trustee tailored super

Productivity Commission Submission

Tailored Superannuation Solutions Ltd

Stage 3: Assessing Competitiveness and Efficiency

Smart Defaults - An Efficiency Outcome

Smart Defaults can improve retirement outcomes on average by 35+%

They can provide $5.0+ billion per year more into these MySuper member's accounts

By focusing on members likely to receive the Age Pension, the system objective is targeted

Tailoring benefits exceed $300 per MySuper account per year, that is greater than the $280 in total costs (administration + insurance + investment), outstrips the $70 in merger benefits and the Super Stream efficiency gain ($70)

Improving stability and system wide long-tern net returns requires PC action on Smart Defaults

Executive Summary

Following Stage 1 (how to asses) and Stage 2 (different default models) reviews, it is time to be forthright in providing clear implementable recommendations for this final Stage 3 (Assessing Competitiveness and Efficiency) of the Productivity Commission's extensive inquiry into Australia's superannuation system.

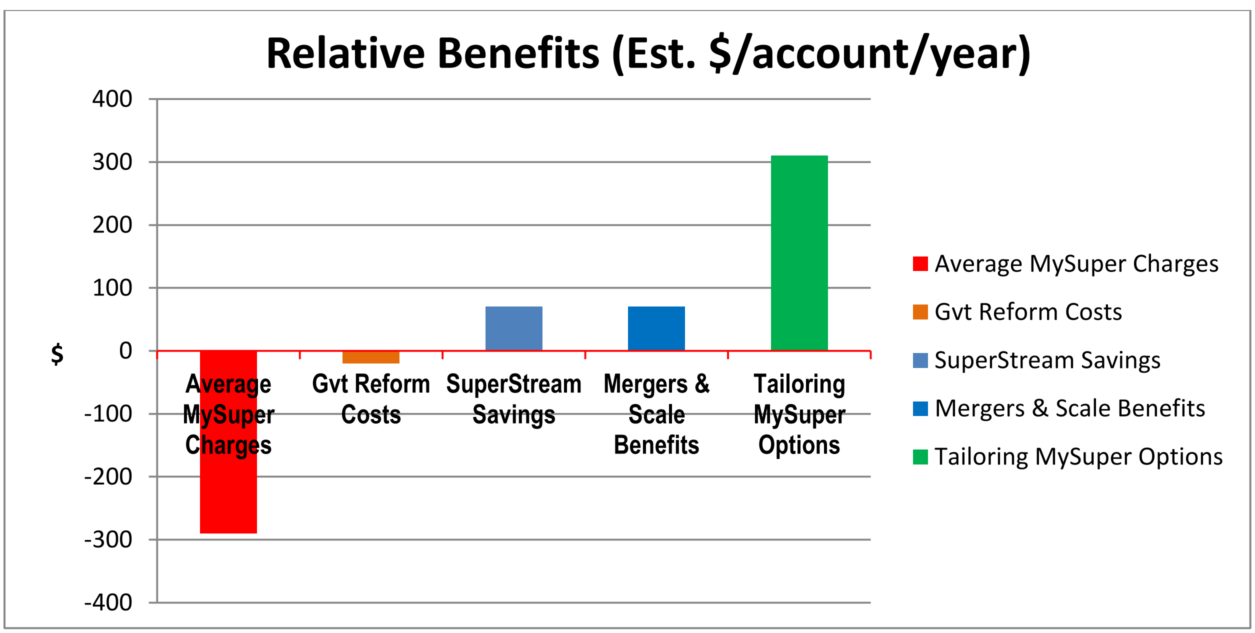
There has now been ample opportunity and time for industry players to quantify before the Commission their ideas or implement MySuper efficiency improvements in the marketplace.

Despite detailed voluminous submissions from all parts of this industry to the Commission over the past 18 months, to the 2016 Treasury Objective of Superannuation consultation and to the 2014 Financial System Inquiry – no other party has, or is publicly proposing to implement in the market, an efficiency improvement of the quantum and impact of Trustee Tailored Super (TTS).

