Innovation in Superannuation

Smart MySuper Defaults

FINANCIAL SERVICES COUNCIL

trustee tailored super

This report is a collaborative research effort between the Financial Services Council (FSC) and Trustee Tailored Super (TTS). The FSC developed sections 1-5 of this report while TTS developed section 6.

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01

Executive summary

The world is changing fast, driven by rapid technological advances. However, the $2.1 trillion superannuation industry in Australia looks much the same as it did when universal super was legislated 25 years ago – it has simply increased in size.

No industry is immune from the disruption of modern technology. Prudent superannuation funds and their trustees are constantly on the lookout for change and opportunity, and embrace competitive forces that generate innovation and the adoption of new technology.

Yet, few have answered the question: what does genuine innovation in superannuation look like?

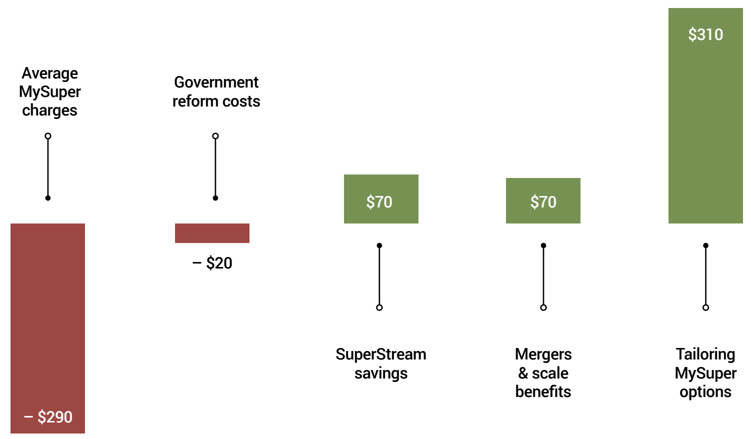
One source of innovation is 'smart defaults'. The world's first smart default - Trustee Tailored Super (TTS) is being introduced by an Australian company, Tailored Superannuation Solutions (TSS).

TSS is advocating for smarter default investment strategies, that more effectively use existing choice investment options implemented through funds' own Investment Strategy Committees.

TSS has tested its strategy and identified an efficiency gain, by adding the investment horizon and retirement goal for MySuper members, of 1.00% real p.a.

This report examines barriers to innovation in the superannuation industry, including regulatory reform and the absence of competitive pressure. It recommends a more dynamic and competitive system which fosters innovation and the adoption of technologies, such as TTS's 'Smart Default' product. These recommendations would deliver material improvements to the existing system, as well as higher retirement balances for consumers.

Relative Benefits (Est/ $/account/year)



02

Introduction

The superannuation industry is an outstanding public policy success, managing more than $2.1 trillion in retirement savings in 28 million accounts[1] on behalf of 17 million Australians.

The superannuation system is succeeding in delivering higher standards of living for Australians in retirement than would otherwise be the case.

It is a world leading system, but is it sustainable?

Australia's retirement savings gap is currently $1.5 trillion and is estimated to deepen to $8.7 trillion in 2050[2].

So how can the industry ensure sustainability and improve the chances of achieving the retirement objective? And are parts of the industry too complacent to improve efficiency and innovate?

The 2015 Intergenerational Report showed even after 50 years of compulsory superannuation, there will be no significant reduction in the percentage of Australians drawing on a publicly funded pension.

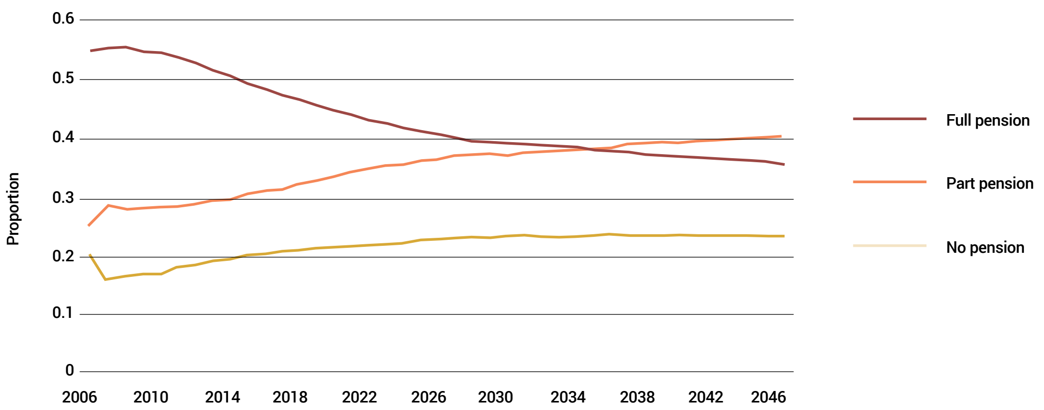
In 2050, with a largely matured system, some 75% of Australians beyond retirement age will still be entitled to the Aged Pension in full or in part.

