Productivity Commission – Superannuation

Stage 3 Submission

July 2018

Comparing Apples with Apples.

About Chant West

Chant West is an independent superannuation research and consultancy firm established in 1997. We specialise in researching superannuation and pension funds, and are well known within the industry for our research capabilities and market commentary.

We publish our research in various forms, including CorporateSuper Research, PersonalSuper Research, Pension Research and, at the consumer level, our Super AppleCheck and Pension AppleCheck comparison tools. We publish regular performance and asset allocation surveys covering all the major public offer superannuation and pension products. We also publish a quarterly fee survey and a quarterly insurance premium survey.

Our research is used by many of Australia's leading superannuation providers and adviser groups. Over 7,000 financial advisers and eight million fund members have direct access to our research. The information we provide allows them to compare funds on an 'apples with apples' basis. We rate superannuation and pension funds and have developed a ratings methodology that considers investments, member services, fees, insurance and organization in determining the rating for each product.

Our research also feeds into our consulting work, which in turn provides us with a special insight into the workings of the industry. Over the past 20 years, we have advised many large and medium-sized employers on their superannuation arrangements, including options for outsourcing investment, administration and member services. We have also advised many super funds on their outsourcing arrangements – administration, asset consulting and implemented consulting. Through our research and consulting, we have an intimate knowledge of the Australian superannuation market, including all the key players, their operations and efficiency.

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1. Executive Summary

1.1 Overview

This report has been prepared by Chant West to provide feedback on the draft report of the Productivity Commission on superannuation. Overall, we are supportive of most of the report's recommendations.

We have provided below a summary of our main points in relation to the current system and the draft findings.

- The vast majority are not engaged with their super and rely on default arrangements
- MySuper members are effectively wholesale members and are well-diversified across asset classes and can access these portfolios at a relatively low cost
- Since 1992, the median fund has delivered with a real return of 5.8% pa which is 2.3% pa ahead of the return target. The return objective has been exceeded by both industry and retail funds
- While the majority of fund members have experienced a similar or better performance from the median, many have not and there has been a wide dispersion of investment returns for different funds over the past 10 years
- There is a performance differential between not-for-profit and retail funds, but a similar differential between large and small not-for-profit funds
- There are also significant differences in the level of services provided to members, with larger funds providing more sophisticated services to drive members to positive action
- Fees and costs are currently not disclosed by funds in a comparable way but we expect there will be some changes to the regime released shortly that will eventually lead to more comparable disclosure
- Any comparison of fees with other jurisdictions is highly problematic
- The main difference between fees for industry and retail funds is in administration fees.
- Employers are not best equipped to make decisions about their employee's superannuation
- There is very little consumer-led competition in the system
- The two main problems are unintended multiple accounts and the defaulting of some members into poor-performing funds

Our comments related to the information requests are as follows:

- The construction of the benchmark BP2 overstates the benchmark returns by between 0.45% and 0.75% pa, mainly due to tax assumptions and the property benchmark used
- Asset allocation and administration fees explain the difference in performance between industry and retail funds. There should be greater disclosure of how funds determine their growth/defensive split
- Lifecycle funds should be a part of MySuper and are the necessary building block towards personalised portfolios for each member

Our summary comments on the recommendations are as follows:

- There is a compelling logic to have a member's super fund follow them to their new employer
- Commencement of the first job is not the ideal time to choose a fund for life, but it will not work to default based on the industry of a first job, which is likely in hospitality or retail
- The system will work if there is genuine engagement through a centralised online service
- A 'best in show' list will direct members to very good funds
- Funds that are specialised for certain industries could be shown alongside these funds, or indeed the current defaults could be shown alongside these funds
- Choice will be the main game if the 'best in show' model is introduced and funds will need to do more on promotion, marketing and brand
- The online service could be extended to the myGov site and employees could be nudged by the government at certain milestones to reconsider their super fund
- An introduction of these changes in the near future may interfere with some key industry innovation, so the start of any assessment should be delayed until at least July 2020
- The expert panel will have a very difficult job to assess complex data sources that are difficult to quantify and require detail knowledge of the industry so will most likely need some expert input
- The MySuper test should be significantly strengthened by APRA based on its outcomes test

2. Overview of the system and how it has performed

2.1 Context

The Australian superannuation system is regarded by many keen observers, both domestically and around the world, as one of the best pension systems in the world in terms of delivering good retirement outcomes to fund members. Key policy decisions were made in the 1980s that made superannuation compulsory for most Australians from 1992 with the introduction of the Superannuation Guarantee, the rate of which has been increased from the original 3% of earnings to the current level of 9.5%. This has resulted in a superannuation system that now has total assets of about $2.6 trillion set aside to help individuals to supplement their income in retirement.

The system has a lot of strong points including wide coverage (especially when compared with other countries), a meaningful level of compulsory contributions, tax incentives to augment savings through super and to encourage additional voluntary contributions, and a trust structure that protects member benefits.

Defined contribution funds

The great majority of members are now in defined contribution products. This follows the sustained movement out of defined benefits over recent decades due to the uncertainty of employer obligations and the lack of flexibility in defined benefit funds. This has placed members in arrangements where they now have the control but also now bear the risk of their super savings not meeting their needs.

For this reason, it should be critical that these members are properly equipped to understand the decisions they can make that will affect their retirement outcomes, especially in terms of fund selection, investment option selection and contribution levels. Members should be making informed decisions on these issues, targeting a retirement income that meets their needs in a way that mitigates some of the risks that may arise. However, very few members are in this situation. The **vast majority are not engaged with their super and rely on default arrangements** to determine their fund, investment option and contribution levels.

In order for the superannuation system to deliver on its objective of providing an income in retirement that substitutes or supplements the Age Pension, and doing this in an efficient way, it is critical that the default process allocates members to superannuation funds, and investment options in those funds, that lead to satisfactory outcomes. The default contribution level also needs to lead to a decent retirement income, as most members will not voluntarily contribute anything more.

Types of products

Most working Australians are either in a not-for-profit fund (ie an industry fund, public sector fund or stand-alone corporate fund) or a commercial fund provided by a retail institution. Many of those retail fund members are housed in corporate master trusts, which are discrete products that have been tailored to particular employers. These provide significant discounts to the standard retail fees together with tailored default insurance cover and premiums.

More than 95% of members are in defined contribution funds, most of which have a mix of ‘choice members’ and ‘MySuper members’. Choice members are those who have actively selected the fund, either on their own or with their adviser, and typically have either chosen their investment option or constructed a diversified portfolio with a mix of managed investments and direct holdings. MySuper members, on the other hand, have generally been defaulted into the fund where they are invested in a single, pre-mixed investment option. In not-for-profit funds, the administration fees for MySuper and choice members are broadly similar, but in retail funds the administration fees for choice members are generally higher than for MySuper members (sometimes much higher), partly due to the greater complexity of these choice products but also due to the profit component.

When we are considering the competitiveness and efficiency of the superannuation system we need to be clear what segment we are talking about. There are very different market dynamics operating in MySuper and choice, and we need to be careful about combining data from the two segments to create ‘industry averages’ and draw conclusions about the competitiveness and efficiency of the default superannuation system. Most MySuper members have not chosen their fund but were defaulted into it, so there is a greater imperative to ensure that these default funds are of a high enough quality and represent good value to them. There is also a need, however, to ensure that the choice route is also providing good outcomes for those members, especially considering the tax concessions that superannuation enjoys.

2.2 Most members of super funds are effectively wholesale investors

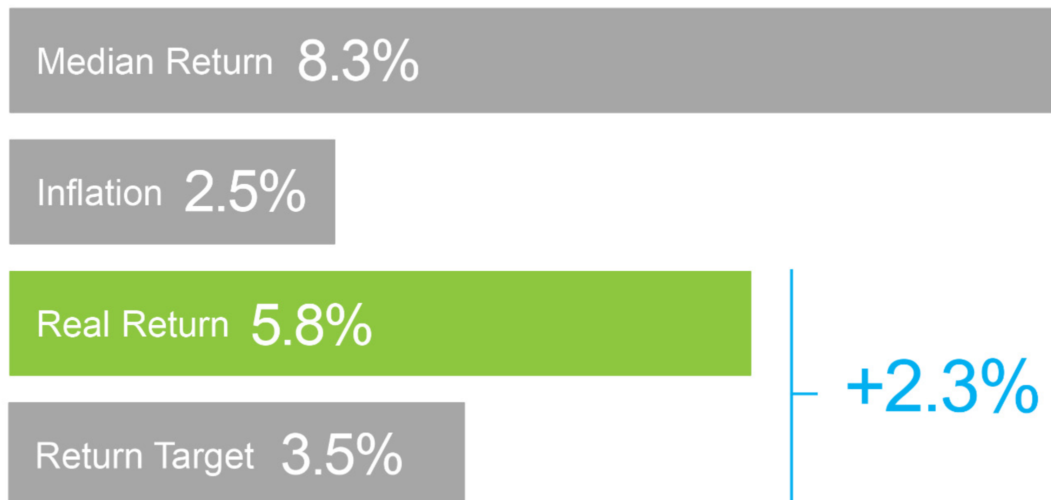
An important point to note about the Australian superannuation system is that **MySuper members**, especially those of medium and large funds, **are all effectively wholesale investors**. No matter how large or small their account balance, they all pay the same investment fee in percentage terms. That percentage fee is, of course, based on the fund's overall size, which is why the scale of each fund is so important. In the case of AustralianSuper, for example, members' investment fees are based on assets of about $140 billion, regardless of whether their account balance is $10,000, $100,000 or $1 million. For example, large funds can access core active Australian shares for about 20 basis points.

