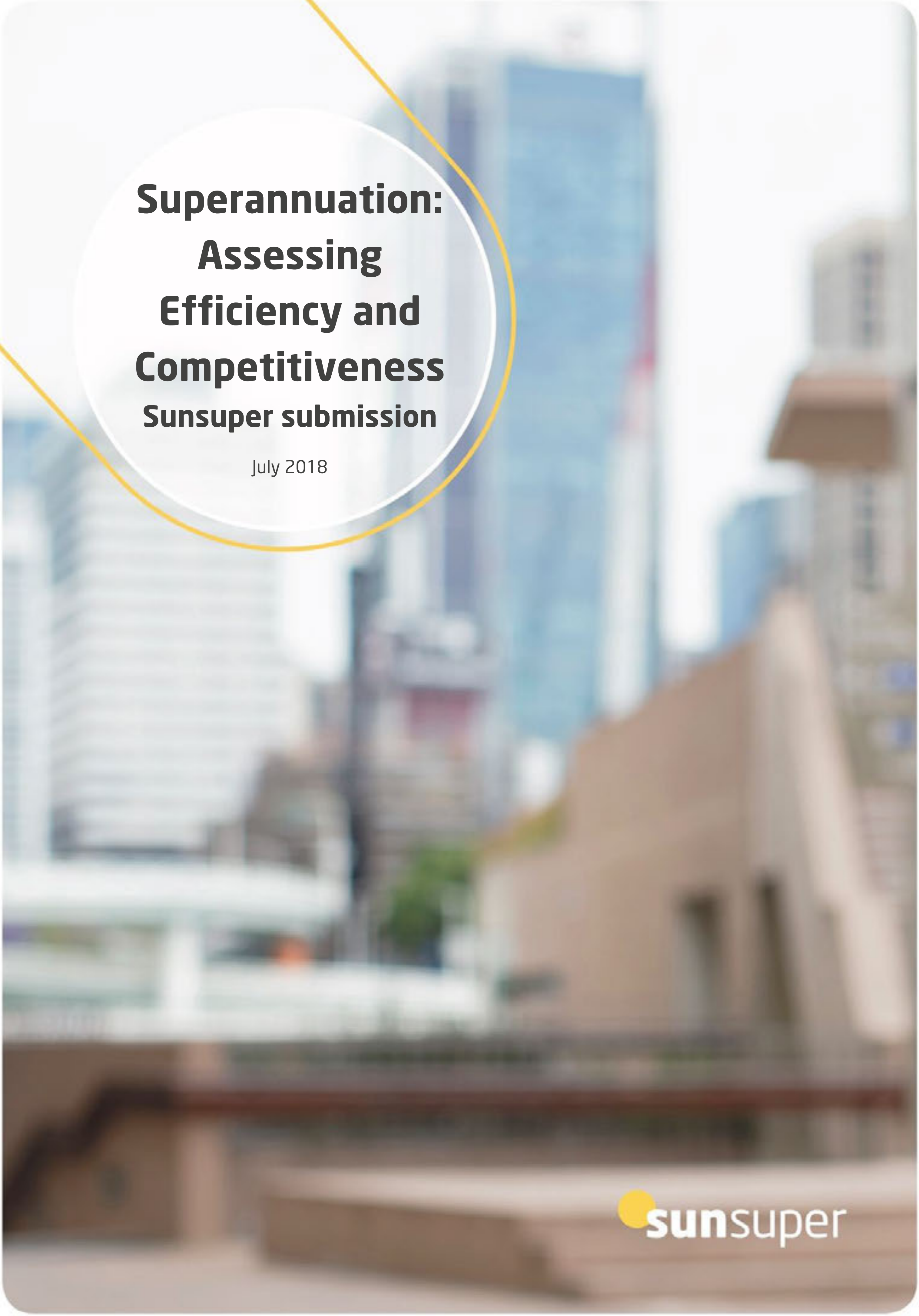
Superannuation: Assessing Efficiency and Competitiveness

Sunsuper submission

July 2018



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27 July 2018

Superannuation

Productivity Commission

Locked Bag 2, Collins Street East

Melbourne Vic 8003

Submission lodged online at http://www.pc.gov.au/

Dear Ms Chester

SUBJECT: SUPERANNUATION: ASSESSING EFFICIENCY AND COMPETITIVENESS – DRAFT REPORT

Thank you for the opportunity to provide comments on the draft report on the stage two and three streams of work under the Productivity Commission's inquiry into the efficiency and competitiveness of Australia's superannuation system.

Sunsuper is one of Australia's largest and fastest growing superannuation funds, with more than 1.3 million members, 100,000 participating employers and over $55 billion of funds under management as at May 2018. We are the largest fund in Queensland by number of members and the ninth largest public offer fund in Australia.

Established in 1987, our profit for members' philosophy means our members can take advantage of low fees and a broad range of services designed to enhance their retirement benefit outcomes.

We are in broad agreement with many of the Commission's recommendations and are pleased to provide further feedback and insights to inform the Commission in its finalisation of this inquiry.

We welcome the opportunity to further discuss any aspects of the responses contained herein with the Commission.

Should you wish to speak to us further in respect to our submission, please contact Dianna Orbell, Head of Government Relations and Special Projects,

Yours sincerely

Scott Hartley, Chief Executive Officer

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Executive summary

We commend the Productivity Commission on a thorough report and agree that there is notable divergence in outcomes for members across the system that must be addressed to best protect member interests and promote community trust in superannuation.

We support the default model put forward in draft recommendation 1 and believe that it should work in the best interests of members to promote engagement through their retirement journey. These changes, if legislated, will transform the industry with all funds being affected - including Sunsuper.

We fully support a system that encourages high performance and transparency in promoting members' interests first and foremost.

We are encouraged that this draft report specifically contemplates existing members and how future default account determinations will be made to address multiple account proliferation which has been a feature of default superannuation since its beginning.

Our key comments on the draft report are:

- We support the concept of a default system that only applies to new workforce entrants to promote a 'first default – last default' framework.
- We support a 'best in show' approach with an independent expert panel making determinations based on clear, well-considered criteria. Administration fees must be comparable by being quoted gross of tax and tax rebates should be passed back to those members that contribute to those rebates being received.
- However, we are conscious a best in show approach may encourage inappropriate peer group herding across fund investment strategies.
- We believe trigger(s) should be established for prompt reassessment of any fund in the best in show if a significant, adverse and fund specific event were to occur.
- We support strengthened MySuper authorisation criteria and associated governance reforms.
- We strongly support making capital gains tax relief for fund mergers permanent and also support transparent reporting to APRA on proposed merger activity.
- We are supportive of the intent of reforms to member insurance arrangements to limit balance erosion from a default opt-out to an opt-in regime but believe this should only apply to inactive members.
- We do not believe an independent review into insurance in super is necessary given other insurance reforms proposed.
- We support ATO account reunification initiatives subject to refinements.
- We are in favour of member engagement and transparency initiatives and provision of information on related party outsourcing arrangements and adviser trailing commissions.
- We do not support additional dashboard requirements as being beneficial to increase member engagement or education. The inconsistency in administration fees and tax treatments would need to be resolved to allow comparability.

Our submission provides feedback on each 'Information Request' and 'Draft Recommendation' posed by the Commission in its draft report.

Submission in full

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?

Sunsuper comments

We believe there are some shortcomings in the assumptions underpinning the two benchmark portfolios (referred to as BP1 and BP2 in the draft report), but recognise that availability of data and the nature of the task presented a particular challenge.

We acknowledge that the Commission has adopted an approach that attempts to provide as meaningful an analysis as possible of system and individual fund value add.

Asset allocation decisions

The fact that the benchmarks are updated annually to reflect asset allocation changes is a meaningful impediment to distinguishing added value or detracted value.

Asset allocation tilts

As a simple example, consider a two asset class fund (or segment/system). If the fund has a target of a 50% allocation to each asset class through time, but an approach of moving to 45% or 55% annually based on an assessment of asset class risk and reward, then both benchmarks will effectively treat the resultant asset allocation changes as a given regardless of success or failure.

That is, the fund will show the same performance outcome relative to BP1 or BP2 respectively when the actual returns do differ between maintaining a 50:50 allocation or employing the 5% tilt.

Picking a rather extreme illustration, say the two assets in the example were domestic and international listed property. Based on the returns in Figure 4.6 of Technical Supplement 4, a 5% proactive asset allocation tilt to international listed property over a period of five years would have demonstrated additional return, but would not be fully captured in the BP1 (or BP2) analysis.

Allocations to unlisted assets

In our view, it is a fundamental asset allocation decision to expose a fund to illiquidity risk (within the risk appetite of the fund) in a bid to harvest an illiquidity premium.

The objective is to enhance returns relative to a fully listed alternative allocation.

BP2 effectively treats this asset allocation decision as a given, thereby leaving the relative performance compared to an unlisted benchmark as the measure of value add. Unlisted benchmarks are not investible and this further complicates evaluation of added value, even at the system level.

In our view a reference listed asset benchmark, reflective of the return and risk objectives of an option would be a more appropriate benchmark for assessment of value add at the fund level.

That is, we suggest embodying the principles of BP1, but with a more stable asset allocation.

We acknowledge that this approach is less straightforward to adopt at the segment and system levels, other than by asset weighting individual fund benchmarks.

In relation to the two benchmarks put forward by the Commission:

- BP1 is more appropriate than BP2 for assessing the performance of the system. As it is constructed from listed markets, BP1 ensures that some asset allocation decisions (i.e. decisions to invest in unlisted assets) are reflected in the comparison of actual performance against BP1
- BP2 does not meet several tests of a satisfactory benchmark, in particular that it is specified with hindsight based on actual asset allocation
- The weight provided to analysis based on BP2 in the report is therefore only partially insightful in terms of assessing value add
- The use of a listed infrastructure benchmark in place of an unlisted infrastructure benchmark is inappropriate
- Evidence exists (for instance in the way Sunsuper invests), that it is inconsistent to assume that all alternative assets are growth assets.

Benchmark principles

In terms of generally acknowledged principles in designing benchmarks, we offer the following detailed comments.

Forward-looking benchmarks

The benchmarks, BP1 and BP2, are designed after the fact, i.e. they are backward looking.

This effectively gives no credit to trustees for strategic asset allocation decisions, despite these decisions being acknowledged as one of the biggest drivers of member outcomes.

BP2 entrenches this aspect further by treating the decision to accept illiquidity risk (i.e. invest in unlisted assets), as a non-value add activity.

More than ten years ago, infrastructure and private equity were emerging asset classes and strategic decisions taken by funds to invest in them should be analysed appropriately and value added credited to the funds who took this step.

1. Appropriateness

Several indices for BP1 and BP2 may have alternatives that are more appropriate to the asset class opportunity set in question. As an example, the use of listed infrastructure in place of an unlisted infrastructure benchmark is problematic. It is unlikely that infrastructure investors would see the narrow universe offered in listed infrastructure as an appropriate alternative.

Two broad issues arise:

i) BP1 equivalents for alternative assets; and
ii) the appropriate BP2 index.

BP1 equivalents

Unlisted/private equity: it is generally recognised that the global universe of opportunities warrants a broader global listed market index, e.g. MSCI World Index (hedged).

Unlisted property and infrastructure (domestic and international): whilst a listed equity benchmark may be appropriate in some circumstances, the funding source or cost-of-capital is often a combination of equity and fixed income. This can be a function of gearing levels, exposure to development activity and other factors. An appropriate benchmark would reflect this combined equity and fixed income cost-of-capital (appropriately apportioned between domestic and international).

BP2 indices

Unlisted/private equity: indices, such as the Burgiss family, exist for global private equity and, consistent with the comment above on the opportunity set, are appropriate indices.

International unlisted property: admittedly, finding a single global index is difficult, but the use of a listed benchmark plus illiquidity premium brings with it volatility of listed markets and difficulties in determining an illiquidity premium. We believe there are combinations of regional indices of unlisted property which could be usefully used as an alternative.

2. Embedded Risk Profiles

The risk profiles for alternative assets assume that these are exclusively growth assets which is inconsistent with how they may be invested in practice.

For example, Sunsuper's listed equivalent benchmark for infrastructure and property is a blend of equity and fixed income reflecting the targeted risk characteristics of the portfolio.

3. Un-investible

The use of alternative benchmarks is debateable given that they are not investible.

Unlisted assets are not divisible, are traded infrequently, and cannot be owned by everybody.

A suitable benchmark is one that best reflects what would have happened in the absence of the value adding investment expertise introduced into the system (i.e. the market return).

Strategic asset allocation decisions and successful implementation of investments in alternative assets have arguably led to significant gains across the system and a benchmark portfolio designed to account for relevant asset allocation decisions would demonstrate that value add.