Further, the aging population is a major headwind against achieving sustainability, as measured by Dependency Ratio. The 2016 Federal Treasury budget papers show in 2015 that ratio was 4.5 workers to fund each pensioner. By 2055, there will be only 2.7 workers per pensioner.

The key question facing superannuation trustees and the industry is: what more can be done to improve sustainability and demonstrate the superannuation system is achieving its retirement objective?

This report examines how the superannuation industry can address disengagement through product innovation. It then proposes an innovative, new approach to investing, being pioneered by TSS, which materially increases long run average investment returns for MySuper members to improve their projected retirement balance and standard of living in retirement.

Proportions of population eligible for pension



1 — APRA, 2016 Superannuation Bulletin issued Feb 2017
2 — World Economic Forum White Paper, We will live to 100, can we afford it? May 2017

Is superannuation achieving its objective?

Sustainability is important for confidence in superannuation. For contributors, the expectation must be that they receive the retirement lifestyle they saved for during their working life, rather than it being undermined by the future need to pay for other Age Pensioners in the community. Without this confidence, voluntary contributions will be lower and community support for compulsorily garnishing 9.5% (and rising) of wages into Super will dissipate.

This is an issue for the Financial Services Industry and the superannuation sector in particular to solve. The looming expense of the age pension to the government, with a proportionally lower number of working tax payers, cannot be simply ignored. It requires an industry-wide focus on the MySuper members, because they are most likely to end up on the full or part Age Pension.

The industry, in relative percentage terms compared to GDP, has outstripped and outgrown other Australian industries since superannuation was introduced. This industry growth and support through compulsory contributions comes with community expectations and legislative obligations.

In 2016, the average super account balance was $49,034 for females and $61,646 for males. In comparison, the average MySuper account balance was around half that, at $28,508 for females and $32,960 for males[3]. Those low levels, even after 25 years of compulsion, provide a further indication of the challenges ahead.

In current outcome terms the average balances for retiring Australians has recently been estimated to be $292,500 for men and $138,150 for women[4].

This does provide a significant additional source of income to replace or supplement the age pension for some. However, the average balance is skewed up by those that have achieved a self-funded retirement, meaning a high number of retirees are left with limited or no Age Pension supplementation. The result is that the public pension system cost Australia $44 billion in 2015-16.

For most retirees, the superannuation system has not yet achieved adequate retirement incomes of 60-65 per cent of pre-retirement income, or successfully replaced the role of the age pension. This, via the super industry structure (compulsory contributions and tax concessions), creates an obligation on trustees to consider what more they can do in terms of their fiduciary duty to help members adequately save for their retirement, and what product innovation would help deliver this outcome.

Can innovation close the retirement savings gap?

What the industry really needs is a more efficient method of converting current balances and ongoing contributions into retirement balances. This is particularly true for MySuper members, as they are proportionally more likely to end up on the full or part Age Pension.

Higher levels of retirement savings can be achieved through reconsidering the traditional design of MySuper products, promoting engagement, and using new technology with member data to innovate product design.

A long-acknowledged shortcoming of the superannuation system is that it fails to promote engagement. This has stifled competition and, in turn, innovation. At least 14.9 million[5] Australians out of 17 million have not yet told their trustee which investment option to use.

This disengagement or leaving it up to the trustee to decide is a systemic issue and is:

- A symptom of superannuation's anti-competitive regulatory framework,
- A major cause of low levels of investment in innovative products and services by superannuation trustees; and
- A major reason for fund comparisons being based on the lowest yearly net fee of the balanced option, rather than the impact on the retirement objective.