TTS can provide $5.0+ billion per year extra into these MySuper members accounts through more efficiently tailoring default investment options compared to one-size-fit-all 'balanced' or age only life-cycling. As highlighted graphically in the chart below, the efficiency benefits of smart defaults:

- are bigger than Super Stream benefits (estimated to cost $1 billion to implement and $20 billion in savings over 10 years).
- are better than the potential economy of scale merger benefits (circa 10-15 basis point p.a.) by up to ten times – without the disruption.
- outstrip all fees and charges ($4.3 billion - insurance $1.7bn, administration $1.4 bn, investment $1.1bn)[1] applied to the 14.9M MySuper accounts in 2016.

What the last point demonstrates is that the efficiency benefits of smart defaults can on average eliminate the impact of all fees and charges for MySuper members.



[1] APRA, 2016 Superannuation Bulletin issued Feb 2017

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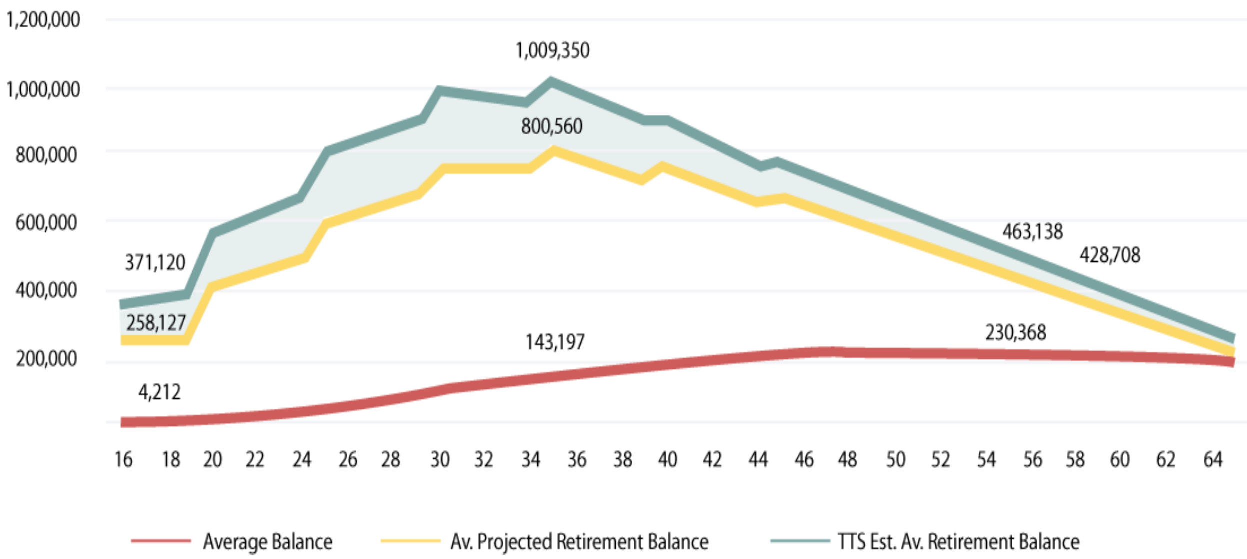
The Treasurer, in his Terms of Reference (TOR), is correct in stating that "small changes in the system can have a real impact on people's standard of living in retirement".

TTS involves a small change - the tailoring of existing investment options to members' own projected retirement outcomes. While this involves only a small change in approach, compounded over time it has a massive impact. TTS can improve retirement outcomes on average by 35+%, with lower risk of loss as retirement approaches. This is best understood as the shaded green area (which illustrates the combined efficiency gains currently being foregone through non-adoption of smart defaults); with the improvement in retirement outcomes being proportionally higher the earlier in life tailoring is commenced.



Furthermore, it focuses on those (MySuper) members most likely to end up on the Age Pension and therefore targets the system objective of retirement incomes, and provides a massive public benefit by bridging the retirement gap and reducing the burgeoning cost of the age pension system for taxpayers.

It is within the capability of MySuper trustees to implement now, but to date there appears to have been little incentive to do so.