MySuper products are typically **well-diversified across all the main asset classes**. Most of them invest with several fund managers in most asset classes. Those managers are chosen for their investment ability and how they blend with other managers in the portfolio. We refer to this as 'multi-manager' investing. This approach is more expensive than a purely passive investment approach that only invests in traditional asset classes and only through market-indexed vehicles, but it leads to much better diversified portfolios. These multi-asset, multi-manager portfolios are less impacted by the vagaries of listed investment markets and allow investment in sectors such as unlisted property and infrastructure that can provide long-term income streams that are well-suited to the needs of superannuation fund members. And most importantly, since MySuper members are effectively wholesale investors, they can access these sophisticated portfolios at relatively low cost.

2.3 How has the system performed?

In terms of investment performance, the system has done well by members, at least on average. Chart 1 shows the median return for the multi-manager options of superannuation funds with 61-80% growth assets since the commencement of compulsory superannuation in 1992. Performance over that 26 year period has been very strong, **with a real return of 5.8% pa which is 2.3% pa ahead of the return target** for this type of fund. In terms of investment performance, therefore, **the system has exceeded expectations**.

Chart 1: Net Investment Returns from 1 July 1992 to 30 June 2018 (61-80% growth assets)



To demonstrate that this result is not reliant on the end-point chosen, Chart 2 compares the growth fund median (61-80% growth assets) with the average return objective of CPI plus 3.5% per annum over rolling five year periods, after investment fees and tax. **Clearly, funds have exceeded their objectives over all periods other than during the GFC and the tech wreck** of the early 2000s. The strong performance of funds relative to their objectives has been persistent, only interrupted by major market shocks.

Chart 2: Growth options – Rolling 5 year Performance (% pa)

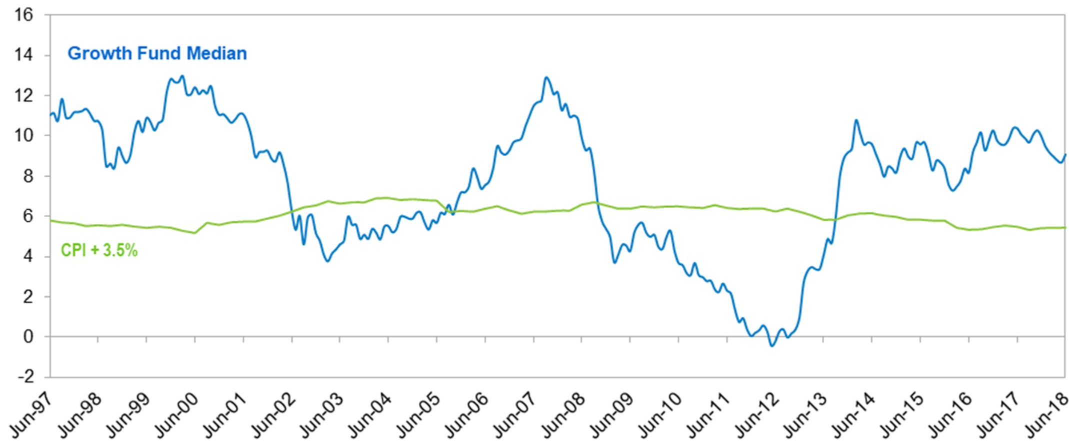


Chart 3 shows the annualised return on a contribution made at the end of each month over the past 20 years, from the date of each contribution to June 2018, for both not-for-profit and retail funds. Once again it shows that members have, on average, been **well served by their superannuation funds that have added significant value to their superannuation savings,** that will improve their income in retirement. **This is the case for both not-for-profit and retail funds**. This finding is very important as workers need to be able to see the benefit that has been added to their enforced savings in superannuation.

Chart 3: Investment return on contributions made at each date to June 2018 (% pa)

3. Assessment of key findings

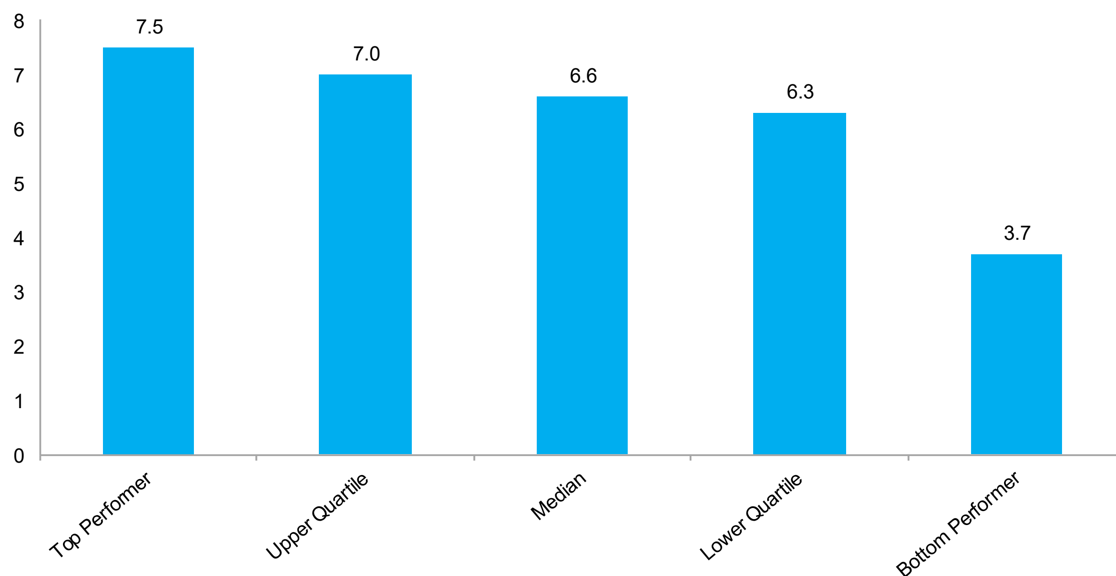
3.1 Overall Investment performance

While the overall system performance has been very impressive and has easily exceeded return objectives, individual members don't experience the system performance but rather the investment performance of their own fund (or funds, as is the case for many Australians). And **while the majority of fund members have experienced a similar or better performance from the median, many have not,** which is consistent with Draft Finding 2.1.

Chart 4 illustrates the **wide dispersion of investment returns for different funds over the past 10 years**, based on our June 2018 survey of multi-manager investment options with 61-80% growth assets. This survey includes all those funds that have been able to provide a monthly time series of investment returns to June 2018. Some smaller funds have not been able to provide this information and, since several of them have been poor performers over long periods, the number of poor performers would be greater if these funds were included and this would reduce the median and bottom quartile returns in particular.

The chart shows that the median 10 year return to June 2018 was 6.6% pa. This is lower than the long-term average because the 10 year return period includes the late 2008 losses incurred during the GFC. The difference between the upper quartile (7.0% pa) and the lower quartile (6.3% pa) is 0.7% pa which is about what would be expected. But the **performance of funds in the bottom quartile ranges from 6.3% pa all the way down to 3.7% pa**. Once again, we expect that many of the smaller funds that are not included would have returns below the bottom quartile of 6.3% pa, as they did for the 10 years to 30 June 2017, which would further reduce the bottom quartile return.

Chart 4: Growth options – 10 year performance by quartile (% pa)



Source: Chant West

At the other end of the scale, there is **relatively little dispersion among the better-performing funds**. The best return for the period was 7.5% pa, which is only slightly above the upper quartile of 7.0% pa. This has implications for the selection of a 'best in show' list of funds, because any differences in long-term performance among the leading contenders will be very small – quite possibly too small to warrant the automatic selection of one fund over another.