We employ a similar benchmarking model internally (and have done so for many years), and have refined our benchmarks through experience.

For BP1 we believe that an 'a priori' benchmark should reflect a listed market only benchmark covering equities, bonds and cash.

We do not believe that BP1 should concentrate in specific sectors of the listed equity market (e.g. REITs and listed infrastructure) as these allocations reflect insights based on past strategic asset allocation decisions.

The advantage of this approach is that risk profile adjustments can be made in a straightforward and unbiased way.

In contrast, BP1 and BP2 are backward looking by adjusting benchmarks for the (historic) appetite for alternative assets as well as risk profile differences.

Before utilising that adjustment in analysis, two questions should be considered:

a) Are the objectives different? If yes, then a risk profile adjustment could be appropriate, but risk profile adjustments need to be justified beyond the observation that they were different historically. The difference could be driven by different objectives or it could reflect a value seeking investment decision. Notably, in the latter case these system benefits are not drawn out in the analysis in the Commission's report.

b) Has the appetite for alternatives been an asset allocation decision or a function of risk profile change? If the former, it is a decision that should be recognised for what it contributed to outcomes. A consistent approach to constructing BP1, founded on the principles outlined above would avoid this misstep.

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?

Sunsuper comments

Some of the factors that influence investment performance both within and across segments of the superannuation industry are:

- Disparate taxation practices;
- Security and asset selection; and
- Cashflow impacts

We expand on each of these factors below.

Fees and taxes

Administration fees are intended to account for the operational costs of managing a fund and should ordinarily not impact investment performance. Rather these are fees that are directly charged to member accounts.

However, there are significantly inconsistent fee disclosures and practices within the superannuation industry that do manifest as differences in investment performance.

In our estimation, this can have an impact of between 10 to 30 basis points on net investment performance depending on the specific demographics of the fund.

We believe these practices must be understood and addressed before a transparent and meaningful comparison of products can be achieved. In a best in show default model, this has obvious and significant implications.

Currently, there is no requirement under superannuation law that administration fees must be set (at least) at cost recovery levels. This means that disclosed administration fees can be established at any level that the trustee deems appropriate and can be established at less than the cost of operating the fund.

At a fund level, allowable tax deductions for expenses, including insurance premiums paid to group insurers (which typically account for a significant proportion of fund expenses) can be offset against fund assessable income (e.g. concessional contributions) and therefore reduce the tax liability of the fund. This is a tax benefit for the fund generated by members' activity.

Funds that do not pass on these tax benefits to members (directly and regularly) can gain significant advantages in fee comparisons. These arrangements are either not disclosed or are very poorly disclosed, allowing some funds to promote artificially lower administration fees than would otherwise be the case.

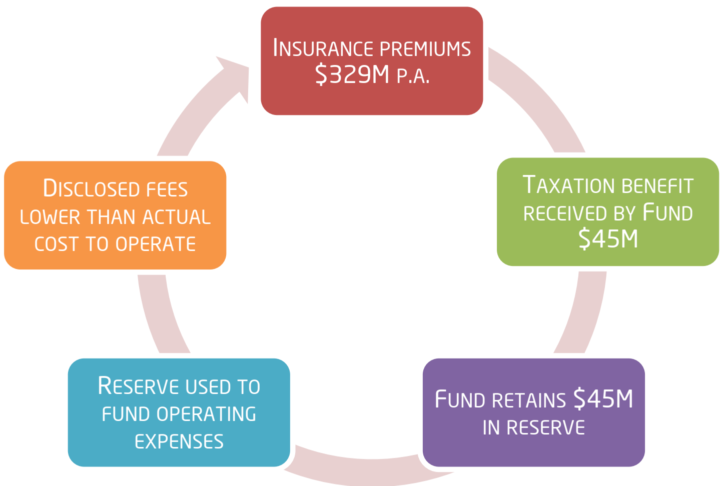
In other cases, the tax differential may subsequently be distributed back from fund reserves (through unit price uplift), boosting disclosed returns.

In practice, a combination of these arrangements occurs and – over time – can materially impact outcomes between funds.

Consider the following scenarios (based on Sunsuper's actual insurance premiums for 2017):

Figure 1 Taxation rebate passed to members (Sunsuper practice)

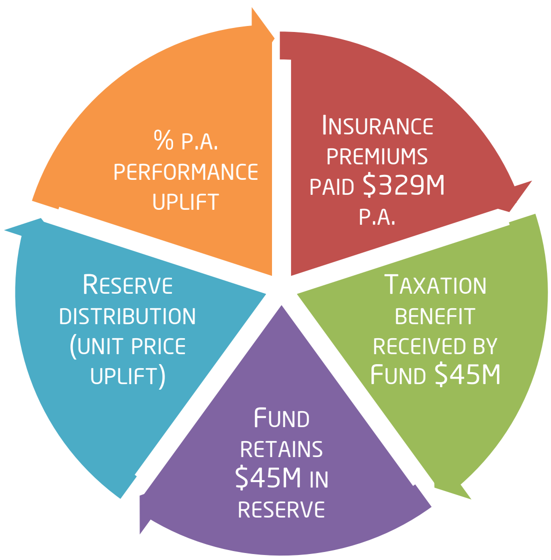
Figure 2 If Sunsuper were to use taxation rebates to artificially reduce disclosed fees



Sunsuper's disclosed dollar based administration fee could be reduced from $78 p.a. to $43 p.a.

Alternatively net investment performance net of administration costs would be around 8 bps greater.

Figure 3 If Sunsuper were to use taxation rebates to inflate performance



These practices mean that a comparison of administration fees, insurance premiums and net investment performance between funds are not on a like-for-like basis, significantly impairing comparability between funds.

For some funds the tax benefit received from insurance premiums is worth many millions of dollars each year (currently well over $50 million for some).

We, and some other funds, recognise the importance of transparency and equity in managing member entitlements and pass on the tax benefits associated with insurance premiums to members directly to their accounts.

PRODUCT DISCLOSURE STATEMENT PRACTICES

When the *Corporations Amendment Regulations 2005 (No.1)* inserted Schedule 10 into the *Corporations Regulations 2001 (Cth),* the accompanying Explanatory Memorandum (EM) stated:

*"In a PDS, fees or costs **must be shown gross of income tax** (but including GST and any applicable stamp duty) and net of any applicable reduced input tax credits.*
Disclosure in this manner is required as the impact of any entity level tax deductions and the extent to which they will be passed on to members or product holders through lower after tax fees or costs is not known at the time of preparing a PDS" (emphasis added).

However, the *Corporations Amendment Regulations 2005 (No.1)* did not insert a regulation that is consistent with this statement in the EM.

It appears, however, that ASIC considers that administration fees should be disclosed gross of any income tax deduction[1]. Insurance premiums which are often two to three times administration fees for members are not included.

Section 29QC(1) SIS Act (currently deferred until 1 February 2019) will require that there is consistency in the way in which information is calculated (as required by APRA reporting standards[2]) if that same information is given in disclosure documents. However, at present, the deferral of section 29QC(1) means there remains scope for inconsistency in administration fee disclosure in PDSs.

[1] ASIC / APRA joint letter to Trustees - The administration of section 29QC and APRA's reporting standards, March 2014 and RG 97.171 and RG 97.171 of Regulatory Guide 97 Disclosing Fees and Costs in PDSs and periodic statements

[2] APRA Reporting Standard SRS 703.0 states that "fees and costs must be reported 'gross of tax obligations'. This means the fees and costs must be reported prior to taking into account any benefit of a tax deduction relating to a fee that is passed on to a member either as a reduction in tax on contributions or through the deduction of a fee that is lower than what is reported to take account of the tax deduction".

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Security selection / asset selection

The sources and returns from security selection vary through time and that variation may explain differences in investment performance.

For instance, larger funds have less capacity to invest in Australian small cap stocks due to their portfolio size. Small caps can be a meaningful source of security selection value add and so smaller funds and even larger funds in the earlier periods of the analysis may exhibit levels of performance difference due to this source.

To the extent that fund size is reflected in segments, this may be a factor.

Our anticipation is that the Commission envisaged the role of asset selection/security selection in posing its question as to the potential determinants of performance differences and the construction of BP1 and BP2 is designed to highlight this aspect (amongst others).

Cashflow impacts

The calculation of rate of return (ROR) assumes uniform cashflows. This assumption is practical at a system level but may result in some differences at the segment level.

For instance, for-profit funds may experience flows skewed to the end of financial year and the outsourcing of corporate superannuation funds may have resulted in more lumpy flows for master trusts.

The timing of cashflows has an impact on returns – money-weighted returns can vary measurably from time-weighted returns.

> **Information request 4.1**
>
> Should life-cycle products continue to be allowed as part of MySuper? If so, do they require re-design to better cater for the varying circumstances of members nearing retirement, and how should this be achieved? What information is needed on members to develop a product better suited to managing sequencing risk?

Sunsuper comments

We strongly believe that properly constructed life-cycle approaches are beneficial – particularly for disengaged members and (depending on the particular demographics of the fund) are entirely suitable as a default investment option within a MySuper product.

Lifecycle options do not principally exist to serve engaged choice members or to replace advice. Indeed the opposite is true and lifecycle options assist default members as they approach retirement.

In this latter stage of their working life, a member's human capital (the ability to earn income from their labour) is decreasing and the need for their financial capital to stabilise inherently becomes more pronounced.

Sequencing risk increases substantially as members approach the point of retirement, when members switch from building capital to drawing down on it.

Sequencing risk is the risk that a member's lump sum at retirement - or ongoing income from a pension in retirement - is permanently and significantly reduced from a fall in markets from which the member's superannuation benefit cannot recover.

This means the members' retirement lifestyle, for some decades, is likely to be materially impacted as a result.

This 'retirement risk zone' starts some years before retirement and can continue until members have utilised a reasonable proportion of their superannuation savings.

Negative investment returns early in retirement can be particularly damaging.

The principal purpose of a lifecycle default option is to reduce sequencing risk for disengaged members in the critical years prior to retirement. This is particularly important – in our view – for those members who opt for at least a partial lump sum at retirement rather than only an income stream.

In our opinion and experience, an equally important aspect of lifecycle strategies is their potential to influence member behaviour. A properly considered lifecycle investment approach lessens the likelihood of members making unduly risky or overly conservative investment choices driven by behavioural heuristics rather than based on rational and well considered information.

The knowledge that there is ongoing activity to manage asset exposure over time can assist to mitigate against irrational member behaviour such as de-risking too early or too aggressively in the superannuation lifecycle.

Well considered lifecycle strategies avoid step changes in asset allocations that increase timing risk. They are both transparent in their design and comparable to other investment options across products.

Default member characteristics

In our experience, default members commonly have lower account balances (Sunsuper's average retirement balance only marginally exceeds the current Australian average annual earnings- significantly lower than figures quoted in the Commission's draft report). Consequently, they have a lower propensity for drawing an income stream in retirement and are more likely to opt for a lump sum payment (often to pay out debt – the number of 55-64 year old homeowners with a mortgage has tripled from 1996 to 2014[3]).

Opting for a full or partial lump sum retirement benefit is often appropriate for this cohort and is also where sequencing risk (if realised) is particularly impactful.

Sequencing risk is less significant for those members with higher account balances who tend to seek advice when approaching retirement and are more likely to invest in an income

[3] AIST Housing Affordability and Retirement Incomes report, March 2017

stream. These members remain invested in diversified assets and are afforded the opportunity to recover from market shocks.

Behavioural indicators

Somewhat counterintuitively, there is evidence that through the lifecycle default there has been a resulting increase in Sunsuper members' allocation to growth assets.

Since launching our lifecycle default investment option in 2013, the total allocation to growth assets of members aged over 50 has increased, even though the default growth allocation has slightly decreased as members progress through the lifecycle glidepath.

We believe that this is as a result of risk averse members remaining invested in the lifecycle option where they would otherwise have switched from a single diversified default as they approached retirement to consciously de-risk (potentially to an inappropriate level e.g. 100% cash). Instead they stayed in the lifecycle default and maintained an exposure to growth assets.

Similarly, more engaged members (with a higher risk tolerance) have switched from the lifecycle default to more heavily growth focussed portfolios when they previously would have stayed invested in the single diversified strategy.

Thus, the allocation to growth assets of members (in accumulation phase) aged 50+ has substantially increased by over 15%, as risk-averse members have remained in default and risk-aware members have made choice.

Not all lifecycle options are equal

We agree with the implication of the question that many lifecycle strategies would benefit from redesign.

We are of the view that a well-designed lifecycle option is:

1. transparent and simple to understand
2. comparable – performance can be compared easily to other products
3. de-risks (partially) close to retirement – otherwise the trade off in returns outweighs the risk reduction;
4. minimises market timing risk as part of any reduction in growth assets; and
5. simple to administer and report to members.

