

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

13 September 2016

Subject: Superannuation Efficiency and Competitiveness

Dear Karen and Angela

Mercer welcomes the Productivity Commission's invitation to make a submission responding to the Commission's Draft Report entitled *How to Assess the Competitiveness and Efficiency of the Superannuation System*.

We have segmented our analysis according to the core items in the Draft Report about which the Commission sought feedback, namely the 5 draft 'system-level' objectives; the 27 assessment 'criteria'; and the 115 'indicators'. Our comments for each element are in a separate attachment to this letter as follows:

1. System-level objectives: pages 6 - 8
2. Assessment criteria: pages 9 - 17
3. Indicators: pages 18 - 57
4. Information requests: pages 58 – 63
5. Further comments: pages 64 - 67

In addition to these responses, we wish to make the following general comments:

- Mercer considers the Government's proposed superannuation system objective is too vague and arguably permits any level of superannuation to meet the proposed objective without any assessment as to adequacy. For the development of sound future policies, Mercer believes it is important that agreement is reached on the objective of the overall retirement income system as well as the objectives of each pillar within the system, together with an agreed understanding of the integration and relationships between each pillar. We have recommended that the objective for the overall retirement income system should be:

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

Nevertheless we are broadly supportive of the set of system level objectives proposed by the Commission. We have recommended a number of refinements in Attachment 1.

- We recognise that the superannuation industry has many aspects to it and congratulate the Commission on the necessary breadth of its report.
- Notwithstanding the need for this breadth, we are concerned at the size of the task that the Commission proposes for itself. The Draft Report has 5 system-level objectives, 27 criteria and 115 indicators plus extensive evidential sources. We are concerned that the Commission may be forced to pursue 'short cuts' in its assessment and rely upon easily accessible or amenable, but not necessarily appropriate or comprehensive, data.

Further, we are concerned that the references to 'industry data' and 'surveys' could coalesce as multiple demands upon industry to supply or develop information, or complete surveys. We recommend the Commission use publicly available information or data held by the regulators as much as possible and minimise the extra requirements that could be placed on the industry. By definition, surveys' utility is limited by the survey sample size and design, and we caution the Commission about relying overly upon this source. We also highlight that the "easy" availability of any data requirements should not be assumed due to the diversity of operations within the industry.

- We acknowledge the Commission's discussion about the heterogeneity of the superannuation 'market' at 5.1 in its Draft Report but emphasise caution by the Commission in perceiving the 'superannuation system' as a solitary market. The superannuation system is very complex, comprising multiple markets and segments. The Commission is vague about this segmentation at places, mentioning on page 77 that it will "nominate for which segment [of the market] the proposed indicators are most relevant" for example.

It is important that the Commission appreciates the significance of this market segmentation when developing and applying criteria to assess the efficiency and competitiveness of the 'superannuation system'. This is important especially when attempts are made to benchmark the performance of industry participants' actions and market segments' performance. As a minimum, we recommend that the Commission should recognise the fundamental differences between:

- Default (or MySuper) products within APRA regulated funds
- Choice products within APRA regulated funds

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- Non-APRA regulated funds in the public sector
- Self-Managed Superannuation Funds

Our reason for highlighting these differences is that the decisions taken by members, or available to members, are very different in each of these segments thereby affecting both competition and efficiency. We also highlight that competition and efficiency issues as they relate to different providers within the industry (e.g. insurers, fund managers, administrators, and custodians) vary greatly and will need to be considered using different criteria. In short, each of these types of providers operate within their own marketplace.

- We remain concerned that, because fees can be objectively measured and aspects such as service and product quality are difficult to measure objectively, inappropriate weight will be attached to fees when assessing efficiency. As noted in our submission on the Commission's Issues Paper, while headline overall investment fees may not have reduced significantly due to scale, the quality of investment portfolios of many major funds has improved significantly over time so that the value per dollar of investment fees has improved due to increased scale. The 'product' of superannuation has many possible features and therefore it should not be considered to be a commodity and assessed on price alone.
- We note the Draft Report does not directly assess the contribution that regulatory costs make to the efficiency or competitiveness of the superannuation system. While we acknowledge the Commission proposes to take "current policy settings as given when developing the assessment criteria" (page 13), we do not consider this should preclude the Commission drawing conclusions on the contribution that regulatory approaches make to efficiency. We consider that indicators should be added relating to the impact of regulatory change, complexity and restrictions on member engagement, system costs and product and service innovation and have recommended a number of indicators in respect of these factors in Attachment 3.
- We note members' needs and preferences are very diverse, particularly in the retirement years. For example, some members will want to take a lump sum benefit at retirement while other retirees will desire a steady and reliable level of retirement income. Most retirees are risk averse and many are wary of market volatility (that is, the variability of their assets in their account based pension). On the other hand, others are more concerned with risks to the value of their regular income or pension payment. These contrasting requirements and desires mean that the optimal asset allocation and product design for retirees varies considerably.

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Who is Mercer?

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

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

We would be delighted to meet with you to discuss our submission. Please contact me on 03 9623 5464 or by email if you would like to arrange a discussion. I would add that due to the time and resources constraints at this time of year, we have not been able to respond to every issue raised by the Draft Report or information request. However if there are particular issues that you would like to explore with us, please let me know.

Yours sincerely,

Dr David Knox
Senior Partner

Attachment 1: System-level objectives

As submitted in our response to the Productivity Commission's Issues Paper, Mercer believes the superannuation system objective must be defined with a total retirement income perspective in mind. To do this properly, we have recommended to Government that defining the objectives of both superannuation and the Age Pension should be conducted simultaneously, with a key factor being the inclusion in the objective of a desired level of total income from both superannuation and the Age Pension. We have recommended that the objective for the overall retirement income system should be:

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

We do not believe it is appropriate, as the Government has done in its proposed superannuation system objective, to state that superannuation should be restricted to substitute or supplement the Age Pension. It is too vague and arguably permits any level of superannuation to meet the proposed objective without any assessment as to adequacy. Whilst recognising that supplementation and substitution will occur, Australia needs a clear and sensible line in the sand as to when superannuation income should move from supplementing the Age Pension to becoming a substitute for it. We submit again that, for the development of sound future policies, it is important that agreement is reached on the objective of the overall retirement income system as well as the objectives of each pillar within the system, together with an agreed understanding of the integration and relationships between each pillar.

We note that as part of trustees' obligations to act in members' best interests, superannuation objectives could include any or all of the following objectives:

- to provide a level of retirement income that enables retirees to maintain their previous standard of living during retirement;
- to provide death and disablement insurance during the pre-retirement years at a cost lower than available to most individuals, outside of superannuation;
- to provide education to the member so they understand more about their superannuation, its purpose and the options available; and
- to provide a range of appropriate retirement products, recognising the diversity of risks faced by retirees.

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

The Government may also have slightly different objectives. For example, the Government may wish to see:

- reducing costs of the Age Pension in future years as the superannuation system matures;
- increasing provision of insurance related products, both in the accumulation and retirement periods, thereby reducing future costs to Government of supporting those in financial need;
- the ongoing development of deep and sophisticated capital markets, thereby promoting some export opportunities; and
- the development of well-resourced regulators to ensure that there is appropriate protection for consumers; a level playing field for product providers; and appropriate disclosure of relevant information in a cost-effective manner.

There exist a variety of objectives for superannuation depending on the position of different stakeholders and different objectives may lead to conflicting outcomes. For example, the provision of group insurance may provide valuable protection to members and their households during the working years. However, higher levels of insurance inevitably leads to lower retirement benefits which reduces the future age pension saving. Such tensions are inevitable but unsurprising as the ultimate objective of providing retirement income should be able to be modified or adjusted to reflect the needs of the actual members.

Having made the above broad statements on the optimal characteristics for objectives of the superannuation system, Mercer makes the following comments on the Commission's proposed system-level objectives:

	System-level Objective	Comment
4.1	<p>Competition in the superannuation system that drives efficient outcomes for members through:</p> <ul style="list-style-type: none"> • a market structure and other supply and demand-side conditions that facilitate rivalry and contestability; and • suppliers competing on aspects of value to members across the accumulation, transition and retirement phases. 	<p>REFINE: We support the direction of this proposed objective although the term "rivalry" seems inappropriate. In place of 'facilitate rivalry and contestability, we suggest "facilitate contestability supported by transparency".</p> <p>We also recommend refinement of the wording to refer to "Competition... that drives efficient and valued outcomes for members..." as the desired outcome is more than just efficiency.</p>

4.2	The superannuation system maximises net returns on member contributions and balances over the long term.	REFINE: The term 'maximises' in this objective should be replaced with the term 'optimises', in order to recognise that the risk preferences, service preferences (both quality and breadth) and the time horizons of individual members preclude the system being solely focused on maximising long-term returns.
4.3	The superannuation system meets member preferences and needs, in relation to information, products and risk management, over the member's lifetime.	CONDITIONAL SUPPORT: We support this proposed objective. However we wonder whether it may be preferable to combine objectives 4.2 and 4.3 as the optimal outcome for members should depend on their preferences and needs. We do not believe they should be considered in isolation.
4.4	The superannuation system provides insurance that meets members' needs at least cost.	<p>MODIFY: We consider this objective is problematic as currently framed for two key reasons.</p> <p>First, default cover cannot inappropriately erode member balances and this constraint generally means it cannot be targeted at a level expected to fully meet most members' insurance needs. Whilst optional cover arrangements may enable many members to meet their death and disability insurance needs through superannuation, funds' offerings will be constrained by what is affordable (for sufficient numbers of members) and efficient for them to provide.</p> <p>Second, we are concerned that 'least cost' does not recognise the variety of issues that need to be considered in assessing whether insurance represents good value for members, including terms and</p>

		<p>conditions and sustainable pricing. We suggest 'fairly priced' rather than 'least cost' as we consider this better caters for considerations such as the terms of cover (including disability definitions), the financial strength and stability of the insurer, the services offered by the insurer including claims and data management, underwriting and reporting. This philosophy is embedded in APRA's Prudential Standard (SPS 250) Insurance in Superannuation and Prudential Practice Guide (SPG 250) Insurance in Superannuation. We suggest that 'fairly priced' suitably conveys that premiums do not include unreasonable profit margins or cross-subsidies, whereas "at least cost" is an absolute statement and implies testing by competitive tender or similar.</p> <p>We suggest this objective be replaced by an objective along the following lines:</p> <p><i>The superannuation system provides access to fairly priced near universal death and disability insurance cover via a level of default cover suitable to the membership (offered on an automatic acceptance basis where appropriate), with the ability for individuals to tailor cover to better meet their insurance needs.</i></p>
4.5	The superannuation system complements a stable financial system and does not impede long-term improvements in efficiency.	<p>REFINE: We support the direction of this proposed objective although suggest that sustainable may be a better word than stable, as it has a longer term perspective.</p>