Why then have they not acted in member's best interests and what should the Commission do about it? The Treasurers comment that 'competition is important as it can drive efficient innovation' is particularly pertinent to the answer.

The Commission's broad response, given its stated and explicit overriding focus is 'outcomes for members' should be obvious.

We commend the Commission's detailed work, but it is now time to be blunt and concentrate on implementing those efficiency measures that can most impact on achieving the Government's superannuation Objective.

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In making recommendations to improve outcomes for members and system stability, the TOR requires the Commission to:

1. focus on assessing system-wide long-term net returns and stability.

2. identify, and make recommendations to reduce, barriers to the efficiency and competitiveness of the superannuation system.

The recommendations must provide encouragement and incentives to adopt Smart Defaults in order to improve the efficiency of Australia's superannuation system.

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Background

We have previously made submissions to both rounds of the Stage 1 study – How to Assess Efficiency and Competitiveness, which are on the public record and contain considerable detail on TTS processes, procedures and outcomes.

Since that time, further beta trails with funds' own data (investment option return and loss ratios plus member demographic profiles) have been undertaken. These trials have continued to confirm the achievement of an efficiency improvement of 1.00% p.a. extra real return and lower sequencing risk (as retirement approaches). Our initial beta phase is now complete.

Submissions and consultation with Federal Treasury on both the system objective and their MARIA (Model of Australian Retirement Incomes and Assets) model have occurred. We are hopeful that Federal Treasury will in August 2017 run a version of a Smart Default, through MARIA, utilising the whole 14.9M MySuper account dataset (held with the ATO) and provide the Productivity Commission with the results.

No submission was made by us in respect of Stage 2 – Alternate Default Models. While that aspect of the Commission's work may excite many, we submit that the vast majority of the real value is to be gained from getting Stage 1 right and ensuring the Smart Default innovation occurs regardless of what alternate default model is selected.

This submission is in two parts:
1. This submission
2. The Financial Services Council (FSC) report on Trustee Tailored Super (TTS)

Super System Assessment

We agree with the Issue Paper's comments that there is little precedent here (and internationally) for reviewing the competitiveness and efficiency of a superannuation or pension system in its totality. The broader efficiency and system-wide perspectives are both unique and make this a challenging task. TTS continues to face similar challenges.

However, there are tools and mechanisms available to the Commission to quantify quite precisely expected outcomes in respect of Smart Defaults. Additionally TTS's introduction, concurrent with the Commission's reviews, provides a live example on industry's competitiveness and barriers to the adoption of efficient innovation.

The following three of the Commission's Objectives are relevant to this submission:

- *Objective 2*: The superannuation system meets member needs, in relation to information, products and risk management, over the member's lifetime,
- *Objective 3*: The efficiency of the superannuation system improves over time, and
- *Objective 5:* Competition in the superannuation system should drive efficient outcomes for members through, a market structure and other supply and demand-side conditions that facilitate rivalry and contestability and suppliers competing on aspects of value to members.

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There are five relevant assessment criteria, as outlined in the table below and three repeated indicators.

Assessment Criteria	Indicator
Objective 2 – E6 Is the system providing high-quality information and intra-fund financial advice to help members make decisions?	1. Funds' application of the lessons from behavioural finance to improve information provision and product design# (behaviour, output)
Objective 2 – E7 Is the system providing products to help members manage risks over their life cycles and optimally consume their retirement incomes?	2. Development and active take-up of tailored products and member services#* (output) 3. Funds' use of member information to inform product design and pricing#* (input)
Objective 3 – E9 Does the system overcome impediments to improving long-term outcomes for members?	2. Development and active take-up of tailored products and member services#* (output)
Objective 5 – C8 Do funds compete on member-relevant non-price dimensions?	3. Funds' use of member information to inform product design and pricing* (input)
Objective 5 – C9 Is there innovation and quality improvement in the system?	2. Development and active take-up of tailored products and member services* (output)

This set of objectives, criteria and indicators, used appropriately can produce a **one- third** increase in industry performance, by adopting more efficient investment strategies (that superannuation funds already offer to 'choice' or engaged members). They represent the vast bulk of the efficiency upside achievable and should be the basis for the most significant recommendations in the Commission's Final Report.