3.2 Retail vs not-for-profit performance – whole-of-fund data

Section 2 of the Productivity Commission covers 'Investment Performance'. We believe any performance comparison should be net of tax and investment fees only (gross of administration fees) if possible. This allows an analysis of how well each investment option has performed, without the distortion of what additional fees are charged in the product. Administration fees are a separate issue and a very important one that needs to be taken into account – see Section 3.5 where we disclose the administration fee differential between industry fund and retail funds.

In comparing the performance of not-for-profit funds with retail funds, the Productivity Commission has used **APRA whole-of-fund level data** which we believe is **not of relevance when comparing investment performance** as superannuation fund members do not invest in it. They invest in individual investment options. Additionally, **whole-of-fund data is an aggregate** of accumulation and pension investments which have completely different tax treatment.

The Productivity Commission acknowledges these points but argues that whole-of-fund performance is still indicative of what many members earn. It ignores the fact that each individual investment option has specific return and risk objectives and funds are managing those investment options accordingly. **Using aggregate performance of all these investment options to compare the performance of one fund with another is flawed**. As an example, a fund with an older member base will tend to have fewer members and a lower proportion of its assets under management in the more growth orientated investment options than a fund with a relatively young member base. Over the long-term, based on whole-of-fund performance data, you would of course expect the fund with the young member base to have a higher return. However, in no way does that reflect how well the funds are managing the individual investment options.

Table 1 below shows key performance numbers used by the Productivity Commission in assessing the investment performance of the system as a whole, as well as the not-for-profit and retail fund segments. The performance difference between industry and retail funds from the APRA data is 1.9% pa.

Table 1 : Performance from the Productivity Commission Report based on APRA data (% pa)

Fund category	12 yrs to June 2016
All APRA Funds	5.9
Not-for-Profit Funds	6.8
Retail Funds	4.9

Note: Performance is shown net of investment fees and tax. It is before administration and adviser commission.

To more accurately and fairly compare investment performance, it is the performance of investment options with similar risk profiles should be compared.

Table 2 shows investment performance based on Chant West's Growth universe (61 to 80% allocation to growth assets and where most major funds' MySuper default funds sit). Our analysis excludes the cohort-style lifecycle MySuper solutions adopted by a number of retail funds as they are managed very differently – they encapsulate both investment and product decisions. The performance difference between industry and retail funds from the actual product-level data is 0.7% pa.

Table 2 : Chant West Growth Fund Performance (% pa)

Fund category	12 yrs to June 2016
Overall	6.7
Not-for-Profit	7.0
Retail	6.3

Note: Performance is shown net of investment fees and tax. It is before administration and adviser commission.

By comparing the returns in Table 1 and 2, it can be seen that the returns for the not-for-profit segment are reasonably close, with Chant West's median 0.2% per annum higher. However, the returns based on APRA whole-of-fund data are significantly lower than Chant West's median for retail funds and the overall industry as a result, partly due to the deduction of higher administration fees and partly due to retail funds including a wider range of options with different investment objectives.

The typical return objective for growth funds is to outperform inflation by 3.5% per annum. Despite this 12 year period including the unprecedented losses incurred during the GFC (about 27%), **both segments have met the typical return objective of 6%** (CPI was 2.5% per annum) over the period.

3.3 Retail MySuper performance vs benchmark

In its analysis of MySuper products, the Productivity Commission has used SuperRatings data which links the performance of MySuper options that have limited return history with pre-2013 precursor products (page 11 of the Technical Supplement 4: Performance Methodology & Analysis). There are problems with this as for the retail fund precursor products, in most instances, it appears that SuperRatings uses the performance of legacy (closed) products with high administration fees and adviser commissions for the pre-2013 returns. **Those legacy products are of no relevance in the MySuper and post-FOFA environment**.

This approach understates the investment performance of the affected retail funds and as a result their performance relative to the benchmark portfolios. Additionally, while it is clear that the not-for-profit funds have outperformed retail funds as a group, **this approach also overstates the performance differential between the two segments**.

It is also unclear which lifecycle has been used in the analysis for those retail funds that have adopted a cohort lifecycle approach. We believe it may be the 1960s funds that have been used as it has had a similar level of growth assets to single option MySupers in the past. If so, this also understates the relative performance of those retail funds as the 1960s funds have been de-risked over the past few years, meaning they have a materially lower growth asset allocation than most other MySuper default options in the analysis.

3.4 The advantage of scale in investments

While there is a clear differential in average performance between not-for-profit and retail funds, there is also a clear differential in performance based on fund size. Table 3 shows the **performance differential between large and small not-for-profit funds** over various periods to 30 June 2017. We have used returns to 30 June 2017 as several of the funds in the 'small' category have not yet published returns to 30 June 2018 and several of them do not publish December returns.

Table 3: Not-for-profit funds: large vs small – median performance to 30 June 2017 (% pa)

	3 Years	5 Years	7 Years	10 Years
Large funds – 10 largest funds	8.6	10.9	9.4	5.6
Small funds – under $5 billion	7.7	10.0	8.6	4.7
Difference	**0.9**	**0.9**	**0.8**	**0.9**

*Based on the investment performance after investment fees and tax of each fund's main investment option with 61-80% growth assets.

The reason for only including not-for-profit funds is that these funds are more homogenous in their structure, whereas there are other dynamics at play for retail funds that would impact performance. **By just looking at not-for-profit funds, we are better able to see how scale affects returns**. For 'large' funds, we have included the 10 largest in terms of assets (all about $20 billion or over) and for 'small' funds we have included those under $5 billion.

The table shows a consistent **0.8% - 0.9% pa difference in investment performance over all periods shown**. While this may not seem much, as the cameos included in the draft report demonstrate, such a performance differential will make a significant difference to a member's ultimate retirement savings.

Why do larger funds perform better on average? Firstly, they typically have access to a wider investible universe including unlisted property or infrastructure assets that they can access either directly or through co-investment opportunities. These are assets that would often not be available through pooled arrangements or would be available for a higher fee. Secondly, larger funds are able to negotiate lower fees from their investment managers due to their scale. They are also able to insource some functions to reduce cost. Finally, larger funds can employ highly capable in-house investment teams to construct portfolios and assess managers, complementing the input from their asset consultants.

However, we do need to treat these average returns with some caution. **Not all large funds are strong performers and not all small funds are weaker performers**. What the table does show is the advantage that scale can provide if used well and the challenges of producing strong performance for small funds.

3.5 Member Services – scale matters here too

While there is a wide divergence in performance, with a long tail of underperforming funds, there are also **significant differences in the level of services provided** to members that help them get the most out of their super and guide them towards a retirement income that meets their needs. Once again, there is a correlation here with scale, in fact even more so than with performance.

Many of the funds that we rate highly in terms of member services invest large amounts of money in **data analytics**. They do this **to understand their members better and to drive positive behaviour** that will improve retirement outcomes.

While the use of data may be nascent in most funds, there is a **core of larger funds that are very sophisticated in their analysis of member data and in using that analysis to deliver consistent personalised messages to members through multiple communication channels**. Some of these funds use automated campaign management that allows them to focus their energies on producing highly engaging communications that use a 'test-and-learn' model to focus on what works, ie what leads to the right member actions. The funds that have done this well have seen **very impressive results, in terms of members taking action to grow their super** through consolidation, additional contributions, more aggressive options at younger ages and more appropriate insurance cover. These funds are driving better retirement outcomes for their members, but all this work comes at a cost.

Draft Finding 4.5 states that super funds make insufficient use of data to develop and price products. In our experience, many funds use member data and conduct member research to develop products and, more importantly, they use data to drive positive member action.

The reason why larger funds are doing better in this area is that **member services (data analytics and engagement) is much more efficient delivered over large numbers**. It doesn't cost that much more to provide these services for 1 million members than for 50,000 members. This is the area where we see the biggest difference in practice between funds and, second only to investment returns, it is the next best way to drive positive member outcomes.

3.6 Fees

A number of the report's findings relate to fees and costs.

Finding 3.1 recognises the problems with inconsistencies between how fees and costs are disclosed. The recent changes from RG97 have tried to address this but in reality have just made fees and costs less comparable. **We expect there will be some changes to the regime released shortly that will eventually lead to more comparable disclosure**.

Finding 3.2 stated that fees in Australia are higher than other countries. It is **very difficult to compare fees between countries** and there was a claim a few years ago that we charged fees that were three times that of in Chile but after loser examination it was shown that the administration fees in Australian super funds were lower than in Chile. If there is a lack of consistency between funds in the Australian market, there is much greater inconsistency between different jurisdictions. It is true that the costs are higher than some countries with defined benefits as it is **more expensive to run defined contribution funds with investment choice, insurance and the level of regulation in Australia**, but that is the nature of our system.