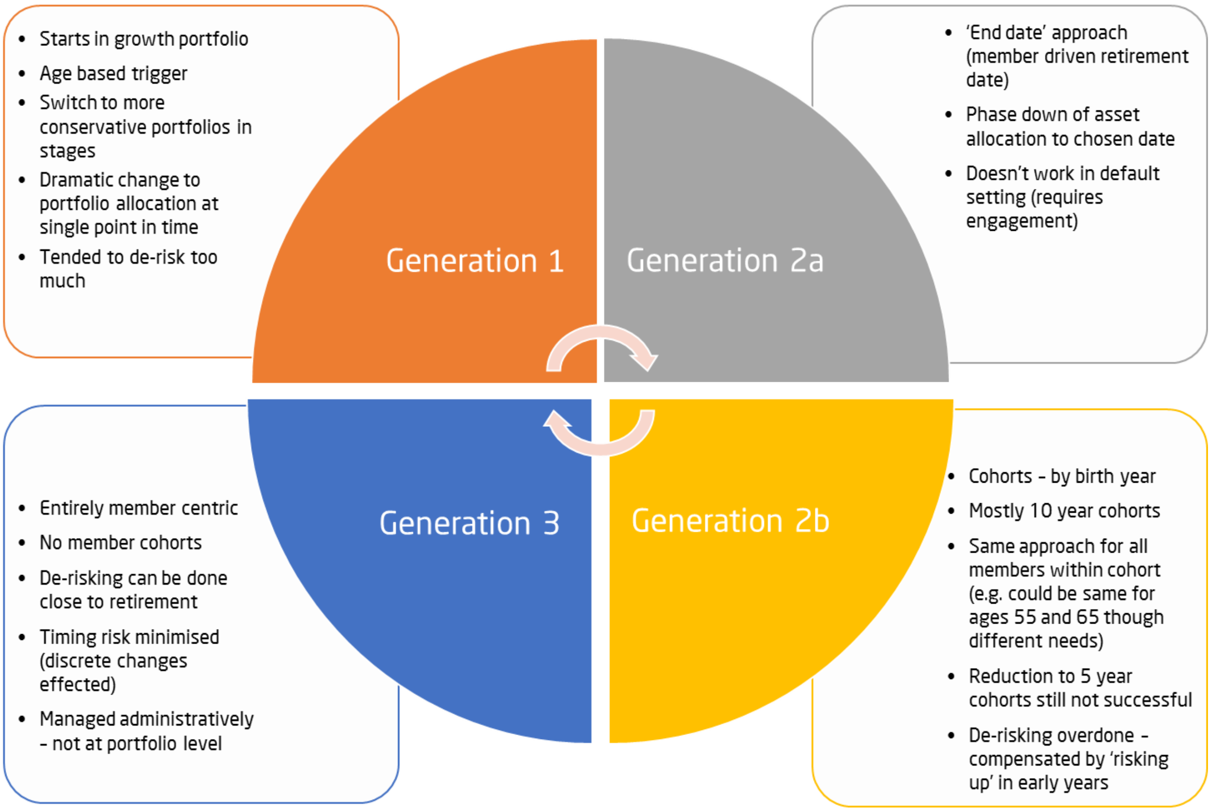
The evolution of life-cycle products is relevant in understanding both the failings of these historically but also how a well-managed approach (such as that adopted by Sunsuper) is beneficial and suitable for default members.

We have described this in Figure 4 (as a development of 'Generations' of lifecycle options).

Our design was strongly influenced by our experience during the GFC when the overwhelming feedback from retiring members was 'I did not realise that the Balanced option (70/30) was so exposed to volatile share markets'.

This was also in the context of our options having a higher investment in lower volatility and better performing unlisted assets.

FIGURE 4



The analysis of outcomes presented by the Commission assumes an entire portfolio balance is allocated to a "safe" portfolio, in a single transfer five years from retirement[4] (which we agree is counterproductive to optimising retirement outcomes). This is akin to a 'Generation 1' approach and is less common in today's environment.

SUNSUPER'S LIFE-CYCLE APPROACH

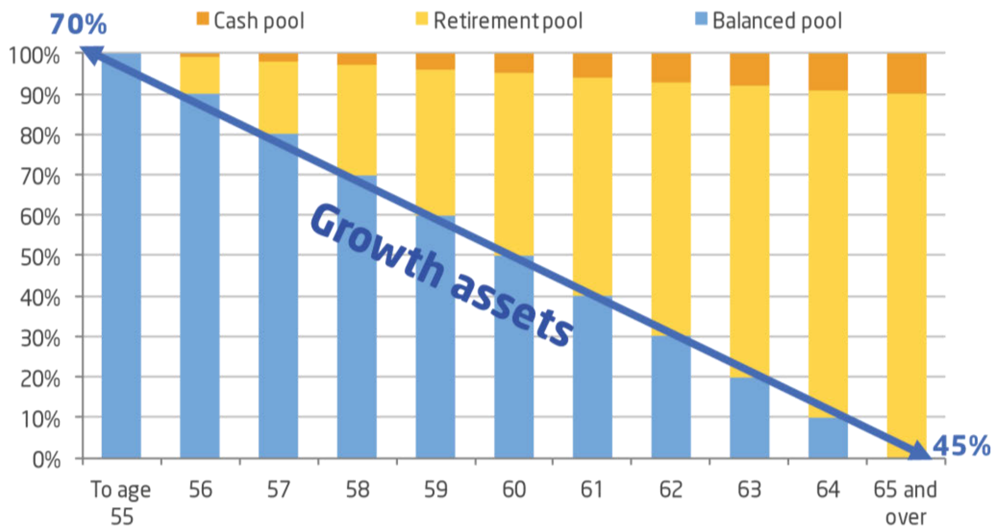
We promote the importance of maintaining a diversified approach to asset allocation in retirement through the Sunsuper Lifecycle Investment Strategy (Figure 5) that is designed to position members (through an administratively managed approach) to move into the retirement phase. This is critical in the mitigation of sequencing risk.

We believe our design overcomes the deficiencies identified by the Commission in meeting the needs of disengaged default members.

[4] Source: Productivity Commission, Analysis of members' needs, Technical Supplement 6.

Further, the performance of our lifecycle investment option is directly comparable to other, non-lifecycle diversified options, is transparent (members see the changes in their annual statement), maintains full growth asset exposure to age 55 and partially de-risks gradually over 10 years.

FIGURE 5



Our MySuper default strategy is a 'Generation 3' approach as:

- It is a true lifecycle investment strategy and not a moving diversified strategy.
- It aims to move people from an appropriate default strategy for an accumulating member to that which is appropriate for the retirement phase.
- It is a lifecycle strategy which de-risks in the latter years of a member's working life. Members are kept in a proven Balanced option until age 55 as de-risking is not needed prior to this (that is a likely economic cycle before retirement).
- It avoids a generation 2 approach where a higher level of risk in listed markets is used to achieve the same expected return. This is problematic because it has a much higher volatility. It avoids the need to start the de-risking too early.
- Our de-risking is done on an individual member basis; systematically moving money (for each individual member) between our longer term Balanced Pool and our Retirement and Cash Pools, on a monthly basis.
- Our strategy does 120 individual switches between ages and 55 and 65 so there is no inadvertent discrete change either before or after a major market move, which would otherwise occur if the switch were done infrequently. This approach also assists to educate members and promote engagement.
- It consequently also avoids grouping members in cohorts - some as long as 10 years, and thereby adopting a common strategy for people at the start and the end of the cohort even though their individual time horizons might be quite different. As an example a 1950's cohort today would have people aged from 58 to 68 in it.

Crucially, we have maintained our commitment to broad based diversified funds that include the better performing and lower volatility alternative asset classes including private capital, infrastructure, property and hedge funds.

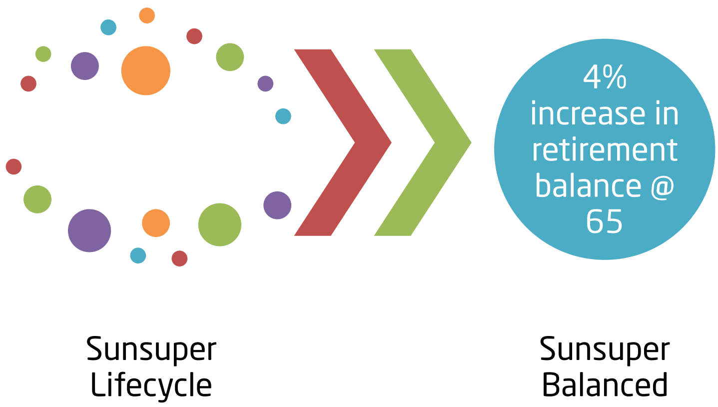
Example

The following example (Figure 6) illustrates the potential 'trade off' in adopting the Sunsuper life-cycle approach.

The example demonstrates the potential outcome for a 65 year old member investing in a Balanced investment option or the Sunsuper Lifecycle Option based on a money weighted return between the ages of 50 and 65.

We have attempted to remain reasonably consistent with the Commission's Technical Supplement 6 and have applied the latest available JANA long-term real return assumptions for each of the underlying options (assuming uniform geometric return through time), net of tax.

Figure 6



Investing solely in the Balanced option would likely generate a higher account balance at age 65 than investing in the Lifecycle strategy (by around 4%).

Thus a relatively small trade-off in end balance acts as a mitigant against sequencing risk, particularly if an event occurs late in the investment period and is relatively severe (a fall in equity markets by 20% at age 64 results in the Lifecycle strategy outperforming). The impact of this is, of course, compounded by the typical investor behaviours that emanate from such situations.

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?

Sunsuper comments

Merger (transition) costs are unique and depend on the specific circumstances of the merger. In our experience, the two largest impacts on costs are product complexity and the size of the fund, particularly in respect to smaller funds (there are fixed costs that mean transitions of smaller funds carry relatively high costs).

Product complexity is a key driver and costs will be influenced by the degree of alignment of product features and benefits against requirements of the Successor Fund Agreement (i.e. insurance product changes and administration platform enhancements may be necessary).

Fund size is also an influencing factor and costs to effectively manage the transition at both member and employer level will vary accordingly. Costs associated with managing people impacts (including staff redundancy costs) are also influenced by the size of the transferring fund.

Technology costs can be significant where capacity uplift is necessary to manage increased volumes of transactions.

The key variables affecting fund merger costs are:

- Complexity of product offerings added (including separate investment menu and options, different insurances, different pricing, defined benefit arrangements) can all add significant costs to mergers
- Numbers of transferring members
- Number of contributing employers
- Tailoring of the service offering
- Brand transition and agreed future branding arrangements
- Any exit costs payable to incumbent administrators for fund wind up
- Staff redundancy costs
- Contractual exit fees or penalties

KEY PROJECT COSTS

In our experience, mergers with smaller, straightforward funds (costs for both trustees) can be less than $1M. Larger mergers involving many member and / or product complexity can be greater than $10M.

Primary costs for the receiving fund are costs related to project management, technology and data migration, insurance migration, due diligence and legal advices, member and employer engagement and communications, people transition and engagement and investment asset transition.

In the case of the recent merger with Kinetic Super, this was a large successor fund transfer that also involved a transfer of business. Given the size and scale of the merger, a review of our operating model involved retention of a majority of existing Kinetic Super staff and establishment of a larger footprint in Melbourne (involving some premises costs).

The merger with Kinetic Super is expected to realise an estimated $30 million per annum in cost savings across the collective membership and has an expected payback period of less than a year.

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?

Sunsuper comments

Realising scale benefits

Costs within superannuation fall into two broad areas: investment costs and operating (administration) costs.

Whilst investment-related costs (associated with making and implementing investment decisions) tend to increase as assets under management increases, they can vary depending on whether an active or passive management approach is adopted, the diversity of investment mandates (including the degree of internal management versus outsourced management) and the extent of investment within alternative and illiquid assets.

Operating costs per member, on the other hand, tend to decrease with growth in member numbers as process and efficiency gains are realised through experience, innovation, harnessing technology and the ability to leverage straight through processing and exception based handling of repetitive processing functions.

Thus there is a correlation between increasing assets under management (AUM) and increasing member numbers and the realisation of scale benefits.

Merger scale benefits

Where members are merging from a smaller fund to a larger fund (with lower fees), scale benefits will typically be realised from day one through direct and visible fee reductions for the incoming members.

The recent merger with Kinetic Super is an example of this with Kinetic members immediately receiving a reduction in their administration fees and also a direct benefit from Sunsuper's approach to the passing on of taxation benefits associated with insurance premiums (as covered earlier in our submission).

Kinetic members are also likely in the medium to longer term to benefit from group insurance discounts, lower investment fees and potentially higher returns than would otherwise be the case, as a result of scale.