The answers to the Objective questions provide a strong starting point to any useful assessment.

The MySuper segment is critical to answering these questions, because:

- there are 14.9M MySuper accounts covering the vast majority of members, by number,
- MySuper covers a considerable part of the accumulation phase for most, by time,
- MySuper members are more likely to end up on the full or part Age Pension, therefore representing a significant burden on the tax system, which superannuation was designed to avoid
- the System's retirement objective is to provide income in retirement to substitute or supplement the Age Pension, and
- it covers $550+ billion in assets

E6. Is the system providing high-quality information and intra-fund financial advice to help members make decisions?

Answer no. MySuper members are disengaged and/or non-responsive, trustees are not acting to place them in better investment options on an opt-out basis, they are not nudging them, they are not making use of the intra-fund financial advice (provided to choice members), and they are not helping them make informed financial decisions.

The current practice is not high-quality; rather it's a limited effort approach, largely reliant on the member becoming involved when their balance reaches a substantial size or their

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retirement looms large. This is largely a safe or risk-averse approach which does not attract criticism, largely due to lack of focus on performance by disengaged members, but involves significant efficiency losses that are not apparent to these disengaged members.

E7. Is the system providing products to help members manage risks over their life cycles and optimally consume their retirement incomes?

Answer no. They are either placing all MySuper members in the same investment option regardless of age (investment horizon not taken into account), or placing them in the same investment option based solely on age and not retirement outcomes.

This means either the risk of loss as retirement approaches (sequencing risk) is not managed at all (i.e. balanced option with a 20 year old and a 64 year old in the same investment bucket with the same risk of loss) or it's poorly managed.

In the age -only based life-cycling approach, there is no strategy for differentiating between members of the same age, but with different retirement needs. For example, there is no differentiation in investment strategies for two 64 year olds, one projected to retire next year on the full Age Pension and the other with $1.6M. Instead they are invested in the same investment option, with the same sequencing risk.

Both methods are entirely contradictory to what trustees advise their choice members to do. Objective based investing using a member's expected retirement outcome does not occur. Current products are pre-digital age, untailored and short term focused. In blunt terms, trustees are not adequately fulfilling their fiduciary duties to disengaged members who effectively have delegated responsibility for their investment choices to their trustees.

E9. Does the system overcome impediments to improving long-term outcomes for members?

Answer no. There is no current targeting or use of projected retirement balances to improve outcomes for members. Trustees' Investment Strategy Committees rarely even consider member demographics, let alone members own projected retirement outcomes. They typically concern themselves with 'which investment' and 'by whom' decisions. There is a void in considering long-term outcomes for members.

The well recognised investment concept of 'investment horizon' is not used to improve long-term outcomes in the 'balanced default', despite the concept being reinforced by Australia's unique preservation rules. That rule ensures that members are locked in to their superannuation investments for up to 40 years, and therefore trustees should be taking advantage of such long investment horizons to adopt more efficient investment strategies.

The across the board reducing of returns and risk for all members in age only based life-cycling, just as balances are the highest, means average retirement outcomes are lower.

These are the two primary impediments to improving systemic long-term outcomes for members that Smart Defaults overcome.

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Smart Defaults enable more return and risk to be taken for some younger members - less so for others. At the same time, less return and risk can be taken for some older members facing an Age Pension retirement – without negatively impacting others facing self-funded retirement.

Smart Defaults are in essence a long term system efficiency mechanism. They facilitate the capturing and then compounding over time of extra returns from younger members and also selectively manage down sequencing risk as retirement approaches. They also enable risk to be optimised over the investment horizon to retirement, and take into account other relevant demographic and financial characteristics of members.

C8 - Do funds compete on member-relevant non-price dimensions?

Answer no. For the vast majority of members, being MySuper members, there is no real take-up of other trustee offerings. The only non-price member-relevant dimension for the vast majority is *long-term retirement outcomes* (see responses above) and that should be covered by the trustee's legislative obligations to 'Act in Members Best Interests'.

That obligation is not currently fully being met and is a systemic issue (see C9 response below).