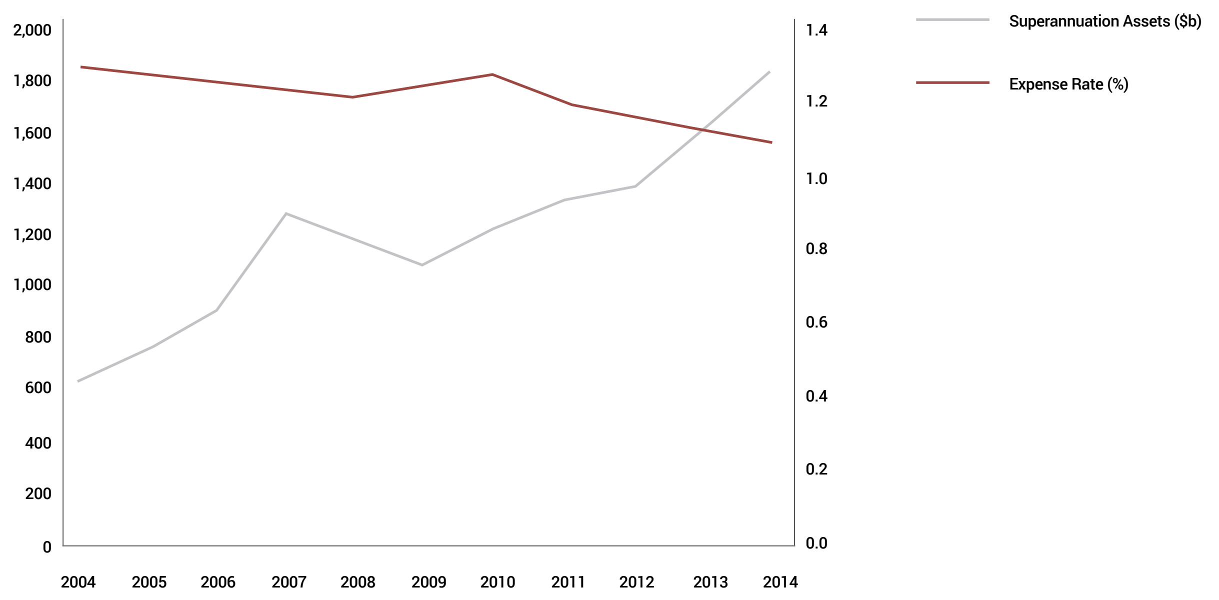
3 — APRA, 2016 Superannuation Bulletin issued Feb 2017
4 — World Economic Forum White Paper, We will to 100, can we afford it? May 2017 Clare, R. (2015) Superannuation account balances by age and gender, ASFA
5 — APRA, 2016 Superannuation Bulletin issued Feb 2017

Low levels of engagement results in trustees escaping the discipline of competitive markets, a driving force for product innovation that targets the retirement objective.

Analysis by Rice Warner Actuaries has demonstrated in the past decade, superannuation fees have continued to decline, as demonstrated in Graph 1[6].

Total fees for MySuper in 2016 were $4.3 billion (Insurance $1.7bn, Administration $1.4 bn, Investment $1.1bn)[7]. It is appropriate within the current framework for members to expect trustees to continue to search for efficient product innovations which increase net returns and improve retirement outcomes (within acceptable risk parameters), thereby reducing average fees paid as a proportion of the retirement balance achieved.

Superannuation market size and total expense rate from 2004 — 2014



Financial Services Council (FSC) experience finds there are three causes of disengagement and low levels of innovation in the superannuation industry:

1. The prescriptive nature of superannuation regulation;
2. The dampening effect of the cost of regulatory reform; and
3. The restrictive industrial overlay on the default superannuation market.

Regardless of these constraints and disengagement, superannuation trustees should be increasingly providing an efficient mechanism for financial intermediation, focused on improved retirement outcomes for members, as distinct from concentrating on one, three and five year return benchmarks.

The current short term (yearly) return and fee focus needs to evolve into a more sophisticated longer term mechanism based on retirement outcomes and the purpose of the superannuation system. Industry leaders need to step up to the challenge, because the current battle on lowest fees will not win the real war – the deepening retirement funding gap.

6 — Rice Warner Actuaries (2014) Superannuation Fees Report
7 — APRA, 2016 Superannuation Bulletin issued Feb 2017

03

The impact of regulation on innovation and competition

The major long term change in the Australian financial system has been in relation to superannuation assets, which have grown to $2.1 trillion and are now far greater than Australia's annual GDP ($1.7 trillion).

Super is now a major factor in how Australia funds its future. There are significant implications for growth and 'capital for end users' that flow from this.

One of these implications is that Australia must increasingly look to its superannuation trustees to provide an efficient mechanism for financial intermediation – in particular, matching investors (members) available risk tolerances and investment time horizons with underlying investments.

The responsibility of superannuation trustees is heightened to that of typical businesses, due to the important long term economic and public policy impact of superannuation on Australian society. Their role is also very different from banks.

In looking increasingly to superannuation trustees, rather than banks, for financial intermediation, there are a number of obvious philosophical differences. These include the trust and fiduciary nature of superannuation trustees' obligations to members, versus to the corporation and contractual 'banking' relationship between depositors and borrowers.

This is highlighted by the Sole Purpose Test in section 62 of the SIS Act, which in general terms requires trustees to maintain a fund solely for a core retirement purpose. This has been interpreted by courts as ensuring that the paramount consideration in making superannuation investments is financial retirement outcomes.

Superannuation has never been about current account balance or yearly net return, interest paid or fees – it is quite different to bank accounts. Superannuation balances cannot be withdrawn as required, but are 'locked away' until prescribed conditions (generally age-based – Preservation rule) are met. This creates a unique long term investment horizon which is not currently being fully optimised for MySuper members.