Attachment 2: Assessment criteria

General observations

Objective Competition in the superannuation system that drives efficient outcomes for members through:

- a market structure and other supply and demand side conditions that facilitate rivalry and contestability
- suppliers competing on aspects of value to members across the accumulation, transition and retirement phases

Note: The headings used for each objective do not include the suggested Mercer changes outlined in Attachment 1

Assessment Criteria	Sign	Explanation
1. Is there sufficient member engagement to exert competitive pressure?	✓	SUPPORT (delete 2 indicators, add 1 Mercer suggestion) Importantly, it must be recognised that member engagement varies greatly between different market segments. In addition, successful default products may lead to a reduction in observable member engagement. Hence we caution the Commission against giving too much weight to member engagement as a driver of competition given uncontrollable factors such as age, financial literacy and general interest in personal finance.
2. Are members and member intermediaries able to make informed decisions?	✗ ✓	AMALGAMATE INTO CRITERION #4 (delete 1 indicator, move 3) We believe this criterion should be deleted and its indicators assessed for criterion #4 (see Attachment 3). This is because being able to make informed decisions is a critical element of having sufficient countervailing power, which is the focus of criterion #4.
3. Is there low market segmentation along member engagement lines?	✗	DELETE (delete 2 indicators) We do not consider that this criterion and its associated indicators will provide any insights that are not obtainable from answers to other criteria. As such, we feel that it should be removed. In particular, we do not feel that the proposed 'indicators' address the criteria. Fund expenditure on member retention as a proportion of overall marketing expenditure is a poor

		measure of market segmentation, for example.
4. Do active members and member intermediaries have sufficient countervailing power?	✓	<p>SUPPORT BUT AMALGAMATE WITH CRITERION #2 (delete 1 indicator, add 3 from criterion #2)</p> <p>We consider the term ‘countervailing power’ unhelpful and recommend the Commission adopt another label in its place. We support this criterion but, in the interests of efficiency, we suggest consideration be given to amalgamating this criterion and its indicators with criterion #1.</p>
5. Are principal–agent problems being minimised?	<p>✗</p> <p>✓</p>	<p>DELETE/ REFINES (delete 5 indicators)</p> <p>This is an important issue but is not necessarily related to competition. It is also unclear which particular problems are being addressed as there are many principal-agent relationships within the industry. We do not consider this criterion instructive on its own in determining whether the superannuation system meets the competition objective as described. We therefore recommend that this criterion and its indicators be removed Alternatively, the Commission may wish to be more explicit about the specific relationships of concern in a revised criterion and indicators</p>
6. Is there rivalry among incumbent providers?	✓	<p>REFINE AND EXPAND INDICATORS: (delete 1 indicator, add 1 from criterion #12 and add 2 Mercer suggestions)</p> <p>As mentioned in our comments on the system-level objectives, we suggest that rivalry is an emotive and unhelpful term and suggest it be replaced by contestability. We also suggest that indicators for criterion #12 be assessed under this criterion and criterion #12 be deleted. Innovation is an important indicator of rivalry and competition.</p>

7. Is the market contestable?	✓	<p>SUPPORT (delete 1 indicator)</p> <p>It must be recognised there are many sub-markets within the super industry.</p>
8. Are there material anticompetitive effects of vertical and horizontal integration?	✓	<p>SUPPORT (delete 1 indicator)</p> <p>It is critical that the Commission take into account the different vertical and horizontal integration models utilised across market segments to appreciate the extent and impact of integration across the entire superannuation system.</p>
9. Do funds compete on costs?	✓	<p>SUPPORTBUT AMALGAMATE WITH CRITERION #11 (delete 1 indicator, add 3 from criteria #11 and #12, add 2 Mercer suggestions)</p> <p>We consider this criterion and criterion #11 should be amalgamated into one criterion entitled: 'Do funds compete on costs and relevant non-price dimensions? This criterion would use most indicators from criteria #9 and #11, an indicator concerning the introduction of new products from criterion #12 and some further indicators that we suggest (see Attachment 3 for more details).</p> <p>We submit costs cannot be assessed independently of the services provided so comparisons must strictly be on a like for like basis to be valid. The focus needs to be on whether the price of the services/benefits offered represents a competitive value proposition. .</p>
10. Are economies of scale utilised and the benefits passed through to members?	✓	<p>SUPPORT (delete 3 indicators)</p>

11. Do funds compete on relevant non-price dimensions?	<p>✗</p> <p>✓</p>	<p>SUPPORT BUT AMALGAMATE WITH CRITERION #9 (delete 3 indicators, move 2)</p> <p>Competition in most industries has a range of features and characteristics. Therefore we recommend that criterion #11 should be amalgamated with criterion #9. This will ensure a more holistic assessment is made rather than concentrating on costs and non-price dimensions separately. As mentioned in respect of criterion #9, we consider that an indicator for criterion #12 is also relevant to an assessment of criterion #11 and most indicators for criterion #9 and #11 should be retained (see Attachment 3 for more information).</p>
12. Is there innovation and quality improvement in the system?	<p>✓</p> <p>✗</p>	<p>DELETE (delete 1 indicator, move 1)</p> <p>We agree that innovation and quality improvement are important considerations when assessing the competitiveness of the superannuation system. However, we consider their influence would best be assessed as part of the assessment for criteria #6, #9 (as amended) and #13.</p>
13. Are outcomes improving at the system level?	<p>✓</p>	<p>QUALIFIED SUPPORT (delete 1 indicator, add 1 from criterion #11, add 2 Mercer suggestions)</p> <p>We agree this is an important criterion to assess but we are concerned that the proposed indicators are unsatisfactory. We suggest improvements in Attachment 3, which include two further indicators and assessment of the introduction of new retirement income products which is an indicator for current criterion #11.</p>
Objective The superannuation system optimises net returns on member contributions and balances over the long term		

Proposed Assessment Criteria	Sign	Mercer comment
14. Are net investment returns being maximised over the long term, taking account of service features provided to members?	✓	<p>SUPPORT/REFINE: (delete 1 indicator)</p> <p>We consider the word 'maximised' in this criterion should be replaced with 'optimised', for the same reasons that we seek revision of the word 'maximised' in the proposed system-level objectives (see Attachment 1).</p>
15. Are costs incurred by funds and fees charged to members being minimised, taking account of service features provided to members?	✓	<p>QUALIFIED SUPPORT (delete 2 indicators)</p> <p>We note that services offered to fund members are being enhanced over time, both to respond to member needs and preferences and to meet regulatory requirements. This is also relevant to increased utilisation of different investment asset classes (such as direct infrastructure) that are more expensive but offer diversification and enhanced risk/return characteristics. The costs associated with these services and investment enhancements may be offsetting any cost efficiencies achieved by providers (which would otherwise be passed on to members). Accordingly, we do not consider it would be appropriate for the Commission to presume that because fees charged to members are not reducing over time, the superannuation system is not competitive and efficient. We also note that, in assessing this criterion, the Commission needs to recognise that a healthy system generates sufficient profit to support investment in product improvement and for future innovation. A minimum profit system is unhealthy and will mean that the industry stagnates over time.</p>
16. Do all types of funds have opportunities to invest efficiently in upstream capital markets?	✓	SUPPORT

17. Is the system effectively managing tax for members, including in transition?	<p>✗</p> <p>✓</p>	<p>POSSIBLE DELETE (delete 3 indicators)</p> <p>We query whether how effectively the superannuation system manages members' tax is an aspect of the system that warrants a specific criterion for this review. Effective tax management is one of the factors affecting whether net returns are being optimised and therefore in our view is assessed for the purposes of criterion #14. An alternative, more appropriate, criterion could assess whether the current tax system leads to inefficiency within the system, inefficient outcomes in respect of the pre or post retirement phases, or produces competitive biases.</p>
Objective The superannuation system meets member preferences and needs, in relation to information, products and risk management, over the member's lifetime		
Assessment Criteria	Sign	Explanation
18.1 Are member preferences and needs being met by minimising unpaid contributions and lost accounts?	✓	SUPPORT
18.2 Are member preferences and needs being met by funds collecting relevant information to ensure their product offerings are suitable for their diverse member bases?	✗	<p>DELETE (delete 2 indicators)</p> <p>Although it is important for funds to offer a range of products to their diverse member bases, it should be recognised that it is inefficient for a fund to develop a product that only a small number of members would utilise. Such developments can lead to increased costs at the expense of all members for the benefit of a few. We consider this criterion could generate inefficiency by implying a need for funds to solicit increasing amounts of personal information</p>

		from members in an effort to better tailor their offerings and even lead to an implied obligation for providers to ensure that a product (even if selected by the member) was suitable for the member given the information the fund holds about them. We recommend deletion of this criterion and its indicators.
18.3. Are member preferences and needs being met by the system providing high quality information and financial advice to members to help them make decisions?	✓	<p>SUPPORT (delete 2 indicators)</p> <p>The provision of financial advice is important but it can be expensive to provide. It should be recognised that not all members wish to receive advice from their superannuation fund. Therefore there is a balance needed between the fees charged (if any) and the provision of information and financial advice to members.</p>
18.4 Are member preferences and needs being met by the system providing products and information to help members optimally consume their retirement incomes?	✓	<p>SUPPORT</p> <p>However, consistent with our earlier remarks, we note that a major impediment to members receiving appropriate information is the complex and constantly changing superannuation and social security systems. We consider the Commission should assess the barriers to members being properly informed from regulatory change and complexity as part of their assessment of this criterion and criterion #20, and have suggested some indicators for this purpose (see Attachment 3).</p>
18.5. Are member preferences and needs being met by member balances being allocated in line with their risk preferences and needs?	✓	<p>QUALIFIED SUPPORT</p> <p>As mentioned above, we do not consider it efficient for every fund to offer every available investment option to members. It is therefore inevitable some member preferences will not be available in some funds. Such an outcome does not make the industry uncompetitive or inefficient. We consider there should be no obligation for providers to collect information and</p>

		objectively assess individual member needs and preferences. It should be sufficient for trustees to provide members with information on options available (and defaults) and to comply with member instructions (or to apply defaults in the absence of valid instructions).
19. Is the system using lessons from behavioural finance to design products and 'lean' against well-known biases in how people make decisions?	x	<p>DELETE (delete 1 indicator)</p> <p>This criterion and its indicator are problematic. Behavioural finance is a perspective from one academic discipline on human behaviour. There are potentially also lessons from psychology, marketing, law, history and human geography. Further, funds may draw lessons from their own experiences and member feedback. We consider that insights from this criterion would be available from responses to other criteria. We recommend this criterion be omitted.</p>
20. Are trustees acting in the best interests of members?	x	<p>DELETE (delete 5 indicators)</p> <p>This criterion is a governance issue related to trustees following the requirements in the legislation. It is currently overseen by APRA and therefore we do not believe there is a need for this criterion and its indicators, particularly in the context of other criterion and indicators that the Commission identifies.</p>
Objective The superannuation system complements a stable financial system and does not impede long term improvements in efficiency		
Assessment Criteria	Sign	Explanation
21. Are there material systemic risks in the superannuation system?	✓	SUPPORT