Draft Finding 3.2 recognises retail fees have fallen in recent years but are still higher than industry funds. The main reason why retail fund fees are higher than industry fund fees is administration fees – our March 2018 Fee Survey showed that the administration fees of actively managed retail MySuper products are about 0.45% pa higher than industry funds, based on standard rack-rate administration fees. When the average administration fee discounts applied to larger employers are taken into account, the difference is about 0.30% pa. When choice options are considered, the administration fees for a retail master trust are about 0.65% pa higher on a $50,000 balance, but the difference reduces for higher balances due to large account discounts. For example, the difference is 0.40% pa at $500,000.

3.7 Allocation of default funds

The current system of allocating superannuation funds for each employee is **based on the employer deciding on a default fund** to which it contributes, unless an employee exercises choice and directs them to make contributions to a different fund. Since most employees don't exercise their right to choose, this means that employers choose the superannuation fund for most employees.

However, **employers are generally not well equipped to make such decisions**. Often they will seek the advice of tender consultants such as Chant West to guide them through the process. Even though the employers for whom we conduct tenders are generally the most engaged and genuinely want the best for their members, at the start of the process they often feel ill-equipped to choose and rely heavily on us to educate them about how to differentiate between competing funds. This process takes a commitment of time and resources, which is why the majority of employers shy away from it.

This employer-focused process is partly a vestige of the superannuation structure that dominated up to the 1990s when most employers – even quite small employers – had their own in-house company funds. This was partly because many funds of the day were defined benefit, so the employers had a significant vested interest because they were funding the promised salary-based benefits. This is now not the case. The big question is – now that superannuation is almost exclusively defined contribution, **should employers continue to choose the default fund for their employees when they have very little interest in how the fund performs?**

It was **partly to solve this problem** that superannuation was **inserted into awards and Enterprise Bargaining Agreements (EBAs)** so that employers were provided with a **form of 'assisted employer choice'** to help them with their decision. However, neither the employer selection process nor this existing form of assisted employer choice has ensured that members are only defaulted into high quality funds that deliver strong investment performance.

Indeed the criteria for choosing defaults through awards and EBAs **have not generally been merit-based**. The changes to this process that were legislated but not implemented would have addressed this problem to some extent, but it is still unclear why the Fair Work Commission, a body that is expert in industrial relations matters, is considered best equipped to make these assessments. Further, the importance of industrial parties in this process advocating for particular funds on behalf of their members is problematic, as these parties are also often sponsors of particular funds.

To date, the result of this process has been a **qualified success**, in that it has resulted in **most employees being defaulted into high quality funds**. But it has **failed a significant number of members** by defaulting them into sub-scale and/or poor-performing funds. Significantly, we estimate that more than 500,000 employees have been defaulted into such funds – a small percentage of the total workforce but enough in our opinion to say that overall the current system has failed. This is not the only failing, because there are many employees who are defaulted into funds (some of them strong performing and some poor performing) and because of EBAs are not able to exercise choice and switch to a different fund.

3.8 Competition

We observe a lot of competition between funds as they strive hard to differentiate themselves, be it by delivering strong investment returns or by offering new services that drive positive member outcomes. We see this especially in fund tenders where competition is fierce, often due to the large number of default members that will move to the successful fund.

But the Productivity Commission is correct that there is **no consumer-led competition** driven by a critical mass of members who (a) know what they want and (b) know how to select the funds that will best meet their needs. This is due to the perception of **superannuation as remote** (only seen as relevant when you retire) and the perceived and actual **complexity of the system** as a whole and of individual products. This complexity, together with inconsistencies in disclosure, make it **very hard for members to compare funds**. As a result, most just give up and do nothing, never selecting their fund or their investment option or their levels of contributions and insurance.

There are **not enough engaged members to vote with their feet and truly drive fund behaviour**. From the funds' point of view, they generally have enough disengaged members to allow them to continue providing the investments and services they currently do and to charge the same fees, knowing that few members will make the decision to leave. This lack of competitive push from members is made worse by the almost-guaranteed cashflow coming from SG contributions made under awards and EBAs.

3.9 Overall assessment

The Commission is right to identify the two main problems with the default superannuation system as the **unintended multiple accounts and the defaulting of some members into poor-performing funds**. The current system has not done a good job at ensuring all members are defaulted into high quality funds that will give them the best chance for a decent income in retirement.

And that, surely, is the **whole point of the default system**. **To ensure that employees end up in good funds** that will provide them with strong retirement outcomes. Indeed, Chant West has that same goal which we attempt to promote through our ratings, awards and research tools. It is all about helping members get into (or stay in) a good fund.

We agree with the Productivity Commission's finding that **most funds have done a good job for their members** in generating solid long-term investment performance at a reasonable cost that will contribute towards good retirement outcomes, but that this has **not been the experience of all members**.

Given the compulsory nature of superannuation, where most members don't choose to set aside 9.5% of their pay into super and don't (for the most part) choose the fund those contributions go to, **it is vitally important that the system works for all Australians, not just for most of them**.

4. Responses to Information requests

Information Request 2.1

Are the assumptions underpinning the Commission's benchmark portfolios sound? If not, how should they be revised, and what evidence would support any revisions?

Throughout its analysis of investment performance, the Productivity Commission has used 'benchmark portfolios' – BP1 and BP2. There are many problems with BP2 and the **returns for BP2 appear to be significantly overstated** based on a number of assumptions that have been made. We don't believe BP2 represents a fair benchmark as it currently stands. Indeed, most benchmark portfolios use passive benchmarks for each asset class as has been done for BP1. In our view, it would be **better to simply use BP1 as the benchmark portfolio**, but with the adjusted tax assumptions discussed below.

Below are the assumptions that we believe contribute most to the overstated benchmark returns:

1. The **Productivity Commission has used actual tax paid** by APRA regulated funds based on whole-of-fund data rather than unrealised tax liabilities. This is **not consistent with how super funds apply tax to investment returns**, which are also net of unrealised tax liabilities. We do not believe that the returns reported to APRA are only net of tax paid and we are quite sure that the SuperRatings' option-level returns are net of tax paid but also net of an allowance for unrealised capital gains. The actual tax paid by funds will also be lower due to a fund being able to deduct all its operational expenses, which has nothing to do with performance.

   Using this method, the draft report appears to have determined and **used an average annual median tax rate of -1.97% over the period 2005 to 2016** with the annual tax rate ranging from 3.38% to -14.78%. While we recognise that in years where there are negative returns, negative tax rates may apply, this has not been the case for most years during this period. **It is not consistent with the tax that has been deducted from the returns published by funds**. It is also not consistent with the implied tax rate for MySuper default options (or similar options) of 15%.

   We believe **a more appropriate approach would have been to apply a tax rate of 6% to 7.5%**, given most MySuper default options have, on average, just over 70% in growth assets. Indeed, when we compare net returns with gross returns for the same growth options, we calculate an implied tax rate in that vicinity. We understand that the Productivity Commission conducted analysis applying tax rates of 5% and 7.5% but decided to not use them but rather adopt its calculated negative tax rate.

   If a tax rate of 5% was applied to our survey median return of 6.7% pa over the period (for options with 61-80% growth assets), it would **reduce BP2 for the 12 year period by about 0.40% pa** (see pages 38 and 41 of Technical Supplement 4). If a tax rate of 7.5% was used, it would **reduce BP2 by about 0.55% pa**. This is a significant adjustment to the benchmark and changes the conclusions of how funds have performed against this benchmark. Similar adjustments would also need to be made to BP1.

2. While we appreciate that it can be challenging obtaining historical benchmark performance data for unlisted assets, **using listed property index returns for 2005, 2006 and 2007 as the benchmark for unlisted property is flawed as it significantly overstates the benchmark portfolio return given listed property index returns were exceptionally high** over those three years (an average of about 20% pa for Australian and 25% pa for international). We note that an illiquidity premium was then added to these returns.

   It is difficult to estimate the impact of this assumption to the returns for BP2 as there are no reliable unlisted property indices during that time, but we know that unlisted returns during the period were much lower than their listed counterparts. If the listed property returns for these three years (plus an illiquidity premium) were 10% pa higher than unlisted property returns over that time, which is not an unreasonable estimate, and if unlisted property allocations were about 10%, **this assumption would have added about 0.25% pa to BP2**.

If listed property indices plus an illiquidity premium are to be used, they should be applied for the entire period over which performance is measured so there is a consistent benchmark over the period. Indeed, while listed property climbed sharply from 2005 to 2007, it then dropped by about 70% in 2008!

3. We also note that the benchmark used for 'other' assets is a 100% share market index (a 50/50 split between domestic and international). Using this benchmark is inappropriate for this asset class which includes a number of defensive-orientated strategies which targeting cash plus returns.