The paramount importance of retirement outcomes has always been clear, but perhaps more so now that this objective "to provide income in retirement to substitute or supplement the age pension" is specifically being legislated.

The core purpose envisages the provision of retirement benefits for each member, by the trustee, rather than a collective whole. The legislative covenants and duty of care requirements mean trustees must act in members' best financial retirement interests. That is not a passive requirement (i.e. trustees need to be seen by regulators such as APRA to be actively applying strategies to enhance the retirement interests of members).

For 'choice' members, that requirement may be largely outsourced as there is an overarching caveat that they are to be invested as selected.

For MySuper members, that is not the case. Instead (section 29N (a)) specifically requires the promotion of the net financial performance interests of MySuper members. Further, MySuper trustee's standard of care has been set higher in statute, as being that of the Prudent Superannuation Trustee.

The prudent superannuation trustee role requires the assumption of investment risk, which includes formulating an investment strategy for the whole of the entity, and for each investment option, having regard to the trustee's objectives (must include a retirement outcome focus), the ability to discharge its existing and prospective liabilities (requires consideration of when members will retire).

Against this background, it needs to be recognised that MySuper members effectively delegate responsibility for their investment decisions to their fund trustees.

Treating every member in the same way - by placing all members in a 'one-size-fits-all' investment pool - is unlikely to be seen as actively applying strategies to optimise long term investment outcomes and hence retirement balances.

The MySuper framework is new, with APRA-approved MySuper products first entering the market in 2013. There are two dominant designs of MySuper products, including standard 'Balanced Options' or age-based life-cycle products.

Consumers should expect that as the MySuper framework matures and the influence of new technology on the financial system grows, MySuper providers will look for innovative technological solutions to make their products more competitive.

Projected retirement outcomes are already being included on most annual member statements following the adoption of a Financial System Inquiry recommendation. Digital technologies and increased tailoring are available. Care should be exercised by trustees and investment managers when considering default options to ensure that the provision of retirement benefits, for each member, is the overriding consideration behind the investment strategy.

Trustees are required to have a risk management strategy that covers these issues to the extent that they are relevant to the exercising of the trustee's powers, or the performance of the trustee's duties and functions (i.e. formulating the default strategy).

It is certainly reasonable to assume that once the 'first movers' introduce a more tailored approach, there will be pressure for others to either follow suit or explain their inaction in better fulfilling their fiduciary duties.

As in other markets, digital technologies are rapidly enabling service providers to understand more about their customers and better tailor services to individual customer needs than has ever previously been possible.

These matters are not part of the financial advice framework, regulated by ASIC. Rather, they involve the core of the MySuper trustees' purpose and their Investment Strategy Committee work.

This common confusion with personal financial advice has led to inaction and delay. As a result, it has been inappropriately suggested that trustees don't know enough about MySuper members to tailor or stream retirement outcomes.

It is argued that their assets outside super, multiple accounts and personal expectations are unknown to the trustee and hence taking no action to act is acceptable. That approach ignores superannuation trustee's responsibilities.

Any confusion has already been resolved by those trustees who have adopted an Age-Only Life-Cycle strategy. These trustees take personal financial information (a MySuper member's age) and automatically use it to switch investment options on major birthdays. This is not financial advice, but rather acting in a MySuper members' best interest, based on the trustee's responsibility for the funds held.

Another common misconception is that the purpose of the MySuper reforms was just to lower fees. MySuper reform was actually billed as a "new, simple and cost effective superannuation product to replace existing default products".

APRA's Member Assessment Test, (now being legislated in the Outcomes Test) which is about member (retirement) outcomes, will bring into focus how cost effective a MySuper product is relative to its peers. Retirement outcomes may be effected by fees and scale, but the test clearly involves much more than that. In fact, a race to lowest cost would ultimately conflict with the retirement objective of the legislation.

The new Member Outcomes Test includes annually determining whether the financial interests of the beneficiaries of the fund who hold the MySuper product are being promoted by the trustee.
The trustee must assess:

i. Whether the options, benefits and facilities offered under the MySuper product are appropriate to those beneficiaries;

ii. Whether the investment strategy for the MySuper product, including the level of investment risk and the return target, is appropriate to those beneficiaries

They then must compare their My Super products retirement outcomes against their peers outcomes.

Put simply, trustees now need to understand the financial retirement outcomes for MySuper members and take that into account in setting the MySuper default product.

They will need to establish a written evidenced-based methodology which can be compared to other funds. This requirement is new and requires innovation.

Many have argued this aspect is already innate in the legislation and fiduciary responsibilities, but it is now explicit and will be actively assessed by APRA. In other words, trustees will now be held accountable by APRA for the outcomes they achieve through the 'Outcomes Test'.