Objective The superannuation system provides insurance that meets members' needs at least cost		
Assessment Criteria	Sign	Explanation
22. Do funds offer insurance products that meet members' needs?	✓	<p>QUALIFIED SUPPORT (delete 2 indicators)</p> <p>We consider this criterion should be amended to – 'Do funds offer insurance products that reasonably respond to members' needs'. Provision of insurance which (fully) "meets members' needs" is likely to be prohibitively expensive even if that insurance cover is provided at "least cost". The primary purpose of superannuation is to fund retirement, and default levels of insurance should be set such that insurance premiums do not inappropriately erode members' retirement incomes. Whether or not these levels of insurance (fully) meet members' needs is an important but secondary consideration. This philosophy is embedded within subsection 52(7) of the <i>Superannuation Industry (Supervision) Act 1993</i> (SIS Act). Also see our comments on the Commission's proposed superannuation objective concerning insurance (Attachment 1).</p>
23. Are the costs of insurance being minimised given the type and level of cover?	✓	<p>SUPPORT/ REFINE (delete 2 indicators)</p> <p>Refer to our comments on the Commission's proposed superannuation objectives (above). We support this criterion provided that 'minimised' is to be assessed consistently with our 'fairly priced' concept.</p>

Attachment 3: Indicators

Criteria	Indicators	Method	Evidence	Mercer comments
COMPETITION				
1. Is there sufficient member engagement to exert competitive pressure				
1.1 Member account monitoring activity (use of websites, call centre enquiries)* (input, behaviour)		Trend analysis	Surveys, industry data	SUPPORT: As a general comment, for each indicator against this criteria, we recommend the Commission examine all of the metrics by age and balance – in our experience, participation rates for many of these engagement activities vary considerably by age
1.2 Member awareness of key features of their superannuation, including insurance* (input)		Trend analysis, Quantitative	Surveys	SUPPORT: We recommend that any survey of members' awareness include inquiry whether members understand their ability to choose their own super fund and member perceptions of the ease of making any change. We have found that things being 'all too hard' can often contribute to a lack of member engagement.
1.3 Active member ratio (input)		Trend analysis	Surveys, industry data	DELETE: It is unclear what should be regarded as 'active' – is it only members who have exercised choice of fund, choice of investment or choice of insurance or do broader engagements also count (such as contacting the helpline, checking balance online, using a fund's retirement calculator, making voluntary contributions etc.)? Are all pensioner members active since a pension is not a default product (other than some DB pensions)? Furthermore

			a lack of measurable activity does not necessarily imply a lack of engagement. Activity is also prompted by media reports, market volatility, legislative change and government announcements, so trends in member activity must be treated with great caution. Given the subjectivity involved in determining who is 'active' and interpreting the meaning of this measure, we consider this indicator should be deleted.
1.4 Switching rate between and within default and choice funds and between institutional funds and SMSFs, by age and wealth (behaviour)	Trend analysis	Surveys, regulator data	SUPPORT: However we note care will need to be taken in interpreting this indicator. As the draft report notes, passive member behaviour does not necessarily indicate member disengagement. Switching behaviour is also influenced by external factors including the market volatility, media stories and government decisions.
1.5 Default rates for funds, investment and retirement income products, and insurance (behaviour)	Trend analysis	Surveys	SUPPORT: However, we note there are no default retirement income products - members must agree to join. Default rates vary greatly between funds and by age so the conclusion that may be drawn from this analysis is not clear.
1.6 Duplicate accumulation accounts and insurance policies (output)	Trend analysis	Surveys	SUPPORT: However we note survey results will be affected by member awareness It may also be worth considering a comparison of the total number of accounts with insurance cover (based on regulator data) with an estimate of the number of individuals

			under age 65 (say) with superannuation as a very broad measure of duplication of insurance (though cover in more than one fund will be intentional in a limited number of cases).
1.7 Information collection by funds on key member characteristics* (input)	Quantitative	Surveys, case studies	DELETE: The definition of 'key' member characteristics is subjective. What characteristics are 'key' will vary between individuals depending on a variety of characteristics including their age, wealth, balance and investment options. We do not consider that the Commission can adequately survey the appropriateness of key member characteristics collected by funds and their contribution to system efficiency and/ or competitiveness. Hence, we recommend deletion of this indicator from the review wherever the Commission proposed to rely upon it.
1.8 MERCER ADDED INDICATOR: Clarity and simplicity of relevant legal/ regulatory law and guidance	Qualitative	Surveys, reports by others	A critical aspect of member engagement is accessible, concise, clear and adequately explained regulatory and legal arrangements. We believe an indicator like this is needed to acknowledge that the sheer complexity of the superannuation, tax and age pension systems is a major barrier to truly simple, easily understandable communications that promote member engagement.

2. Are members and member intermediaries able to make informed decisions?			
<i>Note: Mercer recommends deletion of this criterion with specified indicators moved to criterion #4 – refer Attachment 2.</i>			
2.1 Availability, cost and quality of information on fees and investment risks at product level* (input)	Trend analysis; qualitative	Surveys, industry data	Moved to criterion #4 assessment:
2.2 Financial literacy and numeracy compared to an 'adequate' standard (input)	Trend analysis	Surveys	Moved to criterion #4 assessment:
2.3 Use of advisers by members and/or member intermediaries (input)	Trend analysis		DELETE: We note that members' use of a paid adviser is not necessarily indicative of the member being better informed so caution the Commission about placing undue emphasis on results from this indicator. There is great variety in the use of advisers within the industry and it will be difficult to obtain objective data and consequential results. We therefore recommend this indicator be deleted.
2.4 Capacity and willingness of employers to select a default fund (input)	Qualitative	Reviews by others	Moved to criterion #4 assessment.

3. Is there low market segmentation along member engagement lines?			
<i>Note: Mercer recommends deletion of this criterion and its indicators– refer Attachment 2.</i>			
3.1 Fund expenditure on member retention relative to overall marketing expenditure (input)	Trend analysis	Surveys	DELETE
3.2 Fee dispersion (between default and choice products, comparable products within a fund, and within products) (output)	Trend analysis	Surveys	DELETE

4. Do active members and member intermediaries have sufficient countervailing power?			
4.1 Fund and product switching costs (administrative, search and learning costs) (input)	Trend analysis	Surveys, industry data	SUPPORT
4.2 Size of the SMSF sector (funds and members) relative to institutional sector (output)	Trend analysis	Regulator data	DELETE: We consider this indicator is unnecessary given the Commission proposes to gather information on market shares as part of a separate indicator for this criterion.
4.3 Switching rate from institutional funds to SMSFs (behaviour)	Trend analysis	Surveys, regulator data	SUPPORT: However, we note that multiple factors may result in switching to SMSFs that do not necessarily that do not necessarily translate as greater countervailing power so the findings from the indicator will have to be approached with care.
4.4 Changes in market shares of funds (output)	Trend analysis	Regulator data	SUPPORT
4.5 Corporate fee discounts (output)	Trend analysis	Regulator data, industry data	SUPPORT

4.6 MOVED CRITERION: Availability, cost and quality of information on fees and investment risks at product level* (input)	Trend analysis; qualitative	Surveys, industry data	MOVED FROM CRITERION #2: We support this indicator in its current form but recommend that it be expanded to assess the availability of information on investment returns as well as risks. Also, why are insurance arrangements not relevant for the purposes of this indicator (admittedly these are more complex and not included in product dashboards)?. To be effective, we note that this indicator will need to be subdivided by product and by industry segment.
4.7 MOVED CRITERION: Financial literacy and numeracy compared to an 'adequate' standard (input)	Trend analysis	Surveys; ABS statistics	MOVED FROM CRITERION #2: We agree this is a relevant indicator however the 'adequate standard' for this Indicator is subjective (and arguably varies depending on the product choices confronting the member). Clearly it cannot be an international benchmark given disparities in national education systems. The report should be clear that the primary responsibility for improving financial literacy and numeracy rests with Government.
4.8 MOVED CRITERION: Capacity and willingness of employers to select a default fund (input)	Qualitative	Reviews by others	MOVED FROM CRITERION #2: Our experience is that many medium and large employers are willing to seek expert advice to help them select a high quality default fund suited to the needs of their employees, provided that their industrial agreements allow them the freedom to do so.

5. Are principal-agent problems being minimised? <i>Note: Mercer recommends deletion of this criterion and its indicators or suggests the criterion become more focused.</i>			
5.1 Existing ratings of system wide quality of governance* (input)	Qualitative	Reviews by others	DELETE: We do not consider an assessment of ratings of governance quality will assist an assessment of superannuation system competitiveness in this context.
5.2 Accurate disclosure of trustee directors' and investment committee members' qualifications and relevant skills/experience, remuneration structures, and potential conflicts of interest due to related party dealings and competing duties* (behaviour)	Qualitative	Review by others	DELETE: It is unclear what this indicator is intended to show. If the Commission elects to proceed with this indicator, we would oppose it being tested against any 'standard' that exceeds legislated requirements.
5.3 Contraventions of regulator governance standards by trustees, employers, service providers and financial advisers* (behaviour)	Trend analysis	Regulator data	DELETE: The contraventions described in this indicator (many of which are minor) very rarely have anything to do with principal-agent issues. Rather they are generally technical infringements driven by the detailed requirements of legislation.
5.4 Level of skills and standard of performance for trustee boards and investment committees, including review processes* (input)	Qualitative	Surveys; reviews by others	DELETE: It is unclear how the evidence will illustrate the level of skills within the trustee board.