The result of all these issues is that the **BP2 returns are overstated, we estimate by 0.45% pa to 0.75% pa**.

Information request 2.2

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

As discussed in the previous section, benchmark portfolio returns are overstated as we believe the many assumptions used to calculate them are inaccurate, especially the assumption in relation to tax. We believe this is what leads to the apparent underperformance of superannuation funds against these portfolios rather than their poor performance.

The **investment performance differential between not-for-profit funds and retail funds**, based on our data (net of investment fees and tax), is **primarily due to asset allocation decisions**. In particular, the not-for-profit funds' significantly higher allocation to unlisted assets.

There is much debate about industry fund classification of some unlisted assets such as property and infrastructure as partly defensive. Retail funds believe this places some investment options that are inherently more aggressive into a lower risk category in performance comparisons which disadvantages retail funds that do not invest in these asset classes. We see some merit in treating some of these unlisted assets as partially defensive, as a meaningful portion of their return is from income or yield, although the same could be said of equities (but to a lesser extent). However, we do believe that there **needs to be more rigour and transparency in how the growth/defensive split of these assets have been determined**. It is not good enough to just use a 50/50 split but rather funds should be required to analyse the income and growth components of each underlying asset to determine how much is growth and how much defensive. Funds should then publish a summary of that analysis on their websites. This would greatly assist in demonstrating greater clarity in the level of risk taken in these portfolios.

The matter of administration fees further increases the performance differential between the two segments if returns are considered net of all fees as retail funds on average have higher administration fees than not-for-profit funds.

Information request 4.1

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

Lifecycle products should be allowed as part of MySuper and in fact that is the only place where they make sense. In the choice environment, members are more engaged and will often have an adviser who will choose their own investment option so will have no need for a lifecycle option. It seems intuitively correct that **younger members should probably be invested more aggressively** than the standard single option MySuper product with 70% growth assets and that is what the typical lifecycle option does. It is also true that some lifecycles become too defensive too early but these lifecycles have been increasing their growth assets at these ages over the past couple of years to correct this flaw.

We understand that part of reason for the Productivity Commission's conclusion about the unsuitability of lifecycle products is the performance that has been attributed to them. We agree that the performance of some of the lifecycle options since 2014 has been disappointing, but they have not been in operation for very long and started with a low level of assets, which limited how they could invest, until Accrued Default

Amounts were transferred into these portfolios. **The longer term performance attributed to the retail MySuper products incorporates both the lifecycle options and the pre-2013 precursors** and for this reason is **not an indicator of lifecycle performance**. Indeed, these returns will be dragged down by the use of retail returns from 2005-2013 that were net of maximum administration fees and net of trail commissions. Trail commissions are no longer a part of default superannuation, so these returns have little relevance to the debate moving forward although they do show that retail members who paid these high fees and trail commissions (many members of corporate master trusts didn't pay these), could have done better in other funds.

Furthermore, **lifecycle funds are the building blocks for moving to personalised asset allocations for each member**, which we expect to see within the next three years. This will be a major step forward for super funds in tailoring products to individual members and should be much more appropriate than a single default option for all members, not matter what their age or situation. **These sorts of innovations, of which lifecycle is the first step, should be encouraged not discouraged**.

In such tailored products, members could be encouraged to provide more information on their household situation (home ownership, debts, other assets, spouse super etc.) so that an even more tailored portfolio can be provided. This further information will be critical in determining whether a member is likely to make significant drawdowns (as a % of balance) within the first few years of retirement which will inform how conservative the portfolio should be.

5. Recommendations

Any review of the superannuation system must be focused on what is best for fund members – not what is best for superannuation funds or for service providers like Chant West.

In particular, any approach to the allocation of default superannuation needs to follow the mantra, 'Do no harm!'**. Default members should be nudged towards or placed in good funds that are not going to hurt their retirement outcome**. The protection of member interests, especially those of disengaged default members, is paramount.

Overall, we are supportive of the direction of the Productivity Commission's recommendations. We have outlined our responses to some key recommendations below.

Draft Recommendation 1 – Defaulting only once for new workforce entrants

Default superannuation accounts should only be created for members who are new to the workforce or do not already have a superannuation account (and do not nominate a fund of their own).

To facilitate this, the Australian Government and the ATO should continue work towards establishing a centralised online service for members, employers and the Government that builds on the existing functionality of myGov and Single Touch Payroll. The service should:

- *allow members to register online their choice to open, close or consolidate accounts when they are submitting their Tax File Number when starting a new job*
- *facilitate the carryover of existing member accounts when members change jobs*
- *collect information about member choices (including on whether they are electing to open a default account) for the Government.*

There should be universal participation in this process by employees and employers.

Chant West view

There is a compelling logic to this recommendation and it will go a long way to solving the first problem with the superannuation system – unintended multiple accounts. Currently, whenever anyone starts a new job, a new superannuation account is opened unless they choose otherwise (or if they already have an account with that fund). Under the recommended approach, whenever anyone starts a new job, the super fund to which their previous employer contributed will continue to be their fund with their new employer. This approach was **one of the recommendations from the Financial System Inquiry** and it has now been made possible by the introduction of SuperStream and the use of clearing houses to direct contributions to a range of superannuation funds through the one data file and one payment from the employer. Under the recommended approach, the continued creation of multiple accounts due to the default allocation regime will end.

An alternative approach?

But is there another model that would achieve the same result? Yes, there is. Rather than a member's previous default fund carrying across to their new employer, **their superannuation balance could be transferred from their previous fund to their new employer's default fund**. This approach would also deal with the problem of unintended multiple accounts but there are **some problems**, as follows:

- On its own, this approach won't ensure that members are defaulted into the stronger performing funds, which is a major weakness of the current system.
- This approach is problematic for someone who works for multiple employers that have different default funds.
- Rather than an employee having multiple accounts at the same time (the current problem), it will lead to employees having multiple accounts over time, as they are transferred from one fund to another when they move between jobs. This will probably serve to disorient them and will make it harder to keep track of their super – it would actually work against member engagement.
- This approach will mean that on changing jobs (and funds), employees will cease one insurance cover and commence with quite different insurance cover with their new fund, often without their consent. There are several problems with this including: they may move to a fund with higher default premiums that will further erode their balance; they may move to a fund with lower default cover and so receive a smaller sum in the event of a claim; they may move from a fund that would have paid them a disability benefit to one that won't pay them due to a particular definition or exclusion.

- This approach also retains the employer as the decision-maker for the employee's superannuation fund, and most employers are neither equipped nor incentivised to seek out the best fund – or even a good fund. A model of employer-driven default selection is not suited to an environment where many workers will have several job changes over their career and some will have multiple jobs at the same time.

Potential problems with the recommended approach?

The main issue with the recommended approach is that **members would only be defaulted into a fund (or strongly encouraged to choose a fund) when they start their first job**. Typically, this will be when they start a part-time job and have earnings over the Superannuation Guarantee threshold. This will probably be in their **late high school or early university years when they will be least interested in superannuation**. It is unlikely that the fund they choose, or are defaulted into, at that time will be the most suitable fund for their future occupation, especially as many funds are constructed to suit employees in a particular industry (particularly in their insurance design).

When someone enters the workforce for the first time, will they choose a fund or will they be allocated a default fund? While the Productivity Commission's experimental survey suggested that more than 95% of respondents would make a choice, **we expect most employees will not make an active choice, especially when they start their first job as teenagers**. Indeed, if past experience is a guide, it is likely that many employees will remain in their default option for their entire working life, all based on a default allocation or choice when they were teenagers and had little or no interest in choosing a super fund.

The solution? Drive choice!

The solution, which is reflected in the draft report, is to **drive employee choice at key milestones**, such as when they change jobs and when they submit their tax return. The key to this working is to create a **centralised online service**, also suggested in the report, so that whenever any employee starts a new job they interact with the centralised online service and are **presented with their current fund and the opportunity either to retain that fund or choose a different fund**. Ideally, this would be provided through an app or mobile-friendly website so that this can be done on a mobile device.

And for this approach to succeed there would **need to be universal participation in the online service from all employees and employers**. This should be possible, given the need for employee, employer and ATO to interact at the commencement of employment to provide the employee's tax file number. The current Tax File Number declaration form must be completed by hand, but this should be updated to an online service in any case – the online super fund choice service could be combined with this and completed at the same time.

As a segue to the next recommendation, if it makes sense only to create a default superannuation account once, when someone joins the workforce or if they don't have a superannuation account, the next question is – what funds are presented to new starters and what is the default if they do not choose (which we expect will be the case for most)? **If we retained the current model** of IR-based defaults through awards and Enterprise Bargaining Agreements (EBAs), but this would mean about **50% of new entrants to the workforce would default into Rest or Hostplus**, as about half of first jobs are in retail or hospitality. This is not a fair way of allocating default superannuation accounts as it is determined by the industry of someone's first job, which is unlikely to be where they will spend most of their career. Further, some of the MySuper products into which members are currently defaulted are poor-performing funds. Clearly, the current system should be modified – but how?