Trustees are not competing on how much they have improved member's projected retirement outcomes. They may compete on the current net yearly returns or fees of the default - but that is not particularly relevant to a young member in the balanced option returning net 3.5% real when they could be in the Australian Shares option earning net 5.5% real.

It is also not particularly relevant to members 60 years plus, facing a full Age Pension retirement and still in the balanced investment option with same risk of loss as 10 years previously (but no longer with the time before retirement to recover if that loss eventuates).

In age based life-cycling, the current fund comparison based on current net yearly returns or the fee of the single balanced default option is particularly irrelevant. Members are more likely to be in another investment option (e.g. Australian Shares than Balanced).

The age only based life-cycling approach also does not compete on member relevant dimensions, and needs to evolve beyond age-only, for example:

- what is relevant to a member who is nearing retirement with a $1 million projected retirement balance is being in an investment option that recognises the need for growth and income generation through retirement age (e.g. returning net 4.0% real p.a.), not the cash option returning nil in real terms.
- Equally and at the same time, a similar aged member facing a part Age Pension retirement, with a $250,000 projected retirement balance, should be in the conservative option with its lower sequencing risk.

Competing on the member-relevant non-price dimension of improved projected retirement outcomes, rather than on the price of the default or current net yearly returns is core to the

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system objective and stability. This should require trustees to act. If that action, automatically placing MySuper members in a tailored investment option, nudges them to make an investment option choice, then that is a sound outcome, and other *member-relevant non-price dimensions* may become involved.

C9 - Is there innovation and quality improvement in the system?

Answer no. The superannuation industry has a poor to nil innovation history, limited R&D expenditure and staid risk culture with limited personal upside for successes. This state of play was recently epitomised by one well known industry stalwart who publicly commented that it would only take a Google or global with a half decent product to come along and many funds would be unable to compete.

A shortcoming of the superannuation system is that it has failed to engage its consumers, largely due to the compulsory contribution (via employers payroll) structure (which has an inbuilt mandated FUM growth strategy, without ever having to think what to do for individual beneficiaries), and this has stifled competition and in turn innovation. This disengagement facilitates both the lack of investment in innovative products and limited quality improvement in the system.

It is unfortunately reinforced by current fund comparisons being based on the lowest yearly net fee of the balanced option, rather than the impact on the retirement objective. These elements combined result in trustees escaping the discipline of competitive markets, a driving force for product innovation that targets the retirement objective.

With total fees for MySuper paid in 2016 being $4.3 billion, it is appropriate for members and society to expect trustees to make 'financial room', expend on R&D and continue to search for efficient product innovations that increase long run net returns per member and improve retirement outcomes, (thereby reducing average fees paid as a proportion of the retirement balance achieved).

This is a core objective and legislated responsibility. However trustees to date have decided to expend more on ancillary purposes (e.g. advertising, ESG and advice to the choice segment) rather than R&D on tailored investment options for MySuper. The reason for that is a structural misalignment between system, society and member long run objectives versus fund business short term drivers.

Technology is having a profound effect on the financial services industry (block chain, robo advice etc.). However, it has had a minimal impact on the operation of superannuation funds, with default MySuper product providers in particular undertaking no discernible technological change over the past decade.

There is no justifiable basis for this outcome. History has shown that technological advancement overtakes all sectors in time. New market entrants, such as Grow Super and Spaceship, indicate that innovation within at least the 'choice member' segment is occurring. When this occurs in MySuper, it will force incumbents to reconsider their product offerings and innovative, or risk losing market share to more agile and efficient competitors. This review and

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the Commission's recommendations to reduce barriers to the efficiency and competitiveness of the superannuation system is a very important change driver in this regard.

Incumbent providers in the superannuation industry have significant competitive advantages that should allow them to quickly apply new technologies, if they are guided by the Commission and a have an incentive to act. In particular, trustees already have access to projected retirement balances which are now being placed on annual statements and more detailed information about their members will accrue over time.

Higher levels of retirement savings (35+%) can be achieved now through reconsidering the traditional design of MySuper products, promoting engagement, and using Smart Default technology with member data. This should be exposed within the Commission's Final Report.