5.5 Member satisfaction and trust* (outcome)	Trend analysis	Surveys	DELETE: Experience indicates that member satisfaction and trust at any time are greatly influenced by recent investment performance. Regulatory changes also have a significant impact on member trust. We consider it will be challenging and almost impossible for the Commission to separate out these influences and obtain an objective assessment of a trustee's performance across the range of matters under a trustee's control.
6. Is there rivalry among incumbent providers? <i>Note: Mercer recommends this criterion be refined</i>			
6.1 Market concentration (Herfindahl Hirschman Index and market shares of largest providers) (output)	Trend analysis	Regulator data	SUPPORT
6.2 Number of institutional funds (input)	Trend analysis	Regulator data	DELETE: It should be noted that reductions in the number of funds have been primarily driven by legislative changes, not contestability. We do not think this indicator adds much to the market concentration indicator for funds. We therefore recommend this indicator be deleted.
6.3 MOVED INDICATOR: Introduction of new retirement products and development of more tailored default products* (output)	Trend analysis Qualitative	Surveys Industry data	MOVED FROM CRITERION #12: Whilst we encourage the introduction of new retirement products, as evidenced by Mercer Lifetime Plus, the limitations of the current taxation and legislative requirements must be recognised – hence Indicator 6.5 proposed. .

6.4 MERCER ADDED INDICATOR: Introduction of new services and improvement in quality of existing services (output)	Trend analysis Qualitative	Surveys Industry data	Innovations in service offerings as well as products are a good indicator of competition between providers.
6.5 MERCER ADDED INDICATOR: Constraints on innovation presented by administrative and legal restraints	Qualitative	Surveys	This indicator would assess industry perceptions on the ease/ efficiency of pursuing reforms. How responsive is Government to industry demands for example? How flexible are regulatory settings to accommodate innovation?
7. Is the market contestable?			
7.1 Height of barriers to entry - effect of default rules on market entry (input)	Qualitative	Surveys; case studies	SUPPORT: Entry to the industry varies significantly by segment. We recommend that the Commission consider particular case studies for new APRA regulated funds and the barriers that have restricted additional entrants rather than undertaking surveys. We do not consider surveys are an effective evidential source for this indicator
7.2 Height of barriers to entry - market impediments to funds accessing distribution channels (input)	Qualitative	Surveys; case studies	SUPPORT
7.3 Mergers prevented by bulk transfer rules (behaviour)	Trend analysis; qualitative	Surveys; case studies	SUPPORT: However, we note that problem areas with the bulk transfer rules are under consideration by APRA. If these areas are suitably addressed this indicator could be removed. Capital gains rollover rules should also be considered.

7.4 New entries into and exits from the market (behaviour)	Trend analysis	Regulator data	SUPPORT
7.5 Capacity and willingness of employers to select a default fund (input)	Qualitative	Reviews by others Surveys	SUPPORT: Our experience is that many medium and large employers (and some smaller employers) are willing to seek expert advice to help them select a high quality default fund suited to the needs of their employees, provided that their industrial agreements allow them the freedom to do so. Care should be taken that 'reviews by others' are unbiased. We recommend the Commission survey employers.
7.6 Prosecutions of fund trustees for contraventions of SIS Act on inducements (output)	Trend analysis; qualitative	Regulator data	DELETE: We recommend this indicator be deleted as it is unlikely to add value due to the very small number of prosecutions (we are not aware of any).

8. Are there material anticompetitive effects of vertical and horizontal integration?			
8.1 Alignment in the structure of member fees and underlying costs (output)	Econometrics	Regulator data; industry data	SUPPORT: However a balance is needed between complexity and ‘user pays’. Also, designing offerings to efficiently provide services taking into account the overall best interests of members may mean that some members contribute to the cost of services they do not utilise.
8.2 Proportion of funds required (by trust deed) to outsource to related party providers (input)	Trend analysis	Surveys	<p>DELETE/ REFINED: Section 58A of the SIS Act voids rules that require a specified provider to be used for particular services (with very limited exceptions). Hence, this indicator would appear redundant.</p> <p>A potential alternative indicator would be the proportion of overall fees paid to related parties, however industry wide data may be difficult to obtain. We also note that the requirements for selecting service providers in members’ best interests are supported by APRA prudential standards covering a range of topics including conflicts of interest and outsourcing.</p>
8.3 Process used by funds to make outsourcing decisions (input)	Qualitative	Surveys; case studies	SUPPORT: However we note this is very difficult to assess and will vary greatly by the service that is outsourced. For example, different processes are normally used for fund managers, administration,

			custodian, actuarial work etc.
8.4 Cost and member fee differences from outsourcing administrative and insurance services to related versus unrelated parties (output)	Trend analysis	Surveys; Case studies	SUPPORT: We note that, in respect of insurance, valid comparisons will be difficult due to the difference in premiums which relates to the impact of different occupational risk profiles (and claims history) of the insured members. Case studies may be needed as an evidential source in addition to surveys.
8.5 Transparency and efficacy of fee disclosure by funds, including for distinct services (behaviour)	Qualitative	Surveys, reviews by others	SUPPORT: However, it is unclear what 'distinct services' will be considered here. Also see our comments at first indicator for this criterion and Attachment 5 section C.

9. Do funds compete on costs?

Note: Mercer recommends this criterion be amalgamated with criterion #11 – refer Attachment 2.

We have therefore recommended specified indicators be moved from criterion #11 to here.

9.1 Costs relative to assets and member base: wholesale (by service) and retail (by segment)* (input)	Trend analysis	Regulator data, industry data	SUPPORT: Ideally, investment related costs and operational (administration) costs should be examined separately as the Commission has noted (page 95) as there are significant limitations with regulator fund-level expense data – see comments in Attachment 5 section C.
9.2 Margins: wholesale (by service) and retail (by segment)* (output)	Trend analysis	Regulator data, industry data	DELETE: It seems highly unlikely the Commission will be able to obtain this data. Also, as noted earlier, a reasonable level of profit is necessary for a healthy and sustainable industry. Therefore, we recommend deletion of this indicator.
9.3 Investment management fees by asset class compared to other countries* (output)	Trend analysis	Industry data	SUPPORT: However care will be required to understand what fees/costs are included and not included in international data vs Australian data. Tax considerations also add an extra dimension in Australia that is absent in most other countries.
9.4 Alignment of the structure of member fees and underlying costs (output)	Econometrics	Regulator data, industry data	SUPPORT: However as noted earlier a balance is needed between complexity and ‘user pays’. Also, designing offerings to efficiently provide services taking into account the overall best interests of members may mean that some members contribute to the cost of services they do not utilise.

9.5 Transparency and efficacy of fee disclosure by funds, including for distinct services (behaviour)	Qualitative	Surveys, reviews by others	SUPPORT: However, as mentioned previously, it is unclear what 'distinct services' will be considered for this indicator. Also see comments at first indicator for this criterion and Attachment 5 section C.
9.6 MOVED INDICATOR: Availability, cost and quality of information on fees and investment risks at product level* (input)	Trend analysis; qualitative	Surveys' industry data	<p>MOVED FROM CRITERION #11: We accept this indicator is relevant to addressing an amended criterion #9 but feel it should include information on investment returns as well as risks –these cannot be considered in isolation. As noted previously, this indicator will also need to be subdivided by product and by industry segment.</p> <p>We note there seems to be some duplication between this indicator and Indicator 9.5 'Transparency and efficacy of fee and product risk disclosure by funds, including for distinct services (behaviour)' (as amended). Therefore, we would expect the Commission to address both indicators in the one survey or request for industry data.</p>
9.7 MOVED INDICATOR: Comparability of insurance product information disclosed by funds* (input)	Qualitative	Surveys, case studies	MOVED FROM CRITERION #11: However we note that disparity in insurance product disclosures may reflect the different types of insurance on offer and not the absence of competition on non-price dimensions.

9.8 MOVED INDICATOR: Introduction of new retirement products and development of more tailored default products* (output)	Trend analysis Qualitative	Surveys Industry data	MOVED FROM CRITERION #12: We agree innovation in product offerings is a good indicator of competition between providers. However we caution that too much tailoring of default products can lead to inefficiency through greater cost and complexity. The introduction of new retirement products is also limited by legislation.
9.9 MERCER ADDED INDICATOR: Introduction of new services and improvement in quality of existing services (output)	Trend analysis Qualitative	Surveys Industry data	Innovation in service offerings as well as products is a good indicator of competition between providers.
9.10 MERCER ADDED INDICATOR: Constraints on innovation presented by administrative and legal restraints	Qualitative	Surveys	This indicator would assess industry perceptions of the ease/ efficiency of pursuing innovation. How responsive is Government to industry demands for example? How flexible are regulatory settings to accommodate innovation?

10. Are economies of scale utilised and the benefits passed through to members?			
10.1 Unused scale economies at wholesale level (administration and investment management) and at retail level (output)	Econometrics	Regulatory data, industry data	DELETE: Unless this indicator can be reliably measured, which seems doubtful, we recommend it be deleted.
10.2 Effectiveness of scale test (number of fund consolidations and magnitude of realised benefits) (output)	Trend analysis, qualitative	Regulator data	DELETE: Consolidations may or may not be due to the scale test.
10.3 Mergers prevented by bulk transfer rules (behaviour)	Trend analysis; qualitative	Surveys; case studies	SUPPORT: As noted above, problem areas are under consideration by APRA. If these are suitably addressed this indicator could be removed. Capital gains rollover rules should also be considered
10.4 Pass through of benefits from scale economies (wholesale and retail) to members* (output)	Econometrics	Industry data	DELETE: The Commission will examine 'improvements in service quality', 'diversification' from growing scale and size of fees under separate indicators of this criterion. Given those separate assessments, and our concern at the imposts for industry of excessive data requests and surveys, we do not consider it necessary to source this 'industry data' of whether benefits are passed through from scale economies. Furthermore, we believe that longitudinal data is unhelpful due to the many legislative and other changes imposed on the industry during the last ten years
10.5 Improvements in service quality in administration due to growing scale (output)	Qualitative	Surveys	SUPPORT: We believe there is strong evidence of fund administrators using scale to improve the quality and scope of member services.