Separately, it is important to note that benefits to members are not always directly realised in lower fees or costs but in realisation of greater value. These scale benefits can emerge via fee reductions for members and / or an improvement in services and/or an increase in fund reserves.

Subscale funds are less well positioned to invest in technology and infrastructure to support streamlined and meaningful member engagement and to harness an omni-channel approach to engagement, education and advice.

Scale benefits for existing members of the receiving fund (Sunsuper) generally take time to reveal post-merger. We estimate that the net revenue (surplus) impact from the merger with Kinetic Super is around $12M in aggregate or $10 per member, representing a merger cost payback period of less than 1 year.

In recent years we have reduced pension fees from $4.00 to $3.00 per member per week, flowing from the increase in the number of pension members and investments in technology which has improved processing times and enabled greater efficiencies.

There has also been an improvement in services including a mobile application, 'e-statements', online rollover functionality, advice service options, improvements to insurance and an enhanced investment menu.

Increased corporate knowledge and incremental increases to technological capability is achieved over time as mergers are undertaken. An element of 'future proofing' can be consciously adopted with each fund transition to position for ongoing growth and to harness the benefit of increasing scale. The ability to leverage prior transition effort is central to realisation of economies of scale and may manifest in lower transition cost, better targeted services, and speedier transition or - more directly - through reduced fees or enhanced services to all members.

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?

Sunsuper comments

Our view is that the ability to gain and maintain insurance on an opt-out basis within superannuation is, and should remain, an important feature of the Australian retirement system.

Ensuring insurance design is appropriately targeted at younger and lower balance members is critical to manage insurance affordability and ensure protection of members' retirement savings from undue erosion.

Sunsuper insurance arrangements

The *Superannuation Industry (Supervision) Act 1993* generally requires that funds offer "death and permanent incapacity" cover to all MySuper members on an opt-out basis whilst the *Superannuation Guarantee (Administration) Regulations (1993)* stipulates the various minimum levels of death cover (based on age) that funds must offer to MySuper members.

Trustees are also required, under s52(7) of the *Superannuation Industry (Supervision) Act 1993* ('the insurance covenant') to implement an insurance strategy for the benefit of members. In doing so, trustees need to consider both the adequacy of insurance (how this insurance will <u>benefit</u> members) and also the affordability of insurance (ensuring the types and levels of cover do not unduly erode benefits). These two 'limbs' that underpin the insurance strategy are naturally in tension.

At Sunsuper we offer default death and total and permanent disability (TPD) insurance as a bundled product.

Sunsuper members have full flexibility to tailor their cover as death only, death and TPD or TPD cover only should they choose to do so ('Tailored Cover').

Our product offering is structured with a higher TPD benefit than death cover at younger ages in recognition that disability insurance is more important for this cohort than death cover (who are less likely to have dependents but are highly exposed to the long term consequences of permanent disability).

From age 33 death and TPD cover is provided at the same level, reducing over time to cease at age 67 (TPD) and age 70 (death).

We have recently introduced tiered levels of cover to better balance the affordability and adequacy of insurance for lower balance members. Members commence with 'Starter' cover and when their account balance grows (to $6,000), their insurance becomes a higher level of 'Booster' cover.

Members retain full control over their insurance and if engaged, can take advantage of new member offers to increase cover, opt-out or reduce their insurance cover or can increase to Booster cover immediately.

As at February 2018, approximately 75% of the Sunsuper membership maintains some level of insurance. Of these insured members, around 90% had 'standard' death and TPD cover (including New Member Offers that allow members to increase cover within a certain period without underwriting) and just under 10% had tailored their cover.

Of the members with insurance cover, only 1% have death only cover, less than 0.10% have TPD only cover. This is indicative that the bulk of Tailored Cover members (in excess of 98%) elect combined death and TPD cover.

SEPARATE DEATH AND TPD INSURANCE

We are not aware of any other funds who do not offer a default bundled product (with the exception of one large profit to member fund offering a death and income protection insurance product design [i.e. no TPD cover]).

Another large profit to member fund offer automatic income protection insurance (opt-out) and lower levels of TPD insurance.

The profit to member market also has a large fund offering automatic death insurance with lower levels of TPD insurance for all new members aged 20 and above, with automatic income protection insurance (on an opt-out basis) commencing from age 25.

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?

Sunsuper comments

We do not offer default income protection insurance (on an opt-out basis). We conducted extensive research in 2011 and 2015 to better understand our members' insurance needs and in both surveys members indicated they did not want default income protection as the cost was prohibitive.

Instead, these surveys demonstrated that opt-in cover was valued (as a new member option or as underwritten cover) for members to be able to personalise their insurance.

Off the back of the 2015 research, we launched 'TPD Assist' paying TPD benefits as either a single lump sum or in instalments over five years based on the member's eligibility under the policy definitions.

This now provides a lower cost disability insurance product, which significantly assists in guarding against account erosion.

Sunsuper income protection

A very small percentage of Sunsuper members have opted-in to income protection insurance.

For this reason (as well as potential self-selection risk factors) insurance pricing for opt-in insurance (including income protection) can tend to be more expensive – particularly in some age cohorts.

Arguably, offering income protection insurance on an opt-out basis is more conducive to facilitating a larger pool of insured members that can serve to moderate the impact of these factors in premium pricing. However, for the Sunsuper membership, we do not believe that there is a reasonable value for money case for offering income protection insurance to members on an opt-out basis.

In some circumstances, income protection benefits may be reduced by other sources of income (where members receive a workers' compensation benefit, sick leave entitlements or have a payout from another policy held outside superannuation) and there may be reduced benefits received from the cover within superannuation. This represents a risk where members pay for cover and may not be able to claim.

We note that Rice Warner's previous submission to this inquiry (*Submission to Productivity Commission – Insurance Aspects - August 2017*) outlined that, where default income protection is included, member balances are more prone to erosion and that this is exacerbated where members receive intermittent contributions or have not built up a substantial balance. The report concluded that consideration should be given to removing default income protection cover from superannuation funds.

Information request 10.1

Would a clearer division of responsibilities between APRA and ASIC (for superannuation) lead to better strategic conduct regulation and better regulator accountabilities? Is APRA best placed to specifically focus on ensuring high standards of system and fund performance, and ASIC to specifically focus on the conduct of trustees and the appropriateness of products (including for particular target markets)?

Sunsuper comments

Engagement with and strength of regulator relationships is valuable and important to achieve regulatory aims and appropriate outcomes. We do not see material issues or gaps with the current delineation of accountabilities and responsibilities between ASIC and APRA.

ASIC adopts a surveillance approach to their supervisory activities (this is espoused in the 'detect, understand and respond' framework) and is outlined in their Corporate Plan. Its supervisory activities in the regulation of the superannuation industry are very much consumer focussed and conduct related.

APRA adopts a more systemic approach to supervision and is concerned with ensuring industry frameworks and standards are in place and enforced to promote overall system stability.

Information request 12.1

Are there any material impediments to high-performing non-incumbent funds participating in a 'best in show' selection process? The Commission is particularly thinking about possible claims for participation by funds with no prior local track record but in-principle claims, such as foreign funds or a government-owned fund.

Sunsuper comments

Conceptually, we believe that both government owned and foreign funds should be able to participate in the best in show selection process, provided the assessment is on the same basis as any other fund.

We concur with the Commission's view that there are potential risks presented by a government owned fund participation that would need to be managed and monitored.

These include the perception that returns might be implicitly 'guaranteed', and risks of political interference in either the management of the fund or the investment of assets.

Practically, funds with either no local experience (foreign owned funds), or with no experience across a broad membership (some government owned funds) may not be positioned to easily demonstrate local performance history, expertise and member service to secure a best in show position.

For example, they may not be exposed to a sufficiently broad membership base to accurately price insurance, may not have expertise in servicing high and low balance members from a diverse range of occupations etc.

Our position is that there should be a level playing field for any potential best in show candidate and that open participation should be encouraged provided the same criteria and principles apply objectively to all.

Recommendations

Draft recommendation 1 Defaulting only once for new workforce entrants

Draft recommendation 2 'Best in show' shortlist for new members

Draft recommendation 3 Independent expert panel for 'best in show' selection

Sunsuper comments

DEFAULT ONCE FOR NEW EMPLOYEES

Whilst the proposed model was not our preferred model, we believe it should work in the best interests of consumers and promote engagement in the member retirement journey.

We support a 'first default / last default' approach for new workforce entrants as a key measure to reduce the proliferation of multiple accounts within the system.

We believe this represents good policy, provided the risks of poor product selection and poor legacy products are well managed.

The enabling technology and successful integration of processes into the employee on boarding process will be central to the success of a 'default once' model.

There is a significant role for payroll providers and technology solutions to play in streamlining the employee on boarding experience. Further maturity is needed in this area for this to be successful and to ensure employers are well placed to respond.

A well founded and considered 'best in show' model is central to best support good member outcomes.

The Commission has requested that we comment on an alternative 'balance rollover' model (posed by some consultation participants as a suitable alternative to the Commission's recommended 'assisted employee choice' model).

This is provided at Annexure 1.

EMPLOYER LED DEFAULT SYSTEM

We do not believe the Commission's report accurately recognises the very strong competition currently existing in the corporate and institutional default segment, nor the benefits that flow from this competitive activity.

The corporate and institutional segment is comprised of medium and large employers who actively appoint a default fund to manage their employee superannuation arrangements.

This generally occurs via a market tender process run by a third party. The process usually entails providing a formal response to a Request for Proposal with shortlisted respondents typically conducting a formal presentation, being involved in site visits and undergoing reference checking.

The competitive nature of these tenders extracts the best ideas from competing funds and actively contributes to raising the bar on services and outcomes for members.

Outcomes of these processes mean better arrangements for members:

- The ability to offer 'large employer' discounts for members
- Competitive insurance rates and enhanced terms and conditions for members (tailoring different insurers for employer sub-plans)
- Product development or enhancements that ultimately cascade to the broader membership
- Improvements to existing processes or service standards that cascade to the broader membership
- Employer specific member services or education requirements that become institutionalised and part of the broader offer to members.

Other proposals and initiatives

Recent initiatives to minimise the proliferation of multiple accounts through changes proposed in the draft *Treasury Laws Amendment (Protecting Your Superannuation Package) Bill 2018* (increased 'sweeping' of inactive accounts to the ATO and capping of fees for example) together with APRAs proposed Superannuation Prudential Standard on member outcomes (irrespective of broader legislative change on member outcomes) are likely to exert considerable financial pressure on some funds and result in a reduction in the number of products in the market.

Collectively, the default market may – in a relatively short period of time – largely shrink to force a natural best in show outcome without the need for more immediate and expensive interventionist measures.

There is expected to be industry transformation and, potentially, instability if these changes are effected. This is not without its risks and impacts to individual funds and their members and the flow through impacts will need to be monitored closely and managed carefully.

Systemic risks – transition to new default model

In line with our previous submission, we reiterate that an orderly transition of the industry to a best in show model is vitally important so as not to significantly impact trust and to protect incumbent members of funds that might not gain a best in show place.

The Commission has acknowledged the 'signalling effect'[5] that the best in show shortlist is likely to have for existing fund members.

We are concerned that there has been an underestimation of the potential risk of large scale member movement and resulting system instability as a result of the introduction of this model.

As those funds not securing a best in show position enter into negative cashflow (or experience a material exacerbation of negative cashflow) resulting constraints on investment strategies and revenues may result in incumbent members being subject to higher fees and reduced services on top of diminished performance in the interim period.

Focussed supervisory activity from regulators will be important to ensure unintended consequences to members are not realised during any consolidation phase that is likely to ensue.

Systemic risks – consolidation / merger activity

We welcome these recommendations as a lever to elevate the focus of trustee boards on mergers as a strategically considered outcome for members – however a 'rush' on merger activity in anticipation of a best in show model could have unintended member impacts and we caution against 'mergers for mergers sake'.

Fund mergers require careful consideration of member interests, concerted management and focussed execution. Poorly managed mergers would negatively impact members and only serve to erode trust and confidence.

Subsequent to the publishing of the draft report, we have been requested to provide our views on the 'digestibility' of consolidation in the system.

Given the degree of uncertainty that surrounds the potential impact of any change to the default model on individual funds within industry segments, it is difficult to express a view on the cohorts, timing and destination of funds that might come under increasing pressure to consider merger activity. We have therefore provided our view on some important considerations, based on our past experience.

There may be a need for potential regulatory reform to better support an orderly exit of funds that might otherwise find themselves in a position of 'distressed' consolidation.

Our views are provided at Annexure 2.