The superannuation system is one of the most highly regulated sectors in the Australian economy, and is governed by a plethora of legislation, regulation and prudential standards. The regulatory framework has largely ensured a stable and well governed system, with few major systemic failings. It does, however, add significant cost to the operation of the system and stifle innovation by trustees and service providers, thereby resulting in significant efficiency losses. When new innovation does occur, it needs to be tested then celebrated and supported, not stifled due to concerns around competition, IP and changing the status quo.

Trustees do need a flexible way to carve their own path; based on their funds own circumstances and that won't arise from government lead regulation. It requires industry lead innovation, however there is a 'tipping point' and the Commission has a historic role to play in providing the catalyst, the confidence and driver for this to occur for the sake of meeting the Retirement Objective for society rather than funds own business priorities.

Innovation may be disruptive, but often it occurs in a collaborative manner and is necessary particularly when the operating environment changes. By definition, it involves a changed mindset - to do the same thing/think the same way, use the same consultants/gatekeepers produces the same outcome/solutions (i.e. requires overcoming principal agent issues).

The operating environment has been shaped by the prescriptive nature of the MySuper framework in which trustees who are inclined to consider innovating are largely prevented to doing so by strict product rules.

The one exception to that prescriptive nature is the allowance of a MySuper life-cycle option (section 29TC). Approximately one third of the industry has already taken the opportunity to move to age based life-cycling. This has permitted some limited competition through the offering of a non-homogenous MySuper product with associated management of sequencing risk as retirement approaches.

The MySuper regulation that permits life-cycling (Reg. 9.47) also provides for a combination of other factors apart from age to be used. They include the member's account balance, contribution rate, current salary, gender and time to retirement.

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These additional factors allow for tailoring. They permit both retirement goal investing and the remaining investment horizon to be taken into account by the trustee. However to date they have not been used because no fund has innovated, found an implementable solution and also been willing, had the incentive or been coerced by market pressures, to chase an outcome.
It's time that changed. In effect, life-cycling is the first tentative step towards a smart default product. It is a 'semi-smart' default option. Smart default options such as TTS are the next logical progression from life-cycling.

In the national context, this new Smart Default approach could add $5+ billion p.a. or 1.00% real to MySuper balances per year. That compared to the 2015/16 Age Pension Cost of $44 billion is not insubstantial. Over future decades, particularly given the MySuper/Age Pensioner demographics involved, it may substantially fill the Retirement Funding Gap.

It is this scale of quality improvement across the system that is required to overcome the retirement funding gap and the increasing dependency ratio (4.5 working per pensioner now - 2.7 workers per pensioner in 2050). It is required now in order to holdup the confidence of members that are deciding if to make (compulsory and voluntary) contributions today - in the expectation that it will benefit their retirement lifestyle rather than be whittled away by future taxes to fund those that haven't contributed sufficiently.

It is already clear to us and our beta fund clients that this efficiency improvement, over time, can far outweigh the benefits from other government mandated changes such as Super Stream ($20 billion in savings over a decade) or indeed the scale benefits achieved from mergers (estimated in the 0.10%–0.15% p.a. range per year) via the legislated APRA Member Assessment (scale) test. We submit that the Commission should highlight this result in its Final Report.

The twin approaches – quantification and live example insight to innovation (qualitative aspects) – are highlighted below in a de-identified manner.

<u>Quantification</u>

As previously mentioned, we are hopeful that Federal Treasury will provide the Commission with the results of running a Smart Default version in MARIA. Those results would provide both a detailed analysis on both the short term yearly impact plus the long run impact on the national accounts and retirement funding gap.

Regardless, the Commission has stated it will conduct the majority of the required analysis and is already proposing to collect sufficient data to run a version of a Smart Default by itself. That data requirement can be restricted to the elements in the following two tables. We are able and willing to assist if and as required (refer also to prior submissions for detail).