04

Regulatory barriers to innovation

The cost of regulatory reform

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.

In addition to the existing regulatory framework, there have been extensive reviews and examinations of the system arising from product failings during the financial crisis.

The FSC estimates that across superannuation and related sectors, there have been more than 18 reviews and inquires in the past decade, with eight major inquires taking a detailed examination of consumer protections.

These major inquiries have made recommendations in at least 74 areas for thematic reform. There are also at least 30 issues and recommendations for reform that are currently ongoing or are being implemented, with a further 19 areas of reform that are showing no evident progress from when the review was completed.

Tria Partners concluded that across the financial services industry, the past five years of reform has cost $2.75 billion, which is estimated to reach almost $3 billion by the time current reforms are fully implemented.

Tria Partners also estimated a cost of $105 per superannuation account over the past five years – amounting to more than 25 per cent of the typical fixed fee charged to superannuation fund members.

The impact of the cost of regulatory reform on innovation is simple: when a trustee must comply with changing regulation, the cost of those changes is taken from a fixed pool of revenue. This results in less revenue being available for a trustee to invest in innovative product and services, reducing the quality of product that a member receives.

Relative Benefit of Reform (Est. $/account/year)

It is therefore somewhat understandable that the industry is cautious in respect of its own initiated industry reform, the benefits which in the case of Smart Defaults have been estimated at $5.5 bn p.a.. There has been a tendency to look and consider, then wait for others or government to act.

To give that inertia perspective, the costs of compulsory regulatory reform of $105 per account per year, are less than one third of benefit achievable by industry-lead reform on Smart Defaults, which is estimated at more than $300 per account per year. The industry must get over its reform fatigue.

The operating environment is ever changing, be that driven by the Productivity Commissions' MySuper efficiency program, changing default fund status arrangements, or simply reduced or negative net contribution flows resulting from a funds own aging member demographic and the maturing system.

Some funds investment teams are already more engaged with which investments to sell next to meet negative net contribution flows, rather than having new fund flows to invest. Industry consolidation is underway.

Trustees do need flexible methods of carving their own paths based on their funds own circumstances, and that should not have to arise from government-lead regulation. Industry should lead innovation. 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 - doing the same thing, thinking the same way and using the same consultants will likely produce the same outcomes. Trustees need to understand that the status quo is not always sustainable, nor is it in the best interest of members.

MySuper and the industrial system

The vast majority of the 14.9 million MySuper accounts have been 'defaulted' into a MySuper product through the industrial relations system; modern awards and enterprise agreements.

MySuper products are controlled by highly prescriptive regulation that stipulates product features and fee structures for members. Regulation is a major driver of homogeneity between superannuation funds that have a restricted capacity to develop innovative, new products which may deliver superior retirement outcomes.

The industrial system also stifles competition between trustees for default members by ensuring that employers have limited choice (or no choice at all) between the default funds available for their workplace.

Recent research by Deloitte Access Economics concluded that as many as 2 million consumers had no choice of fund as a result of anti-competitive terms in enterprise agreements. A further 13% of modern awards removed choice of fund for employers by naming only a single MySuper product in the award.

Consumers, members (Choice and Default) and future tax payers are the ultimate losers in the uncompetitive industrial relations regime because it has prevented innovation.

Superannuation trustees which are not required to find new and innovative ways to attract and retain fund members by outperforming their peers are incentivised to maintain the status quo to the detriment of all.

A dynamic and competitive industry, with small and large players, competing to reduce the impending retirement funding shortfall should not be delayed for fear of upsetting currently entrenched special interest groups or those set to win market share within the currently consolidating industry by not acting. The retirement lifestyles of the vast majority of citizens are far too important to let that happen.

Small funds, large funds with negative net contributions and those funds with older or niche member demographics should be able to compete for new members. Those differing member demographics can provide different value propositions for these funds in attracting new membership bases. Those new members, by weight of numbers, must involve the 14.9 million MySuper accounts from the 17 million Australians. This element goes to the heart of efficient competition and concerns a structure that encourages performance against the retirement objective. It is not sectoral.

Some funds ultimately will merge, but they should be those which are the least efficient, least competitive and those unwilling nor able to adapt to the changing operating environment.

The operating environment has been shaped by the prescriptive nature of the MySuper framework in which those trustees which 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. Approximately one third of the industry has used the advent of MySuper to move to age-based life-cycle investing. 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 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.

These additional factors allow for tailoring of investment strategies based on members circumstances. 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 grasped the opportunity, found an implementable solution, had the incentive or been coerced by market pressures to chase an outcome.

Technology

Technology is having a profound effect on the financial services industry, with the introduction of contactless payment technologies, block chain, robo advice and other innovations revolutionising how consumers interact with their finances.

The technological revolution has had minimal impact on the operation of superannuation funds, with default MySuper product providers in particular undertaking no discernible technological change over the past decade. A recent Mercer survey of fund executives found that an astonishingly low 35% of executives believed technology is a top influencer of their fund.[8]

There is no justifiable basis for why developments in technology have not generated new solutions and improved products and services in the superannuation sector as it has in other sectors of the financial services industry.

The slow adoption of new technologies probably has many causes. FSC experience has found the absence of competitive pressure in the default superannuation market allows trustees to avoid considering which changes may be necessary to adapt to technological change. This inertia is reinforced by unwillingness by trustees to incur the additional expense and risk of investing in new technologies. This may be particularly acute following the failed Super Partners administration system. However, not all advancements require such significant upfront costs.

History has shown that in time, technological advancement overtakes all sectors. New market entrants such as Grow Super and Spaceship indicate disruption at least within the 'choice member' segment is occurring. When this happens in MySuper, it will force incumbents to reconsider their product offerings and value propositions or risk losing market share to more agile and efficient competitors.

Incumbent providers in the superannuation industry have significant competitive advantages that should allow them to quickly apply new technologies. In particular, trustees have access to detailed information about their members, their saving and consumption patterns and their needs in retirement.

At a session about the future of superannuation at the FSC Leaders Summit in July 2017, 75% of respondents nominated MySuper default product efficiency as an obstacle for them. A further 15% were unsure and only 10% could see a clear road ahead.

The challenge for trustees is to identify technological solutions which bring together their knowledge of their members' needs and deliver on those needs by better tailoring their offerings.

8 — Knox, D. (2016) Change or be changed: 2020 Super Fund Executive Report, Mercer

05

What consumer benefits would reform deliver?

As outlined already, reforming the superannuation industry to improve system efficiency and achieve materially higher retirement balances for consumers is notoriously difficult.

A range of reforms have been successfully implemented over the past decade to achieve this objective, and this chapter assesses the relative success of those reforms.

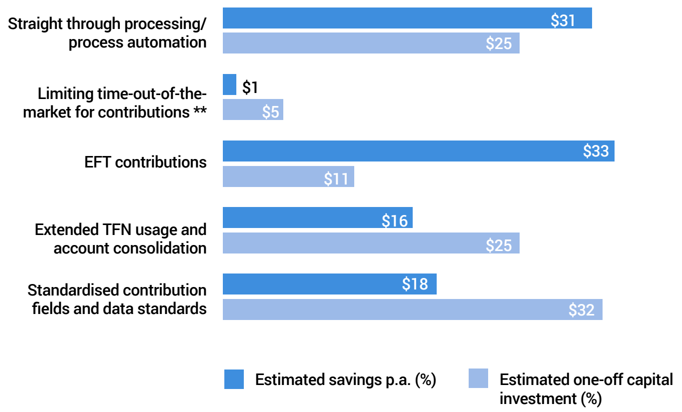
SuperStream

SuperStream is the most significant technology project undertaken by the superannuation industry since its inception. In 2010, EY and the FSC jointly estimated that the full implementation of SuperStream would require an upfront investment by the superannuation industry of more than $1 billion.

SuperStream is one of the few true success stories that demonstrates what can be achieved when trustees collectively take a long-term view of the sector. The estimated $20 billion in cost savings across the industry during a decade reflects what can be achieved when the industry works together to focus on what is in the best interests of consumers.[9]

This collaborative approach has continued with the joint establishment and management of the Gateway Network Governance Group by all the major superannuation and gateway players in the industry.

Estimated savings per annum and one-off capital investment by SuperStream measure*



** These figures are based on those participants who provided a detailed breakdown of aggregated estimated capital investments and savings per annum across each analysed SuperStream measure. We have extrapolated their figures using asset under management. Individual responses vary considerably.*

*** Most participants did not consider likely member benefits*

9 — EY (2010) The $20 billion prize; An industry blueprint to implement SuperStream

Fund consolidation

FSC analysis of APRA and Fair Work Commission data relating to MySuper products in the default superannuation system has confirmed the significant disparity of performance of MySuper products.

Rice Warner's Superannuation Fees Analysis report found funds of more than $2 billion have overall fees of at least 10 basis points below smaller funds – and the differential grows with size. Larger funds will also often provide more services, which only serves to exacerbate the relative inefficiency of some small funds.

However, these benefits and cost reductions are small in raw and comparative terms to the benefits from tailoring investment options to MySuper members projected retirement outcomes. This is outlined in the next section.

06

Smart Defaults

While universal superannuation has been in existence in Australia for 25 years, MySuper has only been in operation for 3 years. The current MySuper default options could be viewed as still being relatively immature. For example:

1. The balanced default option places 24 year olds and 64 year olds in the same investment option regardless of their significantly different investment horizons.
2. The age-only life-cycle option, places two 55 year olds, one projected to retire with $1.6 million and the other projected to retire on the full age pension, in the same investment option, regardless of their significantly different retirement prospects.

As noted above, about a third of MySuper funds have introduced age-based lifecycle investing. In essence, this is an embryonic form of a 'smart default'.

However, better MySuper default products are now starting to emerge. These are the next generation smart defaults, and they will enable a fund to apply the same investment options for disengaged members as it offers to engaged ('choice') members.

The advice models and websites of Funds inform their members to use goal-based investing and to take into account investment horizons. The MySuper defaults of trustees, however, don't yet do this.

No industry professional should be surprised that including these two elements could create a more efficient default. Further, if there is a way in which both can be included, it is difficult to continue justifying the current default approaches as being in member's best interests.

It is a question of how to improve the MySuper default; not why or when.

A solution from Trustee Tailored Super

Trustee Tailored Super (TTS) is the world's first smart default. It is smart because it adds the 'time to retirement' investment horizon and the retirement goal of MySuper members automatically into a more tailored investment strategy for disengaged members.

By adding these dimensions, TTS produces efficiency gains, fund by fund - member by member at very significant circa 1.00% real p.a, or 35+% cumulative over the accumulation phase of members.

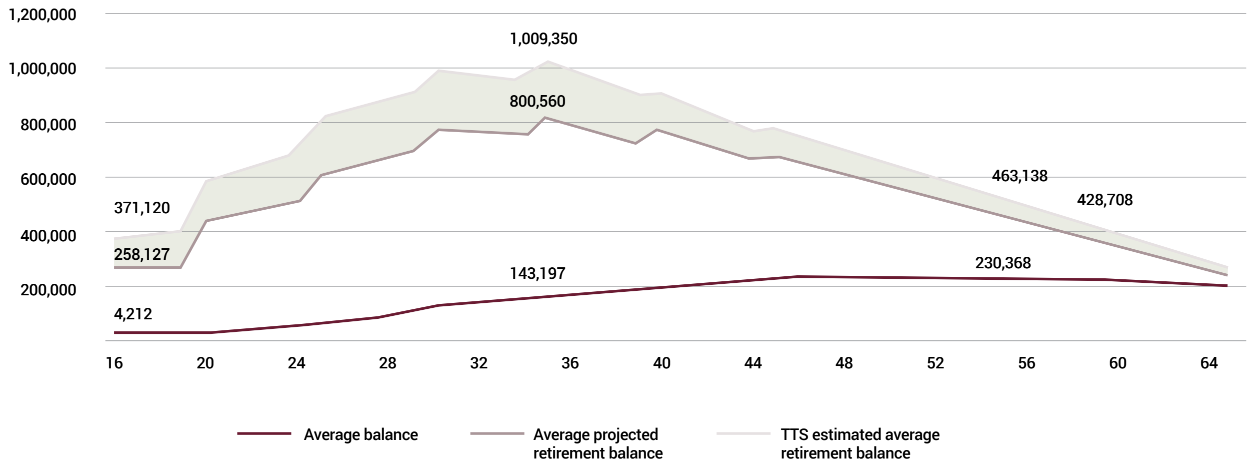
This outcome uses actual fund data, is auditable member by member and uses funds own investment option return and risk data (not assumption based).

In current market conditions, it could improve MySuper returns from an industry average of circa 3.50% real p.a. to 4.50% real p.a.

While a 1.00% p.a. improvement in return is impressive, a focus on net yearly return as the key metric significantly understates the true value of this smarter MySuper default in achieving the industry's retirement objective. Using net yearly returns before or after fees, is hardly appropriate if the goal is how much an average member's retirement outcome has improved.

TTS has the capacity to lift an average member's retirement balance by one third or by $5 billion per year across all MySuper accounts. As an efficiency type measure, it is expected to hold at that one third level over the longer term, regardless of prevailing market conditions. This is best appreciated graphically as the shaded green area in the graph over page.

The numbers on the graph indicate average current balance ($143,197 at age 35 years), average current projected retirement balance ($800,560 per annual statement) and the average projected Smart Default Retirement Balance ($1,009,350).



This broader, long term, retirement measure is possible because 'time to retirement' has been included in the methodology. Due to this tailoring, there is no longer a binary choice between risk and return - more risk for more return, less risk for less return. Instead, more risk can be taken earlier in a working life for some members, less so for others. Plus at the same time, lower risk taken later in a working life as retirement approaches, for some older members, but not others.

Measuring performance in this way should bring to an end the current industry race to lowest (net) fees on a single (70/30 balanced) default option. This retirement metric highlights that achieving longer term compounded returns, through using multiple investment options over time and managing sequencing risk, is the real industry performance to be measured in order to achieve that retirement objective.

In the national context, this new, smarter default approach could add $5 billion to super balances per year. That compared to the 2015/16 Age Pension Cost of $44 billion is significant. In future decades, particularly given the MySuper/Age Pensioner demographics involved, it may substantially fill the Retirement Funding Gap, and help the government with its objective of reducing the cost of an ageing population.

However, it is already clear that this efficiency improvement can far outweigh the benefits from other changes such as Super Stream or indeed the scale benefits achieved from mergers (estimated in the 0.10% -0.15% p.a. range per year).

TTS tailors default MySuper members into different streams (called Lifestyle Retirement Bands - LRBs), based on their own projected retirement balance. That projection, or its derivative retirement income, following the FSI, is already being calculated and included on each member's annual statement.

Lifestyle Retirement Bands

LRB	LRB Characteristic	LRB Amount $
0	Null	1,000
1	Restricted Lifestyle	100,000
2	Basic Lifestyle	325,000
3	Modest Lifestyle	450,000
4	Self-Funded Retiree	575,000
5	Comfortable Lifestyle	900,000
6	Wage Substitution	1,250,000
7	Wealth Enhancement	1,600,000+

For each of those LRBs, it provides a glide path of investment options based on a member's age. This results in an investment option selection tailored to the member. The investment options used are typically the already established 'choice' investment options.

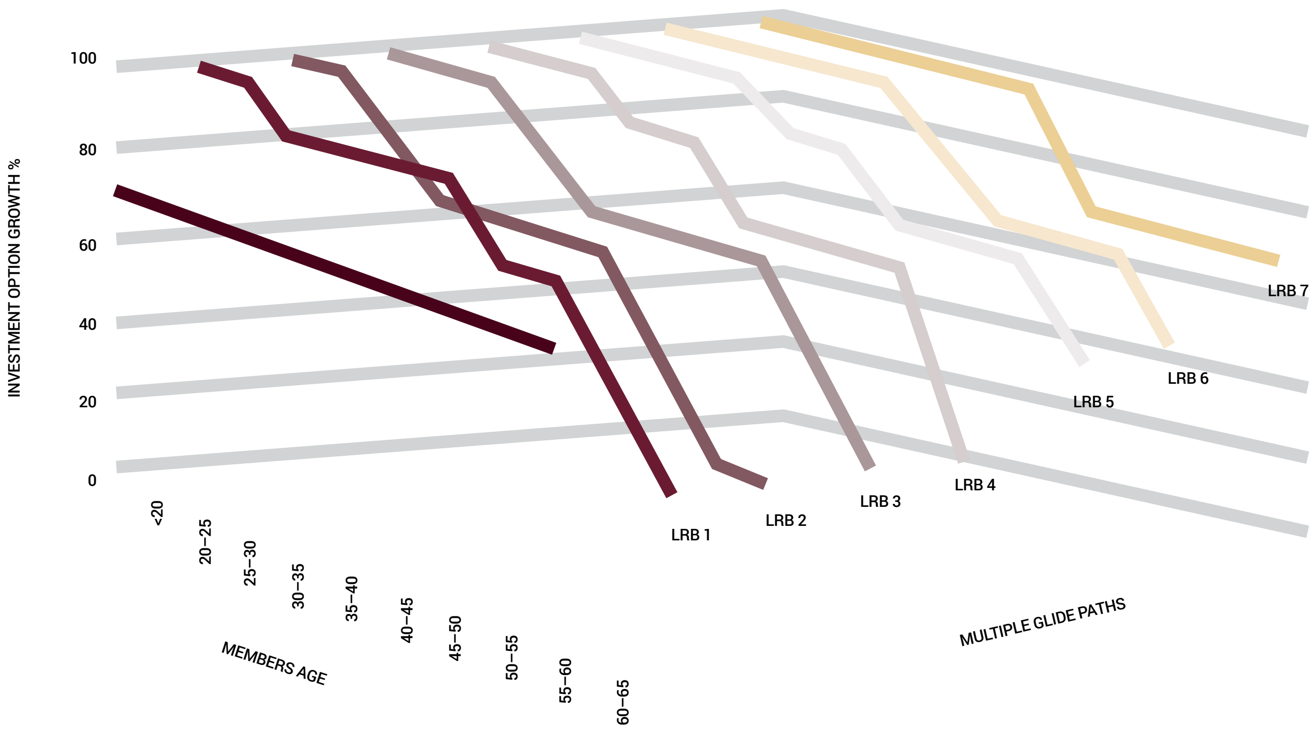
The number of LRB's, their descriptor, respective value ranges and the associated glide path shape will vary fund by fund. Trustees make those choices, based in part on their MySuper member retirement demographics, which in turn is a function of the MySuper member's own industry and workplace structures. There is no industry standard being applied or inferred - each fund will