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[5] Productivity Commission 2018, *Superannuation: Assessing Efficiency and Competitiveness , p445*

Systemic risks – index hugging

There is some risk that adopting a best in show shortlist approach may lead to peer group concentration in portfolio construction with funds unwilling to materially differentiate in their investment decisions for fear of short-term underperformance, particularly if an underperformance benchmark is imposed that carries with it an extreme consequence (potential revocation of MySuper Authorisation by APRA).

The uncertainties inherent in making strategic asset allocation decisions are always viewed through the lens of potential consequences. Extreme consequences for short term underperformance may narrow the risk appetite of trustees for doing anything other than following the herd.

Ensuring an appropriately long-term investment performance filter is applied to any best in show criteria will be necessary to guard against this potential as well as ensuring the expert panel assesses whether funds are operating 'true to label' against purported investment strategies.

Best in show approach and expert panel

We welcome a best in show shortlist approach with an appropriately constituted expert panel to oversee this selection process.

We recognise that net investment returns is (rightfully) an important assessment criteria and are mindful that regularity of assessment must be balanced against the potential to promote 'short termism' in investment behaviour (as noted above).

There should also be the requirement for review of any fund in the best in show list where a material adverse event or change occurs that impacts that fund (for example an enforceable undertaking from a regulator). The role of APRA and ASIC as key industry regulators will need to be considered in this process.

This would act as an important 'gate' to filter best in show candidates and assist to ensure that any fund no longer demonstrating characteristics expected of a best in show fund will be open to scrutiny and will inject a necessary level of competition to encourage a meaningful meritocracy.

The criteria for assessment of the best in show shortlist will require proper consideration and weighting.

Best in show criteria

We remain of the view that an obsessive focus on fees – rather than overall value to members – is not supportive of a structurally sound superannuation system. Net outcomes based on robust and comprehensive selection criteria should be the gold standard.

Inappropriately weighted criteria focussed on investment fees risks ending up with a best in show list that is heavily weighted with low-cost index funds.

Whilst strong and sustainable long-term net returns should be the primary foundation for inclusion in the short-list, engagement initiatives that encourage individual interest in superannuation must be considered so as not to encourage apathy. In short we agree with the Commission's assessment that "*the implication is that engagement is most valuable when matched by readily accessible, salient and comparable information about the best choices*".

The assessment of a fund's ability to provide such accessible, salient and comparable information should be a factor in the shortlist criteria.

In information request 2.2 we have reinforced the impact of disparate approaches to the management of taxation at a member level and the impact that this might have on advertised fees and / or investment returns. This is an area that must be addressed legislatively or expressly taken into consideration in the assessment of the best in show shortlist.

Subsequent to the publishing of the draft report, we have been requested to provide a more detailed view on the potential best in show criteria. This is provided at Annexure 3.

Expert panel

A robust and transparent process is needed to protect the integrity of the panel appointment. There is considerable depth and breadth of expertise within the market that could be drawn upon.

There are experienced researchers from key independent research houses currently operating within the industry that could bring a varied range of views, methodology and expertise in the assessment of quality.

The panel would likely benefit from the inclusion of an independent superannuation lawyer to provide legal interpretative expertise where necessary and it may be appropriate to include an independent actuary to assist in providing technical challenge over investment performance analysis and attribution. We believe this composition would prove an effective and robust expert panel.

We also acknowledge the importance of having an appropriate system of judicial review to protect the integrity of the process and ensure there is avenue for scrutiny of decisions. It would be expected that a degree of challenge will ensue given the significant consequences of not securing a best in show position.

Draft recommendation 4 MySuper authorisation

Draft recommendation 5 Regulation of trustee board directors

Sunsuper comments

We are broadly in agreement with the Commission's recommendations in relation to MySuper Authorisation.

We support a member outcomes benchmark for trustees to judge whether members' best interests are being met and for this to be subject to scrutiny through independent assessment. Any benchmark must be carefully and critically considered.

As stressed throughout this submission, the establishment of an appropriate investment benchmark is necessary for this strengthened gate to be meaningful and we welcome further consultation on how underperformance margins might be established and enforced and over what time period this should be measured.

We support the views of the Commission in respect of the regulation of trustee boards, noting that most would already be adopting practices that align to recommendations relevant to skills assessment and board performance evaluation.

We have long been a supporter of board diversity and have already adopted a one-third independent board. We do not oppose any moves to allow boards to determine their own board structure – whether aligned to an 'equal representation' model or not.

Draft recommendation 6 Reporting on merger activity

Draft recommendation 7 Capital gains tax relief for mergers

Sunsuper comments

We support disclosure to APRA, at the appropriate juncture (such as Heads of Agreement / Memorandum of Understanding stage), of merger attempts and disclosure of reasons why any merger might not proceed (including how assessment of members' best interests has informed such decisions).

We maintain that public disclosure of merger deliberations risks inhibiting candid and transparent discussions and would be counter-productive. The danger of this would be to drive merger activity 'underground' and would be counter to the intent of this recommendation.

We agree that the ability to gain relief from capital gains tax liabilities in the event of fund mergers needs to be made permanent to support a healthy merger environment.

Draft recommendation 8 Cleaning up lost accounts

Sunsuper comments

We are broadly supportive of the recommendations in respect to lost accounts and ATO reunification.

We support this approach for low balance accounts given these are at greater risk of undue erosion through the continued impost of fees and (potentially) insurance premiums. Noting the interplay between other proposed reforms in respect of fee capping and opt in requirements for insurance for inactive members, the erosion risk is expected to reduce substantially.

We believe that disengaged and disconnected members with larger balances will benefit to a greater degree from retention of their retirement savings within market linked investments than a CPI indexed environment with the ATO. The ability for the ATO to reunify accounts is as yet unproven. We do have concerns as to the ability of the ATO to cope with the expected very high volume of transferred low balance inactive accounts (numbering in the many hundreds of thousands) and to reunite these in a timely manner.

We support the ability for members to self-exclude from any mandated ATO account transfer as recommended by the Commission.

Draft recommendation 9 A member-friendly dashboard for all products

Draft recommendation 10 Delivering dashboards to members

Draft recommendation 11 Guidance for pre-retirees

Sunsuper comments

We do not support the imposition of further unnecessary disclosure to members and believe the requirement to *provide* dashboards to members who indicate they wish to switch products is operationally problematic.

Practically and pragmatically, members who undertake switching activity are typically highly engaged and it is not intuitive as to the purpose of the dashboard compared to other disclosure information (PDS and other incorporated information).

We broadly agree with the assessment of the Commission that disclosure documents are not as member friendly as they could be, however, we question whether mandating the provision of additional disclosure material to members is likely to achieve desired outcomes. Cost / benefit factors need to be considered - our experience is that few members access the MySuper Dashboard despite it being readily accessible on our website (or on request).

In the 16 months from mid-March 2017 to mid-July 2018, our website registered only 4,710 unique page views on our Dashboard landing page (213 of these were registered through an email link with the majority of the remaining 'hits' being registered from search engine activity). Unique downloads of the MySuper Product Dashboard numbered 1,273.

Further, it is unclear whether the requirement to provide a dashboard to a member (who in initiating a transaction has already made a decision and has a clear intent) would mean that a request could not be acted upon (for example an online switch request) until a dashboard had been 'provided' to a member, potentially via an email link.

Mandating a requirement to 'provide' a dashboard risks making the transaction experience less seamless for members and result in disengagement and dissatisfaction. This will create a friction point in an otherwise straight forward process and detrimentally impact member experience.

The vast majority of Sunsuper's MySuper members who undertake switching activity do so through our online facility (over 96% in the 2017/2018 financial year).

We agree with the Commission's recommendation that pre-retirees be directed to appropriate resources to assist them with guidance and information.

This will be particularly relevant as the system shifts and matures to a greater focus on retirement income. This will further reinforce the importance of seeking appropriate advice and to inform members on the availability of retirement income products through a neutral mechanism.

Comprehensive income products in retirement (CIPRs)

We are supportive of reforms that will lead to an increase in the availability of longevity products in the product landscape.

We recognise that for a large cohort of our membership – who typically have lower balances – that CIPRs may not serve a need. Similarly, some members with very high balances may not find a CIPR a suitable product. However, there is certainly a significant group in the middle where they can, and potentially should, serve a purpose. Individual needs at retirement are all different.

We support proposals that require funds to *offer* a CIPR to members at the point of their retirement, noting that engagement will be necessary during the accumulation phase to build awareness and educate members about the different types of retirement income products available to them.

We do not support arrangements that default members into particular retirement products and do not support the mandating of CIPRs or any other retirement product in retirement – we do not believe that is commensurate with the principles of our superannuation system.

We agree with the Commission's assessment of the importance of individual choice and the role of quality financial advice in effecting meaningful changes to the retirement income landscape and ensuring members are choosing appropriate products to meet their diverse needs.

The importance of the CIPR certification framework and the principles by which certification is achieved will be important. Certification of a CIPR is unlikely to be enough for the advice market to rely upon to recommend specific products to clients.

In an environment of heightened scrutiny, it may prove problematic for advisers to recommend products that are unproven in the market. There would likely be an increased need for intrafund advice offered by superannuation funds to meet member advice needs in the short term.

Draft recommendation 12 Exit fees at cost-recovery levels

Draft recommendation 13 Disclosure of trailing commissions

Sunsuper comments

We note that the recommendation in respect to exit fees is to extend the limitation to cost recovery for all new members and across all new superannuation products.

We support the banning of exit fees and believe this should be extended to all superannuation products and members – both new and existing..

We note, however, the potential for this to contribute to upward pressure on administration fees.

We are supportive of the recommendation to require disclosure of financial adviser trailing commissions as proposed and welcome increased transparency for members.

Draft recommendation 14 Opt-in insurance for members under 25

Draft recommendation 15 Cease insurance on accounts without contributions

Sunsuper comments

We are a strong supporter of the Insurance in Superannuation Voluntary Code of Practice ('Code') and its benefits to members.

We not only signed up to the Code on 31 March 2018, but were compliant for our Sunsuper for Life product from 1 July 2018, three years before the transition date (as outlined in the Code).

Our view is that the ability to gain and maintain insurance on an opt-out basis within superannuation is an important feature of the Australian retirement system.

We firmly support the intent of insurance reforms (in protecting members' retirement savings from undue erosion.

We support proposals relating to opt-in insurance for inactive accounts and recognise that balancing considerations of adequacy and affordability of insurance within superannuation presents a particular challenge for lower balance, inactive and younger members.

We strongly believe that all members with active accounts (i.e. where contributions are being received) should maintain insurance on an opt-out basis.

We believe this is in line with the intent of the reforms and avoids potentially serious and unintended consequences for a significant pool of members.

We believe that insurance strategy design is the best instrument to achieve the necessary balance of adequacy and affordability of insurance within superannuation.

SOCIAL IMPACTS

The proposed recommendations and inherent disengagement across younger age cohorts and some low balance members is likely to result in a substantially increased pool of young and low balance Australians who are uninsured.

Whilst this may be appropriate for younger members without dependents who do not require death cover, the challenge will be to ensure funds engage and educate younger members and low balance members about the importance of protecting their greatest asset – their future income earning potential – to protect against unforeseen life events that might place their future financial wellbeing at risk.

Different cohorts will be impacted to varying degrees if these changes are put into effect.

Young people in rural and regional areas have a tendency to marry and /or have children well under the age of 25 and these changes will obviously leave this part of the demographic exposed.

There are numerous case studies that have been presented that outline the potential significant adverse impact to young people of not having default insurance. Careful consideration of these impacts against potential benefits of saved insurance premiums is paramount.

PREMIUM IMPACTS

Removing the cross-subsidies that exist in pooled insurance arrangements through the removal of opt-out cover for younger, lower risk cohorts may increase premiums across older age groups. This is likely to increase opt-out across these older cohorts leaving those members with reduced, or no insurance.

Rice Warner, in their AIA commissioned report *Economic Impact of 2018 Federal Budget Proposed Insurance Changes*[6], suggests that implementation of these changes will reduce the sums insured through superannuation by 47.5% (noting this will be variable across funds).

AIA has estimated average premium increases of 15 per cent, whilst KPMG in their report *Insurance in Superannuation: The impacts and unintended consequences of the proposed Federal Budget changes*[7] estimates a 26 per cent rise in premiums for remaining insured members as a result of the removal of opt-out cover for inactive members.

Thus the broader impact of these changes, in the context of the overall impact to retirement savings across the system, and the social and economic impact to individual members, must be carefully considered and balanced.

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[6] Rice Warner, Economic Impact of 2018 Federal Budget Proposed Insurance Changes, page 8

[7] KPMG, Insurance in Superannuation: The impacts and unintended consequences of the proposed Federal Budget changes, June 2018, page 3

There is also a risk that insurers may inappropriately price younger members and low balance member premiums based on perceptions of self-selection from those who do engage and opt-in to insurance arrangements.

These effects would take some time to fully reveal within the system.