10.6 Increased diversification due to growing scale (input)	Econometrics	Regulator data, industry data	SUPPORT: We believe there is ample evidence of funds using scale to enable them to further diversify their investments where this risk/reward value proposition is strong.
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11. Do Funds compete on relevant non-price dimensions?

NOTE: Mercer recommends this criterion be amalgamated with criterion #9 – refer Attachment 2. We have therefore recommended specified indicators be moved from here to criterion #9.

11.1 Fund marketing expenditure (size, composition and share of operating expenses) (input)	Trend analysis	Surveys	<p>DELETE: As mentioned earlier concerning the expenditure on member retention, marketing expenditure comes in many forms ranging from general brand recognition (say from a retail provider) to expenditure relating to a specific activity or promotion for a limited time period. Marketing expenditure can also be related to particular government announcements or an external event (such as the GFC).</p> <p>We consider this indicator is too broad to be relevant to this criterion. The fact a fund spends comparatively more on marketing could reflect characteristics specific to it (i.e. more investment options, greater member numbers/need for education) rather than unnecessary expenditure on non-price dimensions.</p>
11.2 Information collection by funds on key member characteristics* (input)	Qualitative	Surveys Case studies	DELETE. See comments on indicator 1.7
11.3 Availability, cost and quality of information on fees and investment risks at product level* (input)	Trend analysis Qualitative	Surveys Industry data	Moved to revised criterion #9 assessment.
11.4 Comparability of insurance product information disclosed by funds* (input)	Qualitative	Surveys Case studies	Moved to revised criterion #9 assessment.

11.5 Member awareness of key features of their superannuation (including insurance* (input)	Trend analysis Qualitative	Surveys	Moved to revised criterion #9 assessment.
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12. Is there innovation and quality improvement in the system?

Note: Mercer recommends deletion of this criterion and that innovation and quality improvement indicators be included in criterion #6, #9 and #13 – refer Attachment 2

12.1 Declining number of products over time (accumulation) (output)	Trend analysis	Regulator data	DELETE: This seems to be a very poor indicator. For example, the introduction of life-cycle products would rate a negative on this measure, yet represent a major innovation and quality improvement.
12.2 Introduction of new retirement products and development of more tailored default products* (output)	Trend analysis Qualitative	Surveys Industry data	Moved to criterion #6, #9 and #13 assessments.

13. Are outcomes improving at the system level?			
13.1 Growing voluntary consumption of superannuation services (investment, retirement products, advice, insurance) (output)	Trend analysis	Regulator data	<p>DELETE: We do not agree growing consumption of particular services is necessarily indicative of system improvement. For example:</p> <ul style="list-style-type: none"> • as the superannuation guarantee (SG) rate increases, voluntary contributions would be expected to reduce; which would not necessarily indicate deterioration in the system; • voluntary contributions are also affected by changes in contribution caps or other tax changes • the introduction of robo-advice is likely to have a significant impact on the rate of take-up of other forms of advice • lower take-up of investment choice may indicate greater satisfaction with default products (e.g. life-cycle option are expected to reduce the need for members to exercise choice as they age)
13.2 Member satisfaction and trust* (trust)	Trend analysis	Surveys	<p>QUALIFIED SUPPORT: Whilst it seems reasonable that system improvement should result in improved member satisfaction and trust, as noted earlier, experience indicates that member satisfaction and trust at any time are greatly influenced by recent investment performance. Regulatory changes also have a significant impact on member trust. Furthermore member expectations tend to rise over</p>

			time It will be challenging to separate out these influences and obtain an objective assessment of system improvement.
13.3 MOVED CRITERION: Introduction of new retirement products and development of more tailored default products* (output)	Trend analysis Qualitative	Surveys Industry data	MOVED FROM CRITERION #12 We suggest innovation in product offerings is a good indicator of system improvement. However we caution that too much tailoring of default products can lead to inefficiency through greater cost and complexity.
13.4 MERCER ADDED INDICATOR: Introduction of new services and improvement in quality of existing services (output)	Trend analysis Qualitative	Surveys Industry data	Innovation in service offerings as well as products is a good indicator of system improvement.
13.5 MERCER ADDED INDICATOR: Constraints on innovation presented by administrative and legal restraints	Qualitative	Surveys	This indicator would assess industry perceptions on the ease/ efficiency of pursuing reforms to improve the system. For example, how responsive is Government to industry demands? How flexible are regulatory settings to accommodate innovation?

EFFICIENCY			
14. Are net investment returns being maximised over the long term, taking account of service features provided to members?			
14.1 Long term (5, 10 and 20 year) historical net returns from the system and market segments compared to benchmarks (output)	Trend analysis	Regulator data Industry data	QUALIFIED SUPPORT: We note these indicators do not include anything reflecting service features, so do not assess this aspect of the criterion. See comments in Attachment 5 section A.
14.2 Long term (5, 10 and 20 year) historical net returns to specific asset classes at system level compared to asset class benchmarks (output)	Trend analysis	Industry data	QUALIFIED SUPPORT: Data limitations will make this task difficult. See comments in Attachment 5 section A.
14.3 Dispersion of funds and products from a frontier of best-performing funds and products (based on historical long-term net returns) (output)	Econometrics	Regulator data Industry data	DELETE: We recommend deletion of this indicator as we do not believe it will provide robust results over a sufficiently long period.

15. Are costs incurred by funds and fees charged to members being minimised, taking account of service features provided to members?			
15.1 Investment costs and fees across equivalent products and between market segments (input, output)	Trend analysis	Regulator data, industry data	QUALIFIED SUPPORT: As indicated earlier, we strongly believe that net outcomes to members are much more important than a focus solely on costs and fees. See further comments in Attachment 5 section A.
15.2 Investment management fees by asset class compared to other countries* (output)	Trend analysis	Industry data	SUPPORT: However care will be required to understand what fees/costs are included and not included in international data vs Australian data. Tax considerations also add an extra dimension in Australia that is absent in most other countries.
15.3 Relationship between investment fees and returns (output)	Econometrics	Regulator data, industry data	SUPPORT: See comments in Attachment 5 section A.
15.4 Use and disclosure of performance attribution by funds (behaviour)	Qualitative	Surveys, case studies	<p>QUALIFIED SUPPORT: Reporting of attribution analysis at the institutional level is relatively standard in internal publications, but in our experience it is not routinely reported externally. In part, this reflects concerns that reporting of shorter term attribution analysis may be incorrectly interpreted, most particularly because of a lack of understanding of attribution analysis, and due to the risk of short termism in interpreting investment returns. At the retail level there is very little reporting of attribution analysis, for the same reasons.</p> <p>As attribution analysis simply breaks down the total return into asset allocation and manager selection, it is not clear to us that attribution analysis adds much to the debate about system wide efficiency.</p>

15.5 Administrative costs and fees at system level and for market segments (input, output)	Trend analysis	Regulator data, industry data	QUALIFIED SUPPORT: Comparisons need to take account of differences in the service offering.
15.6 Cost savings from SuperStream (output)	Trend analysis	Regulator data Employer surveys	QUALIFIED SUPPORT: We are not sure what will be gained by having this as a separate indicator, particularly given that SuperStream is still in transitional phase. In our assessment, the large investment by funds and administrators in SuperStream to date will have outweighed efficiency gains, with the payback expected to emerge in future years as various stages of SuperStream are implemented and depending on matters such as the speed and level of take up of SuperStream by small employers. If the Commission intends to look at efficiency of the super system for employers, employer surveys could be added as an evidential source.
15.7 Relationship between level of administrative fees and quality of member services (output)	Qualitative	Surveys, case studies	SUPPORT
15.8 Costs relative to assets and member base wholesale (by service) and retail (by segment)* (input)	Trend analysis	Regulator data; industry data	QUALIFIED SUPPORT: Comparisons need to take account of differences in the service offering (including investments).
15.9 Margins wholesale (by service) and retail (by segment)* (output)	Trend analysis	Regulator data; industry data	DELETE: As noted earlier, it seems highly unlikely the Commission will be able to obtain this data and a reasonable level of profit is necessary for a healthy and sustainable industry.

15.10 Pass through of benefits from scale economies (wholesale and retail) to members* (output)	Econometrics	Industry data	DELETE: Having regard to the limited insights likely to be derived from this Indicator and the significant costs for industry of compiling the data, we consider it should be omitted.
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16. Do all types of funds have opportunities to invest efficiently in upstream capital markets?			
16.1 Asset allocation in SMSFs compared to institutional funds (input)	Trend analysis	Regulator data	SUPPORT
16.2 Retail investment management costs compared to wholesale (input)	Trend analysis	Industry data	SUPPORT
16.3 Minimum transaction values (input)	Trend analysis	Industry data	SUPPORT

17. Is the system effectively managing tax for members, including in transition? <i>Note: Mercer queries whether the effective management of members' tax is an aspect of the system that warrants a specific criterion for this review.</i>			
17.1 Use of tax strategies by funds for members in transition (input)	Qualitative	Case studies	DELETE: We query whether it is productive for the Commission to be examining the system at this level of detail.
17.2 Average effective tax rates across market segments (output)	Trend analysis	Industry data	DELETE: This is a very blunt and likely ambiguous comparison tool. Effective tax rates will depend on various features such as investment strategy (including asset allocation and active vs passive management style), the proportion of assets in pension phase, and the extent to which funds use tax-paid investment vehicles such as PSTs and life policies.
17.3 Tax advantages as a motivation for setting up an SMSF (input)	Qualitative	Surveys	SUPPORT: There is some value in considering this indicator and it could be included for assessment as part of the refined criterion that is outlined in the discussion of this criterion in Attachment 2.
17.4 Take-up rates of co-contributions and offsets (input)	Trend analysis	Regulator data	DELETE: Take-up rates are influenced by so many factors we don't see this as being a useful indicator.