Draft Recommendation 2 – 'Best in Show' shortlist for new members

A single shortlist of up to 10 superannuation products should be presented to all members who are new to the workforce (or do not have a superannuation account), from which they can choose a product. Clear and comparable information on the key features of each shortlisted product should also be presented. Members should not be prevented from choosing any other fund (including an SMSF).

Any member who fails to make a choice within 60 days should be defaulted to one of the products on the shortlist, selected via sequential allocation.

The ATO should embed the shortlist and accompanying information into the centralised online service.

Chant West view

The approach

The recommendation is to present all new entrants to the workforce with a list of up to 10 'best in show' funds from which to choose and, if a selection is not made, to allocate them to one of the 'best in show' funds effectively at random. Other parts of the draft report also refer to presenting the online form to any employee who starts a new job so they can review their current active fund and decide whether they want to keep it or make a change.

The proposed draft form on page 443 illustrates the potential layout and proposes employees are presented with the following options:

- Their existing fund, if they have one, which will be pre-selected so if they want to keep it they simply need to click through to the next screen
- The list of 'best in show' funds in a randomised order
- A drop-down box allowing employees to choose from any other MySuper product
- The ability to enter details of an existing superannuation account

It is also proposed that the dashboards for each fund, including the employee's current super account, the 'best in show' list and any other MySupers selected, are included on the online service so that information is readily available for these funds.

Overall assessment

Presenting employees with a subset of the best funds would ensure that they are **only defaulted into one of those funds. It would also direct member choice to a range of very good funds.** And that should really be the main purpose of the default allocation process. Overall, it would achieve the purpose of the allocation process very well, indeed **much better than the current system**. For this reason, **we support this approach in principle**.

While there are probably many more funds worthy of being in the 'best in show' list, we agree with the Productivity Commission's assertion that **too much information can paralyse members**, so there does need to be a cap on the number of funds that are shown – and **10 funds seems about right**. However, the **panel that determines the 'best in show' list should have flexibility** to choose more or less than 10 funds depending on the results of its assessment.

But this approach raises a number of issues, including the following:

- who will determine the 'best in show' funds?
- what criteria will be used for the assessment?
- how will these criteria be weighted?
- what data will be used to inform the assessment of each criterion?

These important issues will be covered in the next section regarding the panel.

How about funds that specialise in catering to members of particular industry?

A number of funds focus on a particular industry and tailor their insurance design and member engagement to suit that group. Examples include Mine Super for coalmining and Cbus for construction. It is arguable that members working in these industries are best served by these funds. Firstly, the design of insurance cover makes it more likely they will have an insurance claim paid (while other funds may have exclusions for workers in that industry). Also, the communication preferences of the fund and its members are generally closely aligned. But if these funds are not part of the 'best in show' list, how will workers in these industries get into them? Conversely, if any of these funds were on the 'best in show' list and received default members from other industries (or members who chose the fund because it was randomly shown first on the list), it is likely that the specialised insurance cover provided would not be appropriate.

In addition to showing the 'best in show' list on the online service, **employees could be also be presented with any fund that specialises in their particular industry** – not as a default as is currently the case but as an option **alongside the 'best in show' list**. Such a specialised fund should be highlighted as such to make it clear that it is not part of the top 10 but has been included because it caters for workers in that particular industry. Clearly, it would **need to be a MySuper product** and would need to continue to be a MySuper product, even after APRA tightens up its MySuper criteria through its outcomes test (see Draft Recommendation 4). The ability to include such specialised funds would need to be approved by APRA based on the particular characteristics of the industry. The **ATO could use the employer's GICS code** to determine whether there are any specialised funds for that industry. Alternatively, **specialised funds could**

be allocated by employer. To assist members, there should be a maximum of two of these specialised funds presented.

In order to provide greater continuity with the current system, this could be extended further. For example, the **current default funds for particular industries, or even particular employers, could be included alongside the 'best in show' list** (up to a maximum of two), as long as they retain their MySuper licence after APRA 'raises the bar' with the strong application of its outcomes test. This would provide these funds with the ability to gain members, not by default, but by being included on a list of options and highlighted as being focused on the particular industry. This approach would **extend to employers that have negotiated tailored arrangements** with an industry fund or corporate master trust that provides lower fees and/or tailored insurance that may be salary-based. Members in these funds receive some of the best deals, especially in relation to insurance, and if these tailored products were not explicitly included alongside the 'best in show' list, access to such arrangements would soon disappear.

This model would make 'choice' the main game, which is the whole point of the 'employee assisted model' – to guide employees to choose one of the best funds or to default them into one of these funds if they don't choose, even after some nudging. In this choice environment, **funds will need to promote themselves** to employees and employers within their industry. For some, it will become even more important to build their fund 'brand', both inside the industry and more broadly in the community. There will also need to be **more resources devoted to distribution**. All of this will add cost to the system, but it will also drive the need for funds to have sufficient scale to be able to do these activities effectively and at a reasonable cost for members. It will be challenging for funds that are not on the 'best in show' list or are not included alongside for particular employers or industries, but they will **still be able to grow if stack up well against other funds and employ greater use of brand, marketing and promotion**.

We would also expect that **employers and other groups will be able to provide information about particular funds** that explain the nature of those funds, in order to nudge employees towards choosing that fund.

Could the use of the online service be extended?

In addition to using the online service when someone changes employers, it could **also be presented to taxpayers through the myGov website** when they submit their tax return. This would ensure that at least once a year every person is presented with their current fund and a list of alternative funds they could choose from.

It may also be helpful to **nudge employees to reconsider their super fund at some key milestones**, especially if they have retained the same fund they were allocated in their teenage years. A key milestone may be their 25th birthday. By this time they are more likely to have finished training and **settled on a particular industry for their future career** (at least for a time). Also, under the proposed government changes to insurance in super, this would be the age when they will move to opt-out insurance. So the **government could send communications to all employees in the year or two leading up to their 25th birthday to encourage them to reconsider their super** now that they (may) have more of an idea what sort of industry they will be working in and now that they will soon be eligible for default opt-out insurance cover.

Further, the online service should be integrated with SuperStream and SuperMatch so that someone's choice of fund (or default) can be implemented automatically. As soon as the employee makes their selection, their details should be sent to the new fund through SuperStream to set up a new account and to initiate a rollover from their current fund if required. The ATO should have all the information required to set up the new account including at least name, date of birth, TFN, postal address and email address (which could be requested in the online service if it has not yet been provided). The ATO could use the existing SuperMatch technology to facilitate this process.

Stability of the system?

If this model seems to work well for members, how does it do in terms of the stability of the system? The draft report anticipates that the impact on funds not on the 'best in show' list will only be small, as it only affects new entrants to the workforce. However, while the **impact may be small in the early years it will be cumulative**.

If a fund experiences several years of receiving no default members – unless they engage in strong promotion to employers and employees – we would expect the impact to be significant. Such funds would likely move from cashflow positive to cashflow negative after a few years of operation outside the 'best in show'. Negative net cashflow then starts to have implications for how a fund invests and the services it

provides to members. Without an inflow of new, younger members the demographics of the fund's membership will also change. That, too, will have implications for its insurance offering, member services and communications.

We expect that **most funds that do not make the 'best in show' list will not be sustainable within five years** of the change, but that **a number of larger funds**, including retail funds that have greater distribution, **will survive and several will thrive** in an environment of greater member engagement.

Timing of the change?

One danger of moving to a 'best in show' list in the near future is that it would **interfere with some key innovations that are currently under development** in the superannuation market. **Retirement income products that include longevity protection** are now starting to be developed after the government recently introduced new rules for the tax and social security treatment of such products. Funds are currently investing in developing these products and we expect to see substantial innovation in the next two to three years.

Also, over the next few years we expect to see **some funds introduce a customised investment portfolio for each member**, based on all that the fund knows about them. This will be an advancement on the current lifecycle approach, which has been found to be a relatively blunt instrument, but arguably delivers more appropriate default portfolios than single option defaults, especially for younger members.

Since innovation has been proposed as one of the assessment criteria, it **may be counterproductive to move to the proposed 'best in show' model at this time**. In our view, any **assessment of the 'best in show' funds should not commence until at least July 2020**, to allow these nascent innovations to bear fruit. By that time it will be possible to identify those funds that are truly innovating in the best interests of their members.

Such a timeframe may be required in any case for the ATO to develop its online service.