Table 1 - input

Member No	Age	Balance	Projected Retirement Balance at Age 65 yrs.
1			
….			
1,000+			

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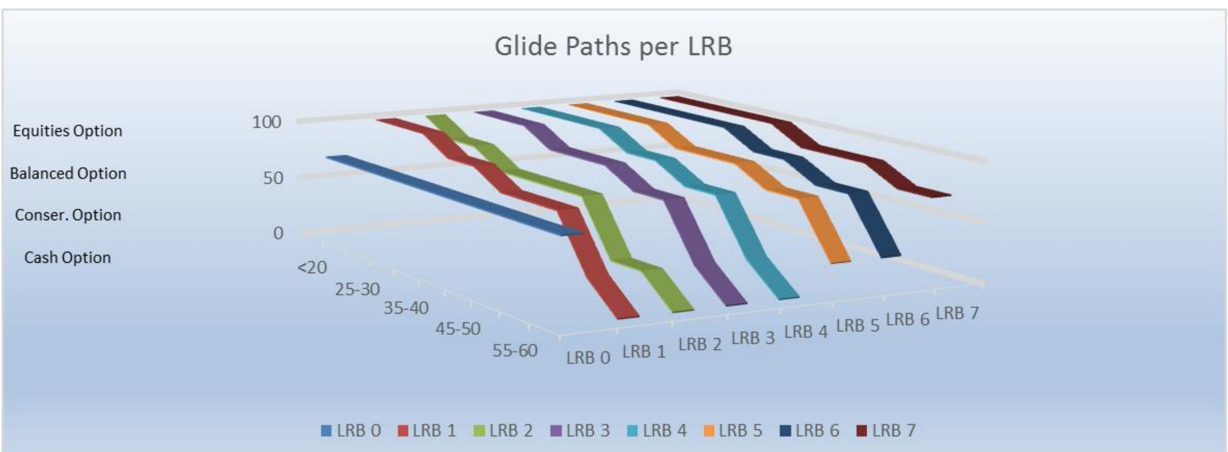
Table 2 - input

Investment Option	Real Return CPI+%	Loss Ratio (e.g. 4/20yrs)	Growth Asset %
Equities			
Aggressive			
Balanced (MySuper)			
Conservative			
Cash Plus			

In terms of cohorts (Lifestyle Retirement Bands - LRB), we suggest a following as a test standard (illustrative only).

LRB number	Start - $Projected Retirement Balance	Finish
Null	0	1,000
1	1,000	50,000
2	50,000	100,000
3	100,000	200,000
4	200,000	350,000
5	350,000	500,000
6	500,000	800,000
7	800,000	1,600,000+

For test purposes, we suggest setting the glide paths so all members over the age of 55 years are in investment options with loss ratios at or below the current MySuper investment option loss ratio. This will constrain sequencing risk to or below current MySuper levels. A glide path example is provided below.



In regards to output (results), the following two graphs summarise the twin objectives of:

- increased yearly real return p.a. on average and by LRB compared to the existing MySuper (input) for members of all ages
- the sequencing risk result for members approaching retirement by LRB compared to the existing MySuper (input).

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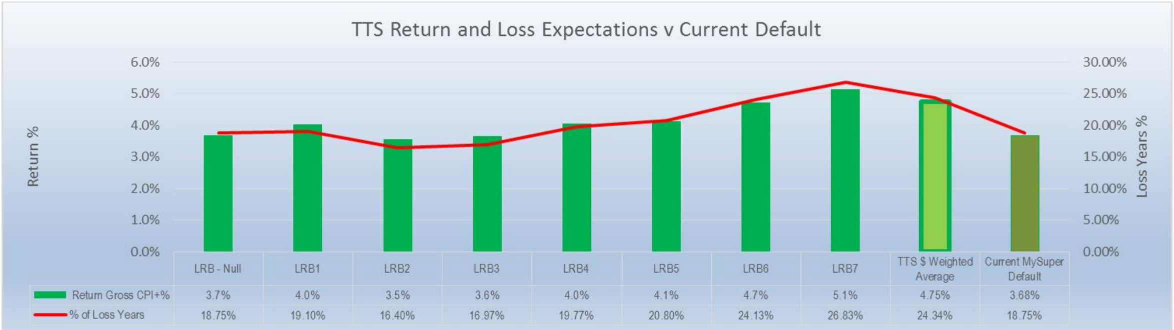