Draft recommendation 16 Insurance balance erosion trade-offs

Sunsuper comments

We support the Commission's recommendations relating to reporting of balance erosion trade-off determinations and facilitating a calculator illustrating the impact of insurance premiums on potential retirement balances.

There should be no existing barriers for funds to be able to clearly articulate to their members how they derived the appropriate cover amounts under their insurance strategies.

We support making this information available to members through fund websites and in annual reports.

Calculators need to be written in plain language and be clear and concise, and show members how much they will be contributing to insurance premiums over time.

To ensure balanced messaging and reinforce the benefit side of the insurance equation, funds should also publish annually on their website how many claims have been paid to members and their dollar value by benefit type, so members can tangibly relate the role of and importance of insurance in protecting retirement income.

Draft recommendation 17 Insurance code to be a MySuper condition

Draft recommendation 18 Insurance code taskforce

Sunsuper comments

We strongly support the mandated adoption of the Insurance in Superannuation Voluntary Code of Practice as a MySuper condition. The Code will only serve to enhance the member experience of insurance within superannuation.

As previously mentioned, we were 'Code compliant' for our Sunsuper for Life product from 1 July 2018.

We support the proposed joint regulator taskforce as we believe it is important to influence and lead insurance changes that will lead to a better member experience and believe the changes espoused in the Code will make the process more efficient for all parties involved.

We actively participated on all of the working streams of the Insurance in Superannuation Working Group, leading two of the streams and put in submissions on every discussion paper that was published for consultation.

We are consistently looking for opportunities to improve efficiencies in both product design and in our service offering and work closely with our insurers to ensure members are receiving the best possible service solution.

Draft recommendation 19 Independent review of insurance in super

Sunsuper comments

We do not believe that an independent review of insurance in superannuation is necessary.

We strongly support the role of insurance within superannuation and believe this represents good social policy.

We are strong supporters of the Insurance in Superannuation Voluntary Code of Practice whilst recognising that it will continue to evolve and develop to ensure it best serves members interests.

The combined impact of requiring opt-in to insurance for inactive members, mandating the Code and measures to reduce the proliferation of multiple superannuation accounts will reduce the rate of undue erosion on member retirement savings whilst ensuring they remain protected through the valuable group life insurance system.

There are tangible economic costs when an individual dies or becomes disabled and these are lessened where life insurance exists.

Rice Warner quantified the potential costs of the proposed draft *Treasury Laws Amendment (Protecting Your Superannuation Package) Bill 2018* measures in their previously referenced report[8] (Table 1).

TABLE 1

ADDITIONAL ANNUAL COST TO GOVERNMENT AND THE ECONOMY OF PROPOSED INSURANCE MEASURES

	Impact ($million p.a.)
Lost tax due to reduced insurance claim payments	277.0
Lost spending capacity due to reduced insurance claim payments	2,493.0
Social security	185.7
Less: Gained tax due to reduced contribution tax concessions	451.9
Less: Gained tax due to reduced earnings tax concessions	40.7
Total	**2,463.1**

As Rice Warner concluded, removal of a significant volume of cover for so many individuals is almost certain to place individuals into significant financial hardship when they are most vulnerable, despite the overall relative fiscal impact at an economic level being less material.

Rice Warner's report also illustrated the estimated average improvement in retirement balances of default members who are not subject to insurance cover until they are 25 years of age. This was estimated as an increase to a typical member's retirement account balance of only 0.76% (with no premium increases) and 0.27% (assuming premium increases of 15% resulting from the changes).

Thus the potential negative consequences at an individual member level seemingly outweigh the likely minor increase in overall average retirement savings.

[8] Rice Warner, Economic Impact of 2018 Federal Budget Proposed Insurance Changes, Table 17, page 17

Draft recommendation 20 Australian Prudential Regulation Authority

Draft recommendation 21 Australian Securities and Investments Commission

Sunsuper comments

We foresee no material issues with requirements for formal due diligence of material outsourcing arrangements and the provision of this assessment to APRA.

Whilst it is not clear in the Commission's Draft Report, we presume that this will be limited to material outsourced arrangements captured under APRA's *Superannuation Prudential Standard (SPS 231) – Outsourcing*.

There will be additional costs associated with this requirement and service providers that participate in these reviews will need to be appropriately positioned to respond.

We welcome additional measures that require APRA to report on progress of merger activity and potential moves to amend legislative provisions that will alleviate potential barriers to promote member transfers from these products.

We also welcome enhanced visibility by APRA of member outcomes being achieved (or not achieved as the case may be) across all APRA-regulated funds. Addressing inconsistencies in reporting practices will empower APRA to better supervise the sector.

Draft recommendation 22 Superannuation Data Working Group

Sunsuper comments

We welcome the establishment of a superannuation data working group to improve and drive consistency across the data analytics capabilities of each regulator.

We support improvements in data collection and reporting that deliver better member outcomes. The costs of delivering these improvements need to be carefully weighed in relation to the benefits derived.

This will be an important initiative in an environment where the availability of transparent, consistent and robust data will be central to the assessment of qualitative and quantitative measures that will be used to filter funds and ascertain whether member outcomes are being progressed in a dramatically changed default system.

Annexure 1 - Balance rollover proposal

We have been requested to comment on an alternative 'balance rollover' model (posed by some consultation participants as a suitable alternative to the Commission's recommended 'assisted employee choice' model).

The Commission is interested in Sunsuper's views of the potential impact on:

- the magnitude of rollovers each year (people and balances)
- how members with multiple jobs could be handled
- impacts on member engagement
- administrative costs
- investment risks (e.g. crystallising losses)
- impacts on funds' investment strategies
- impacts on insurance coverage/offerings
- interaction with the online standard choice form the ATO is developing

Observations

We understand that the balance rollover model has been proposed as an alternative to the Commission's best in show rather than as an adjunct to it.

In this case, there would be no change to the way in which default fund selection by the employer currently occurs (i.e. this is not an 'assisted employer choice model' underpinned by a shortlist of eligible funds as considered earlier in this inquiry).

Rather, there would be a system for automatic consolidation of accrued member entitlements to the new employer default fund on job change (in the absence of member choice otherwise).

Presumably, this alternative would rely on default funds remaining tied to modern awards with the Fair Work Commission retaining responsibility for the filtering of funds (noting this is not currently an active process).

Thus the proposal does not represent an alternative default fund model as such, is less focused on member engagement than the Commission's best in show model and 'behavioural nudges' to support members in making informed choices is notably absent.

This proposal does address multiple account issues which may have indirect positive impacts on member disengagement. Aspects of underperformance within default funds are not dealt with directly through this proposal.

Employers would remain the primary filter through which underperforming default funds would be curtailed from the default system.

This proposal, if underpinned by a 'best in show' fund panel for employers to select default funds (an 'assisted employer choice' model) has more merit in our view (this was our preferred model as outlined in our previous submission).

The balance rollover suggestion requires a concurrent mechanism for ensuring employers are selecting good and strongly performing default funds so that any risk of poor outcomes for members is mitigated. Unintended consequences for members who have actively chosen a preferred product would also need active consideration and management through thoughtful design of ATO facilitated choice mechanisms.

'Choice' members and engaged members

In a balance rollover environment it is unclear how members who have exercised choice of fund (and subsequently change jobs) would be impacted under this model.

Presumably, they would be required to reconfirm their fund of choice each time they changed jobs (as is currently the case) and elect for their employer contributions to be directed to their chosen fund. Otherwise existing accrued entitlements (whether in one or multiple funds) would be rolled over to the new (employer chosen) fund.

There would need to be a mechanism for members to 'opt-out' of a balance rollover. Some more engaged members may wish to take advantage of features and benefits offered by a new employer default arrangement (including taking advantage of insurance arrangements that might only be offered to new members, applying to transfer insurance cover from an existing superannuation product to the new employer default fund etc).

In some cases, members may simply wish to 'buy time' to take a more focussed approach to determining the best product(s) for them which might include seeking advice.

There is, in our view, significant risk of unintended consequences for these members posed by a 'balance rollover' approach.

Magnitude of rollovers each year

We note the assumptions in *Technical Note 7 – Modelling Policy Changes*, regarding mobility rates amongst members (i.e. job change rates).

According to APRA data, there are currently close to 22M member accounts across MySuper authorised funds and 26.5M member accounts in total.

Using this current number of accounts in the system as a proxy (reduced for the estimated 10M 'duplicate' accounts noted in the draft report), this implies that there are around 16.5M active superannuation members in the system today[9]. Hence there would expected to be job changers of 1.5M to 3M per annum (2.2M at the mid-range) based on the Commission's assumed job change rates.

On the presumption that a material proportion of these job changers hold duplicate accounts, (as implied by the duplicate accounts estimate) there would be a considerable increase to the number of account transactions occurring as the balance rollover approach leads to consolidation for each job changer.

This potential movement of accounts on job change would only be reduced where members actively choose to remain with their existing product or where the new employer default fund is the same as the previous employer default fund.

We note comments during the June 2018 public hearings that indicated that around 50% of job changes involve a change in the industry of employment. Even where job changers remain in the same industry, this does not necessarily mean that the default fund is the same with the new employer.

Therefore, there is likely to be an increase in the rate of account movement within the system under a balance rollover approach, although it is difficult to judge to what degree.

Asset churn

A balance rollover model implies more member (and therefore asset) churn within the system.

All other things being equal, this represents a greater degree of disruption to investment strategy although it is difficult to gauge to what degree this might manifest.

If we were to assume 5% greater mobility in assets, this is meaningful in a mature system and would likely lead a reduced allocation to illiquid asset investment. This is potentially prejudicial to member outcomes.

However, it is important to acknowledge that, in our view the comparative asset turnover triggered by

(i) the pace of consolidation in the initial period towards those funds in the 'best in show' list; and
(ii) the impact of loss of MySuper status by a given fund

would be significantly more impactful in a compressed period of time.

There are potential mitigating strategies that would assist to reduce the impact of any concentrated asset turnover.

[9] APRA Annual Fund-level Superannuation Statistics June 2017, Table 1, Total number of member accounts filtered across MySuper Authorised Funds

One example, employed by some unlisted unit trusts, is to have designated 'switching days' wherein transactions between incoming and outgoing (applying/redeeming) funds occur on nominated days (i.e. monthly, quarterly) and reflect net transactions.

This allows for more focussed management of investment flows and minimises transaction costs and undue turnover of assets. Timing risk is also relevant in this context.

Any flow, particularly individual member flows, carry risk associated with time out of the market as flows passes between funds. Employing a 'switching days' approach also assists to mitigate this risk.

Sequencing risk

The question of sequencing or timing risk has also been raised in the context of a balance rollover approach.

Depending on the investment strategy of MySuper defaults of the two funds involved in the rollover and subject to there being safeguards implemented that attempt to match 'choice' member investment options, the potential exposure of members to a step change in asset allocation is real.

It should be recognised that this issue is not unique to the balance rollover model and the potential impact of this should not be underestimated under either the employee assisted choice or balance rollover model where a fund loses default status (absent any mitigating processes).

Members with multiple jobs

It is challenging to consider how members with multiple jobs might benefit by a balance rollover approach.

In the absence of a member election as to their preferred fund, it is likely that these members would retain multiple accounts with consolidation occurring only when an account becomes inactive (under proposed ATO facilitated account reunification initiatives), a subsequent job change prompts rollover of an account or the member actively consolidates.

Member engagement

A balance rollover model is likely to perpetuate apathy towards superannuation and result in a continued lack of member engagement.

The Commission's report contains references throughout to the importance of behavioural 'nudges' as a means to engage members at the earliest opportunity in making decisions about their superannuation.

Under the proposed balance rollover alternative, the 'nudge' further diminishes.

Complexity within the system and the significant cognitive effort required to exercise choice away from the employer default will remain. Disengagement through 'status quo bias' will continue and the tendency for individuals to revert to a single default option presented by their employer will prevail.

The suggestion that it is acceptable for a member to not take an active interest in their accrued superannuation and that is 'all taken care of' under a balance rollover approach may perpetuate disinterest.

More members would be rolled over to a series of superannuation accounts and may be more likely to lose track of their superannuation.

The absence of engagement is likely to disadvantage members from understanding what actions they can take to maximise their super and prepare for a better retirement.

Members who are successfully engaged subsequently take member led action such as combining accounts, contribute voluntarily, make informed choices about investment options and seek advice. These members tend to have higher account balances as a result.

Administrative costs

The cycling of disengaged members through multiple accounts would logically add to the administrative costs of funds who would establish and close out accounts at an increased frequency.

There is a cost to 'onboard' members and a cost to 'off board members' and – particularly in an environment where exit fees might no longer apply, this cost would naturally be borne by the incumbent member base. The expectation would be that administration costs (and therefore administration fees charged to members) would increase.