Draft Recommendation 3 – Independent Expert Panel for Best in Show Selection

The Australian Government should establish an independent expert panel to run a competitive process for listing superannuation products on the online shortlist. This panel should select from products submitted by funds that meet a clear set of criteria (established beforehand by the panel) and are judged to deliver the best outcomes for members, with a high weighting placed on investment strategy and performance.

The panel should have flexibility to select up to 10 products, with the exact number at the discretion of the panel based on the merit of each product and what is most tractable for members, while maintaining a competitive dynamic between funds for inclusion.

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

The process should be repeated, and the panel reconstituted, every four years.

Chant West view

As was raised in the previous section, the selection of the 'best in show' funds raises a number of issues, including the following:

- who will determine the 'best in show' funds?
- what criteria will be used for the assessment?
- how will these criteria be weighted?
- what data will be used to inform the assessment of each criterion?

The difficulty and importance of the task

The proposal that an independent expert panel should conduct this assessment is problematic. The members of such a panel would need to be free from conflicts of interest and yet would need to be able to differentiate between super funds based on differences that are sometimes subtle and only evident to industry experts.

Chant West has been assessing funds for well over 20 years so we have an immense store of information to draw upon to determine the best funds, yet **for our annual Super Fund Awards we still conduct**

upwards of 35 face-to-face meetings with funds to dig deeper into how they operate. This is necessary to provide us with the information we need to determine which funds, from a shortlist of near-equals, deserve to win certain awards.

The differences between the top funds are small and not always obvious. Take investment performance. As mentioned in an earlier section, all the top quartile funds over ten years to 30 June 2018 in our Multi-Manager Survey have produced returns in the range 7.2% - 7.5% pa. So if investment performance is a key criterion, decisions will be made that are based on a difference of 0.1% - 0.2% pa over ten years. Clearly, a deeper analysis is required. **Any assessment should consider all the ways that a fund contributes to member outcomes. It is not as simple as looking at performance and fees.**

The seriousness of the consequences of the panel's decisions need to be recognised. Its decisions will determine the viability and sustainability of some funds and is likely to lead to termination of many funds that do not make the 'best in show' list. Likewise, the decisions of the panel may have significant impact on the share prices of commercial providers if they do or do not make the list. Therefore, **it is imperative that the evaluation process uses all possible resources to ensure that a robust and defensible decision** is made that is then presented in a transparent way.

What makes the best funds?

In what ways can a fund contribute to better member outcomes? What makes the best MySuper funds?

We do not believe that the best funds are the cheapest funds. There has been an argument since the Cooper review in 2010 that, since members are disengaged, MySuper products should be very simple, low-cost, no-frills products and members shouldn't be made to pay for anything more.

However, a member's retirement income is not determined by the costs they pay in their fund. Rather, it is function of the investment returns they receive after those costs have been deducted. **The net of fees result is what really matters**.

The assessment must **not focus on cost but on member outcomes**. And member outcomes are primarily driven by two things – the fund producing **strong long-term investment returns** and **members making wise decisions** at different times in their working lives about how to grow their super.

The consideration of strong investment returns is again far from simple. What really counts is not past performance, which is known, but future performance, which is unknown. A few high quality funds have recently changed investment models and do not have a long-term history of returns. We don't believe these funds should be excluded just because of that.

So rather than just considering past performance we need to **consider the factors that influence the likelihood of producing strong performance in the future**. And what is likely to produce strong long-term performance is not the simplest, cheapest portfolio, but a portfolio that considers all possible investments for inclusion if they have the potential to improve diversification and returns. Other factors that will drive long-term returns are **strong investment governance and input from a high quality investment team**, investment committee and asset consultant. **Sophistication in investment models** is a good thing if it produces better member outcomes. As was mentioned in the earlier section, the larger industry funds have tended to be the best performers and they typically have the most developed and sophisticated investment models. They do not have the lowest costs but, as we have said earlier, that is not what matters.

The second factor contributing to better outcomes – members making wise decisions – means that funds **should not just leave members to work out for themselves how they could do better**, but instead nudge them towards what they can do to grow their super. A trustee would be abrogating its responsibility to act in member's best interests if it knew what actions could impact member outcomes, but failed to take action to steer members towards those actions because they thought they had to keep costs down.

Therefore, a **degree of sophistication is required in default arrangements** to drive the best member outcomes. But funds **don't need to complicate the presentation of the product to members** – they just need to know that their fund is doing all it can behind the scenes. When we board a plane, we want to make sure the engines powering that plane are absolutely fit for purpose and will deliver us safely to our destination. We don't want them to be based on simple technology and cheap parts – there is too much at stake. We want them to be the absolute height of technological sophistication but we don't need to understand the physics and engineering. It is the same with default super. People's retirement incomes are too important to trust to cut-price funds that will just do the basics. **We need funds that will do all they**

can to guide members towards the destination of a decent retirement income, ideally maximised for individual circumstances – using all the resources available to them.

Unfortunately, the areas that have the most impact on member outcomes are often the most difficult to quantify. For example, to help us assess and compare the investment capabilities of each fund, we receive a wide range of investment documentation from them and conduct dozens of interviews with investment teams and asset consultants each year. **Our assessments require the use of judgment that has been informed by many years in the industry**. It is hard to see how a few simple metrics could be used to make these judgements, and if we only include what we can measure we risk putting too much emphasis on what doesn't really matter.

We would **strongly support the inclusion in the assessment process of intrafund advice and the steps taken by funds to identify and respond to member needs**. These are key to driving member behaviour that will lead to good retirement outcomes. But once again it is **very hard to obtain objective measures** on these that are independently measured and can be relied upon for an assessment. As with investments, there is a need to understand the processes, resources and results of these initiatives and then apply an informed judgement to differentiate between funds.

To assess the two critical areas of investments and member services, it is **necessary to spend time understanding the relative capabilities of each fund** in some detail, otherwise any assessment and judgement of the panel would be superficial.

Who should be on the panel?

Based on the tasks that would be required of the independent panel, what sort of members should be on it?

It is critical to have a **number of representatives who have substantial experience in the superannuation industry** who are able to differentiate between a number of very good funds that may all look quite similar on the key metrics. However, it is inevitable that such members of the panel would have some conflicts of interest due to their previous or current employment either at a superannuation fund or a consultancy that has superannuation funds as its clients.

For this reason, it is **vital to include members from outside the industry**, as suggested in the draft report. These members may be academics or experienced board members, with the key requirements being a reasonable knowledge of financial markets but also the skill to be able to evaluate and interrogate complex data and evidence to make decisions.

As long as there is a **majority of independent members** on the panel from outside the industry, the inclusion of some members with previous connections with the industry may not cause governance issues that could not be managed.

One alternative would be for the panel to be drawn solely from outside the industry, but giving it **access to a selection of superannuation fund experts as non-voting advisers to provide research data and insights**.

To provide continuity between successive assessments by the panel (every four years), **we would recommend a 50% carryover of the panel from the period to period**.

Another potential problem is the politicisation of the panel as there are alignments of political parties with different industry segments. It will be virtually impossible to select panel members who are not impacted by this in some way. Further, there is the potential for pressure to be placed on panel members by some parties to make certain decisions, or at least to lean in a certain direction. This is because there is so much at stake – the decisions made by the panel may determine the success or failure of some funds and institutions. We can think of no other area where a government-appointed body makes such decisions. The impact of these decisions will only be mitigated if the online centralised service does produce the level of engagement and choice that has been suggested in the draft report and that the 'best in show' list does not become the sole determinant of a fund's future.

Draft Recommendation 4 – MySuper Authorisation

The Australian Government should legislate to allow APRA to apply the MySuper outcomes test. Authorisation rules for MySuper should be further strengthened to require funds to:

- *obtain independent verification — to an audit-level standard — of their outcomes test assessment, comparison against other products in the market, and determination of whether members' best interests are being promoted, at least every three years*
- *report to APRA annually on how many of their MySuper members switched to a higher-fee choice product within the same fund.*

Funds that fail to meet these conditions — or persistently underperform (for five or more years) an investment benchmark tailored to their asset allocation by a material margin, as determined by APRA — should have their MySuper authorisation revoked.

After implementation, the Australian Government should commission an independent review, every five years, of the effectiveness of the MySuper authorisation rules (including the outcomes test) at meeting their objectives.

Chant West view

The previous recommendations ensure that all new entrants to the workforce are presented with or defaulted into one of the best funds. **But what about those members already in a default fund, some of which are under-performing funds?** The 'defaulting only once' approach would mean they would remain in their current fund for the rest of their working life unless they made an active choice, even if it is a under-performing fund.