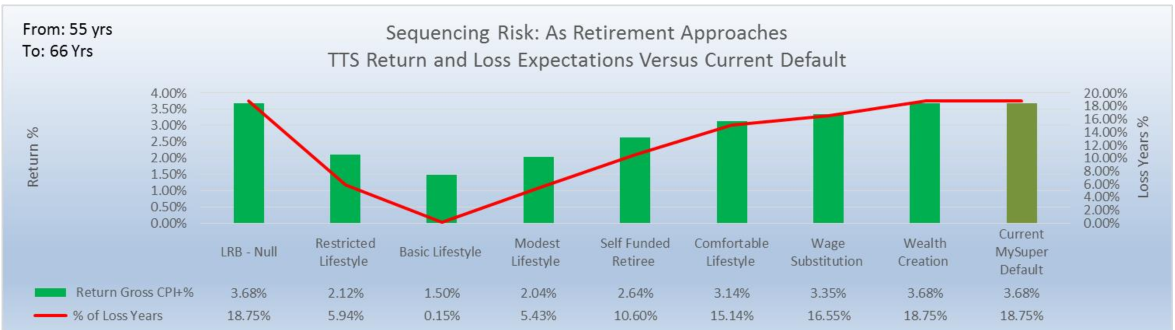

These results can be fully audited, on a member by member, and fund by fund, basis.

We are also prepared to run the Commissions input data through the TTS App and provide a full member table by results for audit purposes. Finally, we may also be able to provide a beta client report with results however this would remain confidential and be subject to an appropriate release authority from the third party fund involved.

Live example insight to innovation (qualitative aspects)

TSS has been seeking to introduce a new innovative product into the MySuper market over this Commission study period – an innovation that is highly significant in quantum (1/3rd improvement) and directly related to the industry's core purpose of acting in members best retirement interests. As a result, our experiences are highly relevant to the industry's current qualitative characteristics in respect of innovation.

De-identified, selective summarised commentary and impressions from our meeting follows:

1. Great concept but we are going to win out of industry consolidation you should be speaking to our competitors (larger fund)
2. Tailoring is definitely to way to go, but we won't be first (smaller fund)
3. We don't have the resources; we are just too busy with all the compliance and regulatory reform, but once we are forced to by competition we will (mid-tier fund)
4. We like our MySuper disengaged members the way they are, when they make choices they often get it wrong, we think we are more likely to get it right in our balanced option – your product may make them choose, our MySuper members are very sticky
5. We don't have a high proportion of MySuper members, if we did or could access them then tailoring would be good

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6. What's it cost, we compete on lowest fees. I have no doubt you can show better average returns and lower sequencing risk for members but the regulators and our board want lowest cost
7. This is really logical, as finance industry professional you don't need to prove the numbers to understand what the impact of tailoring would be, but I can't explain it to my board, they just won't get it, they don't have a finance or super background
8. My executive won't be interested, what's in it for them or us - more compliance and work. Even though you can prove the average is better, some members maybe worse off, at least at the moment they all get the same outcome
9. Why hasn't anyone already done this, surely it can't be that straightforward
10. The governments the biggest winner with this, we are not here to fix it for the taxpayer, you should go to them

Recommendations

We recommend the Commission:

1. Satisfy itself of the member outcome benefits from smarter defaults and automatic tailoring of MySuper investment options to members own retirement outcomes, be that via MARIA numbers, the Commission's own analysis or otherwise.

2. Compare the quantum of that benefit to all and any other *system-wide long-term net returns and stability* measure, including SuperStream and economies of scale benefits achievable via mergers.

3. In respect of Smart Defaults, *identify and make recommendations to reduce barriers to the efficiency and competitiveness of the superannuation system*.

4. Recommends that the Federal Government legislate to require MySuper fund trustees, in proper fulfilment of their fiduciary duties, to apply the same investment options to MySuper members, on a smart default basis, as are offered to 'choice' members.

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