Insurance implications

There are a number of considerations that make a balance rollover model inefficient and problematic from a member insurance perspective.

New member eligibility and 'At Work' eligibility

The majority of funds have a 120 day eligibility rule for insurance (meaning members will be eligible for default insurance if joining the fund within 120 days of joining the new employer).

However, there are typically 'At work' requirements for claim eligibility. The implication of this is that members that may be inadvertently impacted if not deemed 'At Work' (due to changes in work hours, uncertainty over the date of disablement for complex medical issues and the like).

There is a risk more members would fail to meet 'At Work' requirements if their insurance was automatically transferred (by virtue of the balance rollover) when they changed employer.

Cover levels and terms and conditions

Of primary concern would be cover levels and terms and conditions of insurance policies. There are often material differences between fund policies and a member might reasonably be able to claim under one policy but not under another.

Similarly, there are often 'limited cover' or pre-existing condition exclusions attached to policies meaning members may not be able to claim on the new insurance policy (for example if an illness developed during the previous membership – a claim might be successful on the current fund policy but not on the policy attached to the new fund).

Very clear guidelines would be required to ensure adequate member protection in such scenarios.

Default cover amounts and types can also vary significantly. One fund may offer death and TPD cover with another offering death, TPD and income protection insurance. Premium differences might be significant and amounts of cover can be very diverse.

Insurance pools would be highly volatile under such a model with premiums likely to increase as insurers price considerable uncertainty into arrangements. This might exacerbate the propensity for members to cancel cover which will in turn place upward pressure on premiums.

Online standard choice form

A balance rollover model poses a number of considerations for the Online Standard Choice Form.

Clear and transparent warnings

The form would need to clearly and transparently warn members about the implications of not making a choice of fund or making a choice away from any fund holding existing accrued entitlements (i.e. of the auto consolidation of accrued entitlements and the implications for insurance arrangements). Ideally, members would be delivered information about any existing funds at the same time and would also be able to easily access related information (about insurance entitlements they would no longer have as a result of the balance rollover for example).

Multiple job holders

The form would need to provide guidance to members with multiple jobs and reinforce warnings in respect to insurance entitlements. The manner in which the form is structured would depend on the agreed protocols in dealing with members holding multiple jobs. Warnings about the implications of maintaining multiple accounts would be particularly relevant for these members (e.g. fees and insurance implications).

Consolidation prompts

Ideally the online choice form would also contain appropriate prompts or otherwise integrate with online mechanisms to facilitate member directed consolidation to engage and encourage members to take control of their superannuation. The ability to easily and seamlessly access information about products would be fundamental to promote engagement.

Annexure 2- Digestibility of exits - consolidation

We have been requested to provide views on the 'digestibility' of the potential exit of funds from the system that might be triggered by the proposed 'best in show' model.

We believe that it is important to consider the substantive legislative reform underway in the sector currently and the manner in which consolidation between funds occurs to identify any potential friction points or barriers to market consolidation.

Consolidation is more likely, in the short term, to be driven by pending legislative reformand heightened regulatory scrutiny resulting from the the proposed APRA *Prudential Standard 225 Outcomes Assessment (SPS 225).*

The impact of these reforms will impact all funds – including Sunsuper – with some funds expected to be affected to a very significant degree (given the impact of fee capping on low balance accounts and changes to ATO Lost Super account definitions if these are legislated).

Transfers without consent

Members, once they have accumulated amounts within the superannuation system, are fully in control of their accounts, the destination of their ongoing contributions and if and when they want to change products (rollover).

In the ordinary course of managing their superannuation, members must actively direct any rollover their accrued entitlements to another product (with the notable exception of requirements for funds to transfer lost or unclaimed superannuation accounts to the ATO).

For a fund transfer to occur without member consent (a Successor Fund Transfer or SFT), it is necessary that the receiving fund must (when compared with the existing fund) confer 'equivalent rights' (not equal rights) to the transferred members in respect to their benefits

It is also necessary that trustees (of both the transferring fund and the successor fund) make a determination that the SFT is in the best interests of <u>their</u> members– this is a core trustee covenant under s52 of the SIS Act.

The 'equivalency of rights' analysis may not necessarily be problematic. APRA has provided guidance on this point in their Superannuation Practice Guide *SPG 227 - Successor Fund Transfers and Wind-ups* (that clearly articulates that 'rights' as opposed to product features should be considered on a 'bundle of rights' basis)[10] particularly when viewed through the lens of MySuper characteristics.

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[10] APRA SPG 227 – Successor Fund Transfers and Wind-ups, section 21

Determining that a SFT is in the best interests of members is (arguably) a more subjective assessment and requires an active consideration of the overall impact of amalgamation of two memberships – both from a financial and non-financial perspective. In short, the receiving trustee must ensure that there is no detrimental impact to incoming members in taking on the membership of the succeeding fund.

Successor fund transfer

There is typically a lengthy process to effect a SFT. The variability of time and resources required is significantly influenced by the factors referenced in the body of our submission.

In our experience, this could be achieved in as little as six months and can take up to twelve months (ignoring the interactions and discussions preceding any decision by respective boards). Effort is also required to wind up the transferring entity (primarily taxation related activities and finalising regulatory and licensing cancellations).

Evaluation of member rights and benefits and an assessment by both parties as to the history, demographics, membership composition and fit of the two memberships into a consolidated fund is necessary.

The successor fund must assess the impact of taking on the incoming members, the impact to revenue, cost base and any implications to the insurance profile, expected cash flow and liquidity profile of the combined membership and impact to risk profile. This is the singular focus of the successor fund and in line with their fiduciary duties, the trustee board must be satisfied that undertaking the transfer is in the best interests of its incumbent members.

The successor trustees make an assessment as to the degree to which warranties and indemnities might be afforded to the trustees of the transferring fund to understand the implications to the merged risk profile of the consolidated membership – these must then be agreed between the parties.

How much consolidation might occur

The draft report indicates that approximately 32 default products outperformed the Commission's BP2 and that and that 36 default products underperformed BP2 (16 products by more than 25 basis points).

According to APRA's Annual Superannuation Statistics, there were 199 funds under trusteeship and 111 authorised MySuper products in the market as at the end of June 2017[11].

Where a best in show model was operating comprising only 10 products on a shortlist at any time, it is reasonable to presume that consolidation would occur to the extent that a maximum of 40 products would remain in the market to compete ongoing for a best in show place.

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[11] APRA Annual Fund-level Superannuation Statistics June 2017, Table 2, Number of MySuper products authorised

This means that around 70 MySuper products (across industry segments and of various size and complexity) would be wound up or consolidated.

There are a range of uncertainties as which funds might consolidate and when this might occur.

Outflow ratios provide some indication – those funds with outflow ratios exceeding 100% being more likely to experience an exacerbation of their position (impacted by ATO account consolidation initiatives and fee capping arrangements).

KPMG's Super Insights Dashboard 2018 indicates that funds with assets under management below $1B are most likely to experience negative cashflows (Figure 7) compared to funds from $1B to $25B (Figure 8) and funds >$25B (Figure 9).

FIGURE 7

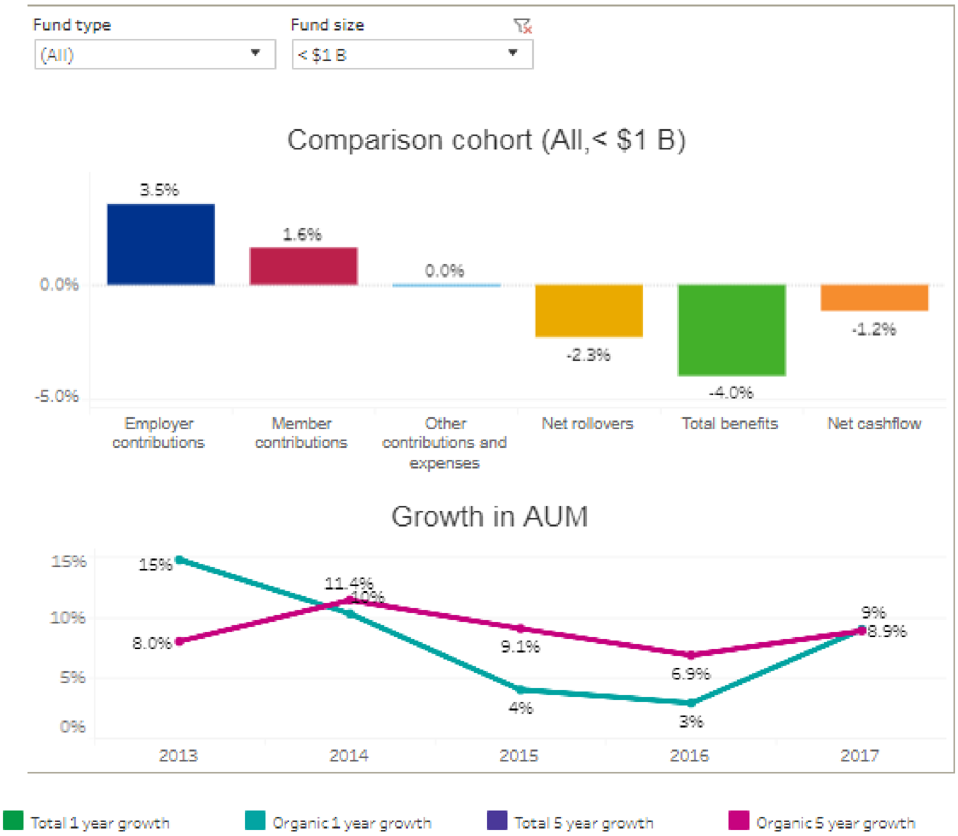


FIGURE 8

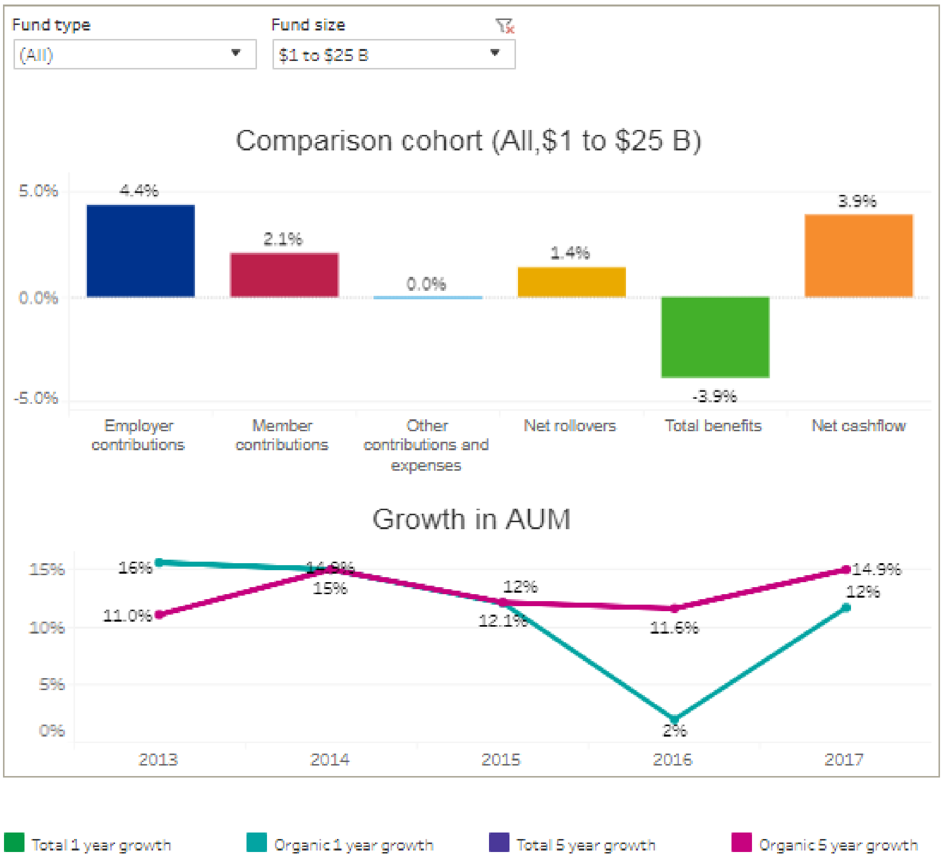
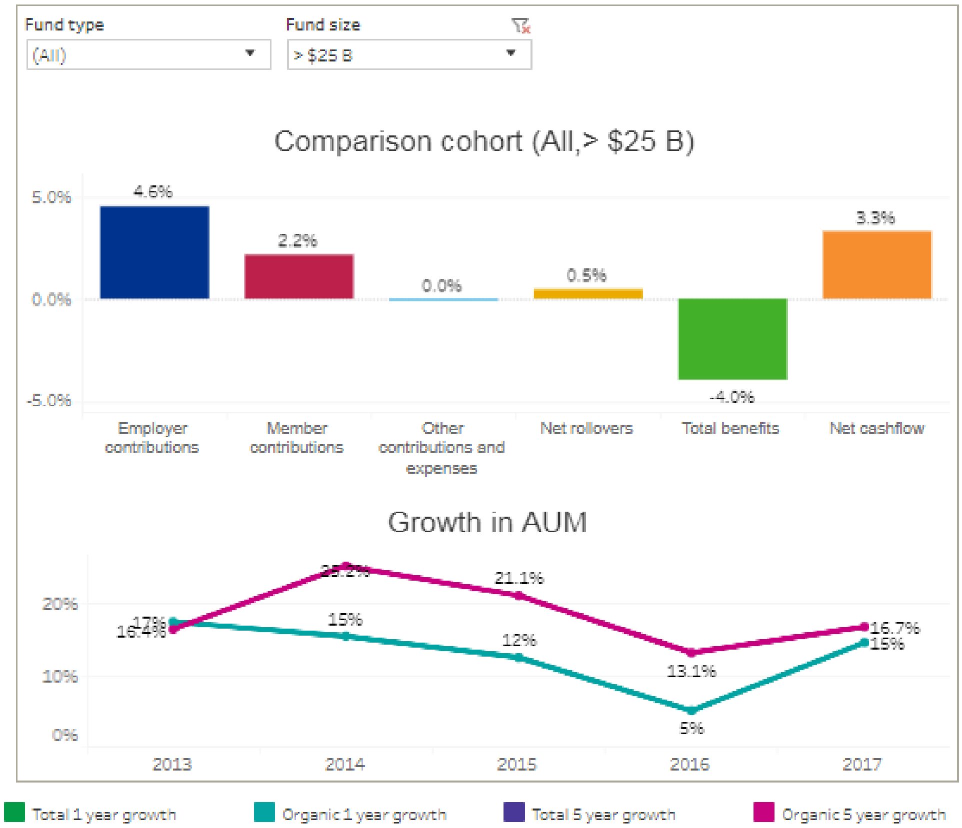