Currently, the bar to gaining a MySuper licence is very low. Almost any fund that applied for a licence was granted one, so **there is little protection for members** to ensure they are currently in a good default fund – which was really the whole point of introducing the MySuper regime. Such protections are vital in any default arrangement.

The requirements for funds to retain their MySuper licences must be strengthened through a decisive use of the outcomes test by APRA to ensure that any MySuper product is likely to deliver strong outcomes for members.

If most members choose their fund through the online service, either when they change jobs or at tax return time, the issue of previously defaulted MySuper members will become less important. However, **we expect many members will not choose and will remain in their current default fund**. Even if there was only a small number of these default members, they need to be protected. The MySuper requirements will therefore remain very important to ensure good outcomes for default members.

A strengthening of the MySuper requirements should lead to a **significant reduction in the number of MySuper products**, with the reduction focused on smaller sub-scale funds. Also, those retail funds that have underperformed will need to demonstrate that they can bring their substantial resources to bear to improve member outcomes if they are to remain MySuper products – most of these providers have the scale to do this whereas sub-scale funds do not.

If the 'best in show' list approach is adopted, it will be difficult for a smaller fund to present a sustainable business case to APRA unless it has some key product and service differentiators that are tailored for its membership – an affinity based on industry relationships is unlikely to be enough for APRA.

We were quoted a few years ago as saying that the number of MySuper providers **should be reduced to about 40 funds**. We still believe that this number is about right, as it would still provide enough competition but it should also ensure the quality and sustainability of each MySuper product, which is what should be required for any default arrangement. Other funds with a close affinity to certain employers or industries could continue as choice funds.

Draft Recommendation 7 – Capital gains Tax Relief for Mergers

The Australian Government should legislate to make permanent the temporary loss relief and asset rollover provisions that provide relief from capital gains tax liabilities to superannuation funds in the event of fund mergers and transfer events.

Chant West view

Yes, this should be done. The way to rationalise the number of MySuper products is for mergers to occur, generally in the form of smaller funds being absorbed by larger funds, but also larger funds merging to create a scale advantage and perhaps make them better placed to appear on the 'best in show' list. **Any barriers to such mergers should be removed permanently** so that they are able to proceed if they are in the interests of members. If APRA and the government are encouraging mergers, the legislative landscape cannot be allowed impede them.

Such measures will also remove a potential barrier for institutions with members in their legacy products that generally charge higher fees and deliver lower performance. It will enable them to move those members to more modern products. **These institutions should do all they can to ensure that their clients are in products that are in the members' best interests** – and that will rarely be these legacy products. We expect that one of the outcomes of the Royal Commission will be a recommendation for institutions to transition members from legacy products over a period of time and for any current or potential regulatory or legislative impediments to this process to be removed, once again for the benefit of members.

Draft Recommendation 9 – A member-friendly dashboard for all products

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

ASIC should:

- *prioritise the implementation of choice product dashboards to achieve full compliance by 1 July 2019*
- *revise the dashboards to simplify the content and provide more easily comprehensible metrics (drawing on robust consumer testing) by end 2019*
- *immediately publish all available MySuper and choice product dashboards on a single website, with the information clearly and readily accessible from the area of myGov that allows for consolidation of accounts.*

Chant West view

We agree that **dashboards should be produced for all superannuation funds**, whether they offer MySuper or just choice options. However, we would **question the benefit of producing dashboards for every investment option in every choice product**. Most members in retail choice are in a tailored portfolio combining different options that has generally been constructed by their adviser. A dashboard on each of the underlying options would thus be of limited value.

Perhaps one solution could be that **dashboards are required for all investment options of any funds that offer a MySuper product**, which would include almost all not-for-profit funds and all corporate master trusts. It is more likely that members of these funds will not have an adviser and the dashboard for each option will be useful and relevant.

We cannot see the benefit in providing dashboards for every investment option provided on platform products in particular (which can have over 600 open options plus other closed options). The cost would be too great and the benefit minimal.

Also the **content of the dashboards should be revised** to make them more accessible to members. A number of alternative presentations have been put forward by groups such as the Actuaries Institute that could be considered and any changes should be tested with members as part of the process. In addition, the dashboard **should incorporate a long-term risk measure**. The only risk measure currently shown is the short-term risk measure which describes most default options as medium-high or high risk, even though a cash option (which is described as low risk) will present far more risk to members of falling short of their retirement objectives.

Draft Recommendation 10 – Delivering dashboards to members

The Australian Government should require the ATO to present the relevant (single page) product dashboard on a member's existing account(s) on its centralised online service.

The Government should also require all superannuation funds to actively provide their members with superannuation product dashboards when a member requests to switch from a MySuper product to a choice product within the fund. This should include:

- *the dashboard for the MySuper product*
- *the dashboard for the choice product the member wants to switch to.*

Chant West view

Access to the dashboards of funds that appear on screen in the centralised online service should be provided. This would include the member's current fund, the 'best in show' list, any specialised funds for the particular industry and any other MySuper products that have been selected for consideration by the member. When a member requests to transfer from one product to another, the dashboards of both products should be provided.

Draft Recommendation 13 – Disclosure of Trailing Commissions

The Australian Government should require superannuation funds to clearly inform, on an annual basis, all members who are subject to trailing financial adviser commissions. This information should include the amount of commissions paid and a notice that trailing commissions are now illegal for new members.

All funds should publicly disclose the extent of trailing commissions and number of affected members in their annual reports and provide this information to ASIC.

Chant West view

Since 1 July 2013, trailing commissions are no longer allowed for new business but they were grandfathered for existing choice members at that time. We believe that sufficient time has elapsed to allow advisers to be rewarded for the sale of the product and initial servicing of the client. **Now is an appropriate time to terminate these trail commissions**, as they are a leakage from the system that in most cases provides no benefit to members.

Most institutions have already turned off these trail commissions for their salaried planners, as these commission were paid to the institution itself. They are still being paid to self-employer advisers who use retail products for their clients.

This change would require legislative changes as it would require the modification of contracts between the adviser and the institution regarding remuneration.

Draft Recommendations 14-19 – Insurance

Chant West view

In principle we **support the recommendations to reduce account erosion but more work needs to be done to understand the implications for other members** of removing cover for younger members and inactive accounts before this is finalised.

The draft report recognises that **insurance in superannuation is far too complex**. We agree.

In terms of product design and disclosure, **members cannot easily understand from reading the PDS whether they are more likely to get a claim paid in one fund compared with another**. This may lead to members transferring from one fund to another and being denied a claim that would have been paid if they had stayed put. This is not good enough. If there are **material differences** in the policies or their application that may lead to payment from one fund but non-payment from another, these **need to be made very clear**.

Is the solution just better disclosure and explanation of the differences between insurance policies? Probably not, as the differences are very subtle and would be hard for members to understand even if explained well.

The problem is that default and complexity don't mix! This has been the root cause of the much-publicised problems with insurance in recent years and has generated the impression that insurers, and the funds that provide this cover, are looking for ways to avoid paying claims. The quantum of claims paid and the payout ratios show this is manifestly not the case but it only takes a couple of members whose claims have not been paid due to some subtle terms and conditions that may seem innocuous to call into question the whole value of insurance, including insurance in superannuation.

The solution is probably greater standardisation of insurance policies. But there are **particular industries** such as coal miners, pilots and construction workers that do **require special terms**. There should be the ability for some funds to include such terms if there is good reason to do so. But this should be the exception rather than the rule and such funds should have to apply to APRA for the right to introduce industry-specific terms. These differences would then be a key disclosure item for these funds. To make clear the differences there should probably be standard wording to summarise the standard insurance policy, accompanied by a table highlighting any differences.

We believe it is appropriate to have default income protection, as long as it is linked to salary. Indeed, it acts well as a supplement to TPD (eg. NGS Super) and there are major problems with TPD that are well-known. If someone can't work anymore, then what is lost is income so what is needed is probably income, which is provided through income protection cover rather than TPD.

Should insurance remain opt-out in super?

Draft Recommendation 19 suggests a review of whether insurance in superannuation should be opt-out or opt-in. Insurance does significantly complicate superannuation, requiring different products for different industries, but it also **provides an immense social good**. It provides insurance to members who would otherwise be unlikely to take up any insurance and leave themselves or their family highly exposed if something were to happen to them. And it makes it **very accessible to members with no requirement for an individual health assessment**. Group insurance in superannuation also **provides much better value than retail policies** that require an adviser, due to their complexity, and charge higher premiums, due to inbuilt upfront and annual commissions. It also provides **more certainty than the direct life insurance policies** that typically apply wide-ranging exclusions for pre-existing conditions. The payout ratios of group insurance are also very high.

But, as discussed in the previous section, we need to do all we can to reduce the complexity with greater standardisation of terms and conditions.