18.1 Are member preferences and needs being met by minimising unpaid contributions and lost accounts?			
18.1.1 Unpaid Superannuation Guarantee contributions (input)	Trend analysis	Regulator data	SUPPORT
18.1.2 Delayed Superannuation Guarantee contributions (input)	Trend analysis	Regulator data	SUPPORT
18.1.3 Number and value of lost accounts (output)	Trend analysis	Regulator data	SUPPORT

18.2. Are member preferences and needs being met by funds collecting relevant information to ensure their product offerings are suitable for their diverse member bases?			
Note: <i>Mercer recommends this criterion be deleted – refer Attachment 2. We do not think its proposed indicators merit assessment under another criterion.</i>			
18.2.1 Information collection by funds on key member characteristics* (input)	Qualitative	Surveys case studies	DELETE – see comments on indicator 1.7.
18.2.2 Response rates to funds' member surveys (behaviour)	Trend analysis	Surveys; Industry data	DELETE: Response rates to member surveys" is a problematic indicator for a criterion that measures funds' responsiveness. Response rates may be affected by a range of factors outside the control of funds such as financial literacy, interest and private attitudes to surveys.

18.3. Are member preferences and needs being met by the system providing high-quality information and financial advice to members to help them make decisions?			
18.3.1 Availability, cost and quality of information on fees and investment risks at product level* (input)	Trend analysis; qualitative	Surveys Industry data	<p>QUALIFIED SUPPORT: We feel this criterion should assess information on investment returns as well as risks. Also, why are insurance arrangements not relevant (admittedly these are more complex and not included in product dashboards)? We presume the Commission will source this data from publicly available information, such as fund websites.</p>
18.3.2 Members acting on intrafund financial advice (behaviour)	Trend analysis	Surveys	<p>QUALIFIED SUPPORT: We note that members may be satisfied with their current arrangements after receiving intra-fund advice, which would not be accounted for by this indicator. Also it must be recognised that the behaviour of members will be influenced by many factors including their age, balance and education as well as external economic events. Hence comparisons between funds or over time are problematic.</p> <p>Furthermore members want to access a range of financial advice of different levels of scope and complexity at different times. Consideration should be given to adding an indicator to assess whether a fund member can efficiently access the level of advice they need each time they need something different.</p>
18.3.3 Member account monitoring activity (use of websites, call centre enquiries)* (input behaviour)	Trend analysis	Surveys Industry data	SUPPORT

18.3.4 Cost of funds' member engagement activities (input)	Trend analysis	Surveys	DELETE: The merits of this indicator for this criterion are not obvious. High expenditure on member engagement activities does not necessarily translate as "high quality information and financial advice". Survey responses on the quality of information about fees etc. (i.e. the first indicator) would seem a better indicator for this criterion rather than raw expenditure. We therefore recommend deleting this Indicator.
18.3.5 Take-up rates of co-contributions and offsets (input)	Trend analysis	Regulator data	DELETE: We recommend deletion of this indicator as the level of voluntary contributions is influenced by many factors, including those external to the industry.

18.4. Are member preferences and needs being met by the system providing products and information to help members optimally consume their retirement incomes?			
18.4.1 Introduction of new retirement income products and development of more tailored default products* (output)	Trend analysis; Qualitative	Surveys Industry data	QUALIFIED SUPPORT: It should be recognised that under current legislation there is not a default retirement income product, not is it proposed that there will be in future (CIPRs are expected to be opt-in products).
18.4.2 Take up of different retirement income products (output)	Trend analysis	Surveys Regulator data	<p>SUPPORT: We suggest that the assessment for this indicator should examine the extent to which retirees choose income products offered by their growth-phase fund, as this would seem to be more efficient than switching to another fund's product.</p> <p>Segmentation of retirement products for this indicator should include those offering (i) longevity guarantees or protection and (ii) investment return guarantees or protection.</p>
18.4.3 Drawdown rates in transition and retirement phases (output)	Trend analysis	Regulator data	<p>QUALIFIED SUPPORT: It should be recognised that the drawdown rates are influenced by many factors external to the industry such as tax rates, the age pension means tests, change to Government rules as occurred during the GFC, fear of exhausting savings before death etc.</p> <p>We suggest the fact so many withdraw at minimum rates and live on more frugal an income than may be</p>

			necessary is a measure of inefficiency.
18.4.4 Unclaimed superannuation (output)	Trend analysis	Regulator data	SUPPORT

18.5 Are member preferences and needs being met by member balances being allocated in line with their risk preferences and needs?			
18.5.1 Introduction of new retirement income products and development of more tailored default products* (output)	Trend analysis	Surveys; regulator data	SUPPORT
18.5.2 Asset allocations by age cohort (across different market segments and products) (output)	Trend analysis	Industry data Regulator data	QUALIFIED SUPPORT: We think this is only relevant to default investments as other balances are clearly allocated in line with member preferences.
18.5.3 Member awareness of investment sequencing and longevity risk (input)	Qualitative	Surveys	SUPPORT

19. Is the system using lessons from behavioural finance to design products and ‘lean’ against well-known biases in how people make decisions?

Note: Mercer recommends deletion of this criterion and its indicator – refer Attachment 2.

19.1 Funds’ application of the lessons from behavioural finance to design products, the effectiveness of fund strategies and whether lessons are being transmitted to other parts of the system (behaviour, output)	Qualitative	Case studies	DELETE
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20. Are trustees acting in the best interests of members?			
Note: Mercer recommends deletion of this criterion and its indicators – refer Attachment 2			
20.1 Existing ratings of system wide quality of governance* (input)	Qualitative	Reviews by others	DELETE
20.2 Accurate disclosure of trustee directors' and investment committee members' qualifications and relevant skills/experience, remuneration structures, and potential conflicts of interest due to related party dealings and competing duties* (behaviour)	Qualitative	Reviews by others	DELETE
20.3 Contraventions of regulator governance standards by trustees, employers, service providers and financial advisers* (behaviour)	Qualitative	Regulator data	DELETE
20.4 Level of skills and standard of performance for trustee boards and investment committees, including review processes* (input)	Qualitative	Surveys, Reviews by others	DELETE
20.5 Member satisfaction and trust* (outcome)	Trend analysis	Surveys	DELETE.

21. Are there material systemic risks in the superannuation system?			
21.1 Market concentration (Herfindahl Hirschman Index and market shares of largest providers) in upstream service provider markets (input)	Trend analysis	Industry data Regulator data	SUPPORT
21.2 Levels of leverage in SMSFs (input)	Trend analysis	Regulator data	SUPPORT

22. Do funds offer insurance products that meet members' needs?			
Note: Mercer recommends this criterion be amended to another criterion – refer Attachment 2			
22.1 Duplicate insurance policies by insurance type (output)	Trend analysis	Surveys	SUPPORT: However we note survey results will be affected by member awareness, as well as the products offered by each fund. It may also be worth considering a comparison of the total number of accounts with insurance cover (based on regulator data) with an estimate of the number of individuals under age 65 (say) with superannuation (though cover in more than one fund will be intentional in a limited number of cases).
22.2 Rates of insurance take up in choice products and SMSFs relative to default products (output)	Trend analysis	Surveys Regulator data	QUALIFIED SUPPORT: Those in choice products and SMSFs may have cover in default products. Rates of take up of tailored cover by default members would also be a useful indicator of the suitability of the optional cover arrangements.
22.3 Member awareness of key features of their superannuation, including insurance* (input)	Trend analysis; qualitative	Surveys	SUPPORT: However we note that non-awareness of key features could reflect poor financial literacy or other incapacity of the member rather than the fact the fund does not provide insurance products that meet member needs.
22.4 Level of unclaimed insurance (output)	Trend analysis	Surveys	DELETE: Unclaimed death benefits will be very low and there is no way of determining unclaimed disability benefits.
22.5 Ease of members opting out of insurance (input)	Qualitative	Surveys	SUPPORT

22.6 Time to respond to members compared to retail provider benchmarks (input)	Trend analysis	Surveys Industry data	SUPPORT
22.7 Information collection by funds on key member characteristics* (input)	Qualitative	Surveys Case studies	DELETE – see comments on indicator 1.7
22.8 Use of member information by funds to target insurance products (input)	Qualitative	Surveys Case studies	SUPPORT
22.9 Comparability of insurance product information disclosed by funds* (input)	Qualitative	Surveys Case studies	SUPPORT: However we note that disparity in insurance product disclosures may reflect the different types of insurance on offer, as well as differences in membership composition or target market.
22.10 MERCER ADDED INDICATOR: Average insurance cover by age band (output)	Trend analysis	Industry data	This measure could be used as a broad indicator to assess the suitability of insurance cover design to member needs. However, if industry data is not readily available the use of member age in insurance product design could be assessed as part of Indicator 22.8.

23. Are the costs of insurance being minimised given the type and level of cover? <i>Note: Mercer recommends this criterion be refined – refer Attachment 2</i>			
23.1 Insurance premiums inside and outside of superannuation (output)	Trend analysis	Industry data	SUPPORT: It is presumed that the assessments of premium levels described in this indicator, and the following assessment of insurance expenses, will make appropriate allowances for the type and level of cover provided, as per the criterion.
23.2 Insurance expenses (incurred by funds) (input)	Trend analysis	Regulator data Surveys	QUALIFIED SUPPORT: This assessment will need to take into account the division of insurance product administration (e.g. underwriting and claims) between the fund and the insurer. Also, consideration is required both of insurance related costs incurred by funds that are passed on to insured members (via premium loadings) and those that are recouped by general administration fees.
23.3 Erosion of member balances due to insurance premiums (output)	Trend analysis	Industry data	DELETE: We suggest a better indicator could be average annual insurance cost as a percentage of annual superannuation guarantee contributions, or the average over a working career.
23.4 Ratio of claims to premium revenue (loss ratio) within superannuation over 5 and 10 year periods (output)	Trend analysis	Regulator data, industry data	REFINE: The proposed indicators imply that loss ratios can be calculated over 5 and 10 year periods without allowance for incurred but not reported (IBNR) claims. This is not feasible and would provide misleading results. We submit that loss ratios should be calculated including standardised estimates of IBNR claims.

23.5 Fee and premium differences from outsourcing insurance services to related versus unrelated parties (output)	Trend analysis	Regulator data, Surveys. Case studies	SUPPORT: In respect of insurance, valid comparisons will be difficult due to the differences in premiums which relate to the impact of different occupational risk profiles and claims histories of the insured members. Case studies may be needed in addition to surveys as an evidential source.
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Attachment 4: Information requests

The following section provides responses to some of the Information requests that the Commission made in its Draft Report.

Information sought

1. What other indicators do the industry and researchers use to assess member engagement? How could those indicators be applied in a system level assessment of competitiveness and efficiency?

Mercer response

In addition to the member engagement indicators that the Commission identified, Mercer also looks at the incidence of salary sacrificed superannuation contributions, extent of voluntary superannuation contributions, uptake of financial advice and number of members that nominate death benefit beneficiaries. We tend to view this information as critical measures of how engaged Mercer's customer base is and whether members are taking the steps necessary to plan for their financial futures.

2. What is the best way to measure the height of barriers to entry arising from the inability of prospective entrants to access the distribution channels available to incumbent funds, including through being afforded default status? Is there case study evidence of new entry being prevented by those barriers?

Mercer response

There have been very few new APRA regulated funds established in the last 10 years. Therefore we recommend the Commission discuss the impact of the current barriers and impediments with those funds which have been established during the last decade.

3. Is there any existing evidence on the effect of bulk transfer rules on mergers?

Mercer response

We strongly agree with the comments in the Draft Report concerning the effects of the bulk transfer rules on mergers. However it may be challenging to obtain industry data on failed consolidations as they tend not to be publicised.

4. What is the best outcome based indicator of effective competition in the superannuation system and why? To what extent could growth in voluntary consumption of superannuation services be an indicator for such assessment?

Mercer response

We do not agree that growing consumption of particular services is necessarily indicative of system improvement. Please refer to our further comments at indicator 13.1 in Attachment 3.

5. What reference portfolio should be used to benchmark long term net returns in the system and particular segments of the market?

Mercer response

We discuss two possible approaches below:

Typical default based:

- One option is given that 70% growth: 30% defensive allocations have been common default strategies over time, such a portfolio could be considered.
- A simple, passively-implemented mix of equities and bonds could be used for benchmarking purposes e.g. 35% Global Equities, 35% Australian equities, 30% Australian government bonds (more sophisticated portfolios, including alternatives, could, of course, be considered)
- Benefits: Simple to calculate, broadly representative of the historical profile of default options. With SG contributions increasing over time, such a reference portfolio should, on average, enable members to achieve a balance at retirement that has a reasonable chance to achieve an adequate and sustainable income in retirement.
- Drawbacks: Such a benchmark would only be valid for comparison against performance of funds/products with a similar risk profile. Even then, any reference portfolio will necessarily be somewhat subjective and other reasonable portfolios with similar expected risk/return profiles may have significantly higher or lower returns across any particular time period, depending on the actual asset class returns over that time period. There would also be some subjectivity in determining allowances for fees and tax rates.
- **Conclusion:** We do not support a 70/30 reference portfolio as an effective benchmark for the performance of the system (or a segment), as a like-for-like risk-return profile is essential for comparisons, even over long periods. At best it would provide a reference point from which learnings may emerge from seeking to understand the reasons for the differences between the theoretical benchmark and actual performance.

Outcome based objectives:

- Alternatively, an absolute benchmark could be considered which is more directly linked with the outcomes that members need or expect.
- This could be expressed in Cash + or CPI + terms given that this provides a solid base comparison in terms of what member would expect to achieve (i.e. the risk-free return (Cash) or maintain real value (CPI)).

- Given common practice in super, CPI would be more relevant for members over their lifetime as ultimately they need to spend their savings in retirement. CPI is a better measure from that perspective than Cash.
- A simple, reference target within the range of CPI + 2.5% to CPI + 4.5% (assuming accumulation phase and after investment and administration fees) would be reasonable to capture the generally accepted risk-profile that most investors can accept over the accumulation life-cycle.
- By converting the above range into absolute returns, we can determine reasonable reference portfolios. For example, we would need simple portfolios that are expected to achieve an absolute return of 5% to 7% p.a. over time, assuming CPI of 2.5% p.a.
- A passively-implemented mix of equities and bonds could be used for benchmarking purposes. Something like 25% Global Equities, 25% Australian equities, 50% Australian government bonds could be used for the bottom end of the above range. Something like 35% Global Equities, 35% Australian equities, 30% Australian government bonds could be used for the top end of the above range.
- Benefits: Simple to calculate. Such reference portfolios are more directly linked with the outcomes that members need or expect over time.
- Drawbacks: The CPI + component is subjective and, as it is static, it does not reflect a change in members' risk profiles over time. Also see the comments above for a 70/30 reference portfolio.
- **Conclusion:** A range of reference portfolios would enable greater matching of the risk profile with the segment being considered. However for the same reasons as above, we do not support the use of reference portfolios as an effective benchmark for the performance of the system (or a segment).

Notwithstanding the possible value of benchmark or reference portfolios, we wish to stress the limited value of any benchmarking for the industry as the needs and preferences of members vary greatly. For example, some members may wish to obtain an absolute return (say 6% p.a.) and not be concerned with benchmarking whilst other members may be concerned with a performance relative to CPI, wages or a particular asset class. Furthermore, the appropriate benchmark or objective will normally change during an individual's lifetime.

6. What other benchmarks should be used to supplement the analysis? If a CPI + X benchmark was used what is the appropriate level of 'X'?

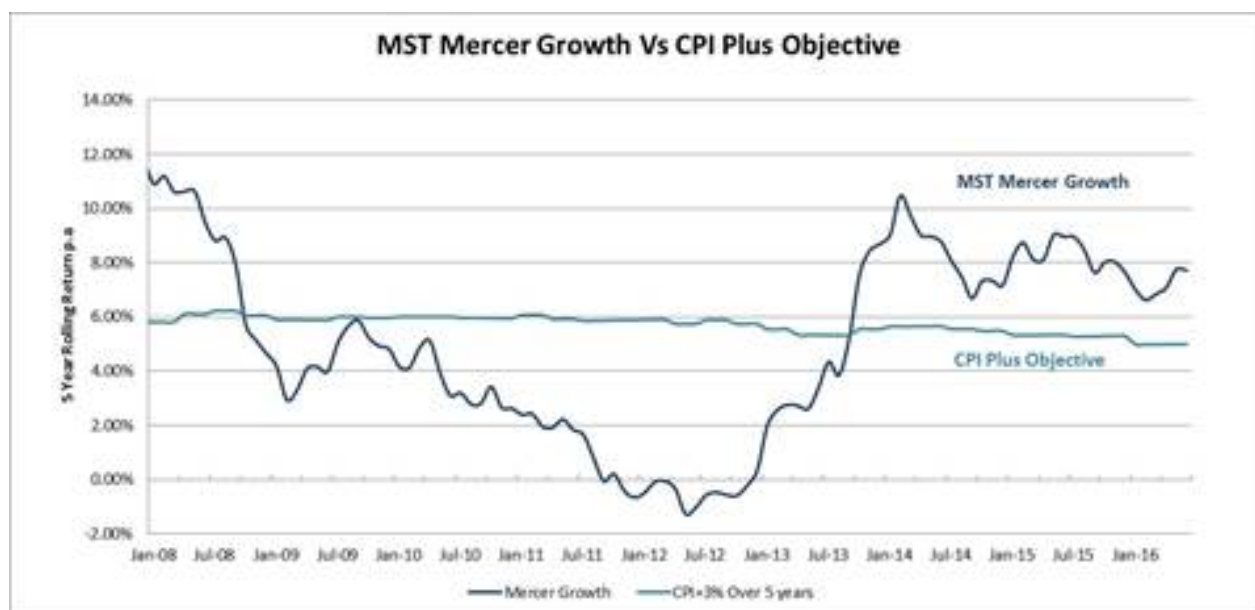
Mercer response

We support the use of a 'CPI + X' benchmark for diversified portfolios (particularly MySuper portfolios) as it is consistent with how investment return objectives are expressed and the need to provide positive real returns on member balances.

However we note that how easy or difficult it is to achieve such an objective will largely depend on the investment environment over the period measured e.g. based on ASFA Investment Group calculations (Superfunds Magazine September 2016), average fund returns over 20 year periods ending 30 June 1982 to 30 June 2016 exceeded CPI by margins ranging from 2.4% pa (1984) to 8.4% pa (1999).

As these figures illustrate, performance is very variable around a CPI+ objective over time, largely dependent on equity market returns. For example, post GFC, the performance over 5 years for

many growth-oriented portfolios ran well below the objective for a period, as illustrated by the example in the following chart below.



Hence the return in excess of CPI does not provide a reliable indication of whether or not returns are being optimized for the level of risk undertaken.

We would also highlight that the current economic and investment environment is very different from the last 20 years. Hence performance over the last decade is very unlikely to be repeated in the next decade, even if expressed as a real return.

7. What data would be required to calculate the net returns (net of fees and taxes) to specific asset classes within or across the superannuation system? How could such data be obtained?

Mercer response

- The actual returns achieved by super funds for specific asset classes can be averaged and used where available. This would be hard to come by in disaggregated form over time as funds do not tend to report on individual asset classes only.
- Applying the benchmarks returns discussed in Mercer's response above could be considered as a proxy, using the average asset allocations over time. The index information can be obtained from the index providers or data provision services e.g. Bloomberg, Datastream. The average asset allocations can be obtained from APRA based on disclosures, or alternatively from providers such as Mercer, ChantWest or SuperRatings.
- To calculate the net of fee component, an average of the disclosed management expense ratios (MERs) as per the product disclosure statement (PDS) documents for funds can be used as an estimate. Again, this might be hard to obtain at the disaggregated asset class

level. Reasonable asset class fee estimates could be sourced from asset consultants such as Mercer who have insights across the full range of asset classes and investment managers.

- In terms of taxes, reasonable estimates could be used based on the current tax regimes in place for domestic and overseas asset classes. For example, the 15% tax rate for super could be converted into a reference franking credit proxy for the pick-up super funds can expect on Australian equities. Such estimates can be obtained from asset consultants, fund managers or accounting firms. For overseas based withholding taxes, fund managers or accounting firms might be the first port of call.

8. How do funds do their internal performance attribution analysis (for example, to what extent is performance attributed to strategic asset allocation, dynamic asset allocation or the individual asset manager)? Are the results consistently reported and made public? What implications can be drawn from performance attribution for the measurement of system wide efficiency in this study?

Mercer response

In Mercer's experience, across both investment consulting and investment management businesses, it is standard practice at the institutional level for attribution analysis of investment returns as described to be calculated and utilised to understand the drivers of investment performance. This type of analysis assists in analysing which aspects have contributed to or detracted from investment performance, and in making investment decisions. While care is needed in analysing performance over shorter time periods, it is nevertheless useful to know which parts have added to or detracted from returns. For example, while it may be the case that shorter term dynamic asset allocation positions may have detracted from performance, if the view on that asset class remains strong, a position would be retained despite the recent negative performance impact.

Reporting of attribution analysis at the institutional level is relatively standard in internal publications but in our experience, it is not routinely reported externally. In part this reflects concerns that reporting of shorter term attribution analysis may be incorrectly interpreted, most particularly because of a lack of understanding of attribution analysis, and due to the risk of short termism in interpreting investment returns. At the retail level there is very little reporting of attribution analysis for the same reasons.

As attribution analysis simply breaks down the total return into asset allocation and manager selection, it is not clear to us that attribution analysis adds much to the debate about system wide efficiency.

9. Are there benchmarks for optimal asset allocation by age cohort? Do these benchmarks have widespread support in the financial literature?

Mercer response

In short, we believe the answer is no as the local legislative requirements in each country affects the optimal asset allocation by age. For instance, where annuities are required to be purchased (as occurs in some countries), the asset allocation approaching retirement must be different from

the Australian context. A range of approaches have been taken by Australian funds implementing life-cycle products. A detailed analysis of MySuper lifecycle products is included in Mercer's May 2016 [MySuper Market Trends Update](#), which includes findings such as:

- Lifecycle products are 25% of MySuper products, representing approximately \$145 billion or 32% of total MySuper Assets.
- Clear divergence of lifecycle implementation approaches, with Industry Funds in general opting for member switching, while Retail Funds favour cohort approaches.

Other factors that could reasonably influence the asset allocation include the member's balance and the adequacy of their projected retirement income.

10. Do regulators significantly influence the scope for dynamic efficiency? How can this be measured and assessed?

Mercer response

There are two key ways in which regulators significantly influence the scope for dynamic efficiency in the superannuation system:

- First, the need for funds to allocate management time, key skilled resources and substantial budgets to amend systems, procedures, fund communications and other items to accommodate ongoing regulatory or tax changes has a substantial impact on their ability to devote resources to process and product improvement and innovation.
- Second, the regulatory framework also constrains the ability to innovate. For example, the ability to use digital media to meet various disclosure requirements is only slowly being enabled by government regulation. Further, restrictive regulations relating to retirement income stream products mean that Mercer's innovative Lifetime Plus group self-annuitisation product is currently only available as an investment option within an account-based pension, as it does not meet the requirements to be a standalone pension product.

A possible way to measure regulators' impact on dynamic efficiency would be to survey funds on regulatory impediments to efficiency and innovation

11. What is the aggregate size and number of corporate tenders run each year, and what proportion of the system is accounted for by funds selected through this mechanism? How reliable are the APRA data on corporate fee discounts? Is there a more reliable source?

Mercer response

Regarding the first question, we suggest the Commission seek details from the key corporate tender managers. Regarding the second question, we note that APRA data on corporate fee discounts relates to MySuper members only, but this would generally be the bulk of members eligible for the discount.

Attachment 5: Other Comments

Section A: Are net investment returns being maximised over the long term, taking account of service features provided to members?

Mercer's view (taking into account our experience as both an asset consultant to many superannuation funds and our own investment products) is that the design of superannuation investment products in Australia is absolutely focused on the objective of delivering the optimal return for investors, taking account of the long term focus of superannuation and the risk preferences of investors. This is evidenced by the underlying strategic allocation work that underpins asset allocations, and the relationship to the stated investment objectives.

In Mercer's view, a further element to this is the adoption of life cycle approaches to investment for superannuation members, which:

- More closely matches the position of individual members (based on age, their time horizon to retirement);
- Provides for a more appropriate risk profile (high level of growth assets for those with longer time horizons, lower for those closer to or in retirement);
- Takes account of the risk of event risk as a member approaches retirement; and
- Tailors the asset allocation consistent with the above factors

For multi-sector options, assessment of investment performance after fees and taxes is both easily undertaken and desirable. In our experience this is standard practice among superannuation funds and is the approach adopted for industry surveys. Performance should be assessed over longer time periods (at least 5 years) and comparisons must be on a like-for like risk profile basis.

Assessment of single sector performance is more problematic, because standard industry benchmarks based on market indices (like the ASX300) do not exclude fees or transaction costs. For a fair comparison of single sector performance, manager performance needs to be assessed before fees, or there needs to be suitable adjustment to market indices for an average fee paid (using a median or average fee), or alternatively comparing against the return for a purely passive index fund return on after fees basis. As an index fund return includes transaction costs for rebalancing back to the benchmark this would be a more like-with-like comparison.

There are potential limitations inherent in the system, some of which are not unique to Australia, that impact any assessment of net investment returns. Those limitations are:

- The risk of short termism impacting on taking a suitably long term for investments. The prevalence of industry performance surveys, and the risk of taking too short term a focus on returns does increase the risk that inappropriate investment decisions may be made. This risk is global, not unique to Australia
- Within Australia, an overly strong focus on the level of investment management fees paid, rather than on the investment return after fees, increases the risk that sub-optimal decisions may be undertaken. In Mercer's view this risk is evident in Australia (see Mercer's second submission to the Issues Paper which preceded the Draft Report which included comments from a range of global investment managers on this issue), and appears to have increased in recent years (in part due to the stated intention of MySuper reforms to lower the cost to investors).
- Also, the excessive focus on absolute fees, rather than on net of fees outcomes, pushes funds towards lower cost outcomes. This could well be to the detriment of longer term performance, as higher cost investments are usually the ones that have lower correlation with equities (such as alternatives, hedge funds, unlisted property and infrastructure).

On the issue of dispersion of returns, care needs to be taken to ensure like-with-like comparisons are undertaken. In particular, the level of growth and defensive assets can vary widely, even within similar risk brackets. The impact of this divergence can be large over long periods. Any analysis of returns needs to adjust for the level of growth/defensive asset positioning.

Assessing whether net investment returns across the system are being maximised (or optimised) over the long-term will be challenging, as the Commission will need to consider (inter alia):

- the impact of differing asset allocations and returns by asset class over the relevant period (with the relative returns between asset classes often varying substantially over different periods);
- for the system and whole of fund returns, the effect of maturing of the system (with greater proportions of assets held by older members and pensioners) on asset allocations and effective tax rates;
- the effect of member preferences as to risk and service levels on asset allocations and fees;
- to what extent investment fees in excess of passive fees represent inefficiency or produce a net benefit in the way of higher returns (or it is reasonable to expect such a benefit); and
- the impact of MySuper and the continual strengthening of fee and cost disclosure rules on actual and disclosed fees and costs.

Comparisons of returns within a segment such as MySuper products will avoid some of the issues but accentuate others, such as the lack of long-term performance history for many MySuper products. In many cases, particularly for life-cycle products, there was no equivalent option whose pre-2014 track record can be used.

On the question about whether investment fees in excess of passive fees represent inefficiency or produce a net benefit in the way of higher returns, utilising our extensive database on investment returns, Mercer has undertaken analysis on the active vs passive manager issue, which has recently been updated, and we would be happy to share that with the Commission. In general, the ingredients for successful active managements can be summarised as:

- Breadth – a wide pool of investment opportunities;
- Insight – the availability of better information or better judgment over the available information; and

- Diversification – not being overly dependent on single sectors or securities.

These ex ante considerations can then be compared against ex post results in different sectors. Mercer's view is that the use of active management has a legitimate role to play in portfolios, but its use needs to be assessed in a sector needs to be determined on sector by sector basis.

Section B: Impact of fund choice on insurance

The Draft Report discusses allocative efficiency whereby well-informed members make decisions in their best interests. Where this involves members switching superannuation funds, it may inadvertently cause inefficiencies for insurance. Group insurance relies on members commencing cover under standard arrangements (i.e. immediately upon commencing employment and joining the fund, subject to a fairly basic definition of being "at work"). Where switching of funds occurs, there are generally conditions or exclusions attached to the insurance cover unless the member undergoes underwriting. This leads to inefficiencies in relation to insurance.

Section C: Lack of availability of comprehensive investment fee information

The Draft Report includes at page 95 some discussion of data quality and availability issues relating to fee information. One of the issues relevant here is that the APRA data on overall fund and MySuper investment fees paid only includes investment fees paid directly by funds and therefore understates the true level of investment fees incurred by funds. Indirect investment expenses (such as where a fund invests in a pooled superannuation trust or other pooled investment vehicle which deducts its fees from the pool rather than being paid directly by the super fund) are not included. Such indirect investment fees do not pass through the fund accounts so that some funds' financial statements will show zero investment fees as all investment costs are indirect.

Hence, to gain a better insight into overall fees/costs incurred for many funds it is necessary to refer to product disclosure statements (PDSs) which are required to disclose indirect costs as well as direct fees. However it will be impossible to calculate this at a system level or to identify the impact of changes in funds' investment structures (resulting in changes from direct to indirect investment fees or vice versa) on system level investment fees.

Furthermore, indirect costs in PDSs are not required to be split between investment related and non-investment related costs, resulting in lower transparency and making it more difficult to consider whether the investment fees and costs represent value for money taking into the asset allocation and investment approach (passive vs active).

Note this PDS issue also applies to some funds which, although they pay some or all investment fees directly, do not disclose these as a member investment fee in their PDS on the basis that they are not charged directly to members – again these are included in PDSs as indirect costs, not split between investment related and non-investment related costs.

These issues mean there are significant limitations with the usefulness of APRA system and fund level investment fee data and at product level with PDS information on investment fees and costs.

The Draft Report includes a table showing ‘Total member fees by fee type and fund type’ (Figure 2.4) based on APRA Annual Report information. This relates only to investment fees paid directly by funds and therefore understates the level of investment fees incurred by funds and members. We suggest there should be a footnote to this table disclosing that the investment fee information excludes indirect investment fees.

Finally we note that the strengthened requirements of Regulatory Guide 97 (applicable from 1 February 2017) in relation to indirect investment costs will result in some increase in indirect costs disclosed in PDSs. Such increases will not indicate an increase in the real costs of the system or lower efficiency.