FIGURE 9



As noted previously, our view is that there is likely to be an increase in consolidation activity absent any material change to the default model. Reasonably, this activity should increase in frequency in the coming 12 months.

There is some risk that two currently sub scale and underperforming funds might consolidate with the merged entity remaining sub scale and underperforming.

Given the cost and resource commitment to undertake a successful fund transition, this would add to any inefficiency within the system. The need for increased regulatory scrutiny in such circumstances is likely to quickly become apparent.

Presuming that consolidation activity occurred such that the recipient funds were concentrated to a 'top 10' pool and that each product is a proxy for a 'fund' – it would be reasonable to assume that two to three transitions might occur to each fund in any 12 month period.

Depending on the nature of the transition, this might range considerably. Simple transitions could be done in a more timely manner or – potentially – run concurrently and be less cost and resource intensive.

Larger scale and more complex transitions would take longer. It could therefore potentially take at least three or four years for a reasonable degree of consolidation to begin to exhibit.

Implications for market segments

It is implied from the Commission's analysis and findings within the draft report that three main cohorts of funds that currently exist within the system:

- Enduring underperforming funds;
- Funds that are average in performance or may 'marginally' underperform; and
- Outperforming funds that are predisposed to securing a best in show position.

Having due regard to comments in the body of our submission regarding the benchmark portfolios, our interpretation of these segments is that 'for profit' or retail funds dominate the enduring underperforming pool and are less represented in the outperforming funds (that is primarily comprised of funds in the profit to member segment).

The implications of this are noteworthy in the context of potential SFT activity.

As a general observation, there is a balance sheet valuation placed on 'for profit' or 'retail' funds by the parent entities (based presumably on the product distribution value of these funds) and as such it would be expected that – for a SFT to occur where a 'for profit' fund is to be succeeded – consideration (payment) would be expected by the parent entity in respect to the 'transaction'.

For the purpose of our response, we have not considered this aspect in detail but make the observation that this additional complexity is a potential barrier to consolidation activity within this segment (absent any regulatory intervention).

Annexure 3 - Best in show criteria

We have been requested to provide feedback on the proposed 'best in show' principles and how these might be constructed to guide an expert panel in assessing funds against clearly defined and meaningful criteria.

Principles

The Commission's view is that a modified version of the existing Fair Work Act 2009 criteria is appropriate for determining the best in show list.

The Fair Work Act 2009 currently states that a standard MySuper product may be included on the Default Superannuation Fund List where the Fair Work Commission (FWC) is satisfied that to do so would be in the best interests of default fund employees (or a particular class of employees).

We have commented on each of the Commission's identified criteria in more detail:

> *The match between the product's long term investment return target and risk profile for the types of members who typically default*

This criteria largely correlates with s156F(a) of the Fair Work Act (the appropriateness of the MySuper product's long term investment return target and risk profile) however, this refined criteria specifically references 'the types of members who typically default'.

Default members

Over time, true 'default members' will be only new workforce entrants (or re-entrants with no existing superannuation) who are sequentially allocated to a product on the best in show shortlist. Thus the product needs to demonstrate how the default investment option is suited to disengaged members in terms of long term investment return and risk profile.

The body of our submission comments extensively on our view of appropriately constructed lifecycle investment options and why we believe these are suitable for truly disengaged members.

A properly constructed default investment option must be appropriately allocated to growth assets and (if a lifecycle option) must not involve significant step changes in asset allocation that might exacerbate timing risk.

Given default members will be at the commencement of their superannuation journey, products should be suitably weighted to growth assets, commensurate with the long term time horizon to retirement.

Job changers

It is implied from the Commission's report and analysis that the best in show list is aimed not only at default members but also at job changers (and in fact all superannuation members who might become sufficiently engaged to consider assessing their superannuation product of choice).

In this case, the wording of the criteria might be reconsidered to better capture the intent of the criteria (that is, the suitability of the product for all members – with a focus on the 'flagship' default investment option for disengaged members).

> *The expected ability of the fund to deliver on the product's return target, given its history and risk profile*

This criteria largely correlates with s156F(b) of the Fair Work Act (the superannuation fund's expected ability to deliver on the MySuper product's long term investment return target, given its risk profile) however, this refined criteria specifically references 'the history' of the fund.

The draft report is explicit in articulating the view that "the key focus of the selection process should be on a fund's likelihood of producing high net returns for members" (emphasis added).

Assessment of this criteria will require both quantitative and qualitative considerations of past performance track record but with a focus on future expected performance to ensure a well-founded view is formed.

Past performance is not a reliable indicator of future returns

Clearly performance history will be a consideration in the quantitative assessment of this criteria. Any assessment of past net performance should not focus solely on long-term returns but also be sufficiently robust to identify trends and any 'outliers' in performance year on year to judge the degree of consistency in performance outcomes with investment strategy.

BP1, with a sensible forward-looking basis for the asset allocation benchmark reflecting the risk profile of the product, should be the basis used for assessing whether the long term net investment performance of products have demonstrated value add.

Prudential supervision on the proposed Member Outcomes Prudential Standard and requirement for independent verification of these might allow for comfort on the part of APRA that an appropriate BP1 has been specified by the fund for the product, mitigating any risk of 'gaming' of risk profiles.

Qualitative assessment

In making a judgement on the "expected ability" of a fund to deliver on a return target, it is appropriate to consider qualitative filters that might be influencing factors in achieving the promise to members. These include internal and external investment capability, investment risk frameworks, related party considerations, exposure to diverse sources of return, investment operations frameworks and cashflow management. Tax management practices will also influence returns and how this is managed should be considered.

Investment governance practices should also be a key area of qualitative assessment and should include an assessment of whether the product is being managed in accordance with the stated investment objective (i.e. is this 'true to label').

Fees and costs, given the product's stated long term investment return target and risk profile

This criteria is based on s156F(c) of the Fair Work Act (the appropriateness of the fees and costs associated with the MySuper product, given its stated long term investment return target and risk profile and the quality and timeliness of services provided).

This proposed criteria notably differs in the absence of a consideration of 'quality and timeliness of services provided'. We presume that this aspect is being picked up in the 'administrative efficiency of the fund' criteria as noted further below.

If this assessment aspect is designed to be focussed on investment fees and their appropriateness only, this is a reasonable omission.

We believe it is important that fees are considered in the context of the overall member value proposition and that low costs are not being delivered at the expense of maintaining or improving value to members.

Trend assessment also has a place in the evaluation of products against this criteria to draw out how funds are responding to increased competitive tension and passing on benefits of increasing scale to members.

Establishing pricing – disclosure documents

Whilst fund disclosure documents might be useful in assessing 'perceived costs' there are fundamental flaws in using these documents to attempt comparison of the true costs of running funds or managing investments.

Disclosed or recovered costs may bear little resemblance to actual costs as disclosed through funds' Financial Statements.

Assessment of tax management practices and member equity considerations will be relevant in the consideration of fees– this should be a 'hygiene' factor for best in show funds with any funds not maintaining a direct and transparent fee structure that passes on taxation benefits directly to members not being considered.

We have commented on this in the body of our submission (Information request 2.2).

Referencing fund financial statements for the purpose of the best in show assessment (and those of any related management entities) would likely yield more meaningful insights in the assessment of fees and costs than simply relying on disclosure documents. Improvements in the standardisation of financial statements would further assist this assessment.

Investment fees and costs

Ongoing lack of consistency and differences in interpretations of investment related fees and cost disclosure requirements make comparisons of investment related fees and costs problematic in the current environment.

The ASIC expert review of fees and costs disclosure in superannuation and managed investments may assist in driving more consistency and ensure more meaningful information for members.

It is important that investment related fees and costs be considered in concert with long term returns – this balance will be important (otherwise indexation may be encouraged and rewarded simply by virtue of this being low cost).

There is potential for investment fee benchmarking across risk profiles to be established so that any material deviations from a reasonable 'price' for particular portfolio risk profiles to reveal over time.

The fund's governance practices, including mechanisms to deal with conflicts of interest

This criteria is aligned to s156F(e) of the Fair Work Act (whether the superannuation fund's governance practices are consistent with meeting the best interests of members of the fund, including whether there are mechanisms in place to deal with conflict of interest;).

The following aspects would be assessed to form a qualitative assessment of the governance practices of funds.

- Board and Board Committee Structure
- Outsourced Functions
- Related Party Transactions
- Risk Management and Compliance
- Trustee Assessment and Education
- Disclosure

Compliance with the Insurance in Superannuation Voluntary Code of Practice

The *Insurance in Superannuation Voluntary Code of Practice* requires funds to publish an annual compliance report on adherence to the Code and any exceptions.

We would anticipate that this self-reporting will be leveraged in the assessment of this criteria. We would expect that the expert panel would conduct a qualitative 'look through' to the compliance report and interrogate certain aspects.

Mature funds might choose to independently audit their Code compliance as part of ongoing assurance activity.

The administrative efficiency of the fund

This mirrors s156F(h) of the Fair Work Act (the administrative efficiency of the superannuation fund).

Administration fees typically capture the costs of managing the 'registry' aspects of the member account (administering contributions, rollovers, investment choice and the like) as well as other service aspects (member enquiries, assisting with insurance claims, education and information, responding to and resolving complaints and grievances) and providing member advice and engagement (intra fund advice, access to financial planning and tools like calculators and estimators) in addition to funding the 'compliance' aspects of managing the fund.

We note the Commission's view that *"the panel should also give heed to the fund's intrafund advice offering and track record on innovation and identifying and meeting member needs (including design of superannuation products)".*

We believe that the provision of services to members is an important aspect (education, advice and initiatives to engage members in taking an interest in their retirement outcomes).

This assessment criteria (or alternatively an additional criteria) should capture this aspect of services provided to members. Qualitative assessment of the services provided to members would be required to arrive at a 'value for money' measure when considered in the context of fees charged to members for these services.

Table 2 outlines the areas that might be covered in this assessment.

TABLE 2

Administration	Member education	Advice offering
• Collecting and reconciling contributions	• Tailoring and segmentation of communications	• Member education
• Administration service standards	• Range of and quality of education material and tools	• Scaled advice
• Administration system processing	• Member seminars	• Financial planning
• Contact centre services	• Resources allocated to member education	• Relationship of planning firms to fund
• Web based services	• Reporting to members (statements and annual reports)	• Remuneration structures
• Employer / employer sub-plan servicing		• Monitoring of services
• Member communications		
• Investment Administration		
• Third-Party Adviser Servicing		

Cost per <u>active</u> member assessments might provide one useful measure (this is employed by SuperRatings in their benchmarking of funds as an example).

SuperRatings believe that this represents a more robust measure that allows for the identification of funds that are less sustainable over the longer term (given the focus on the removal of duplicate and inactive accounts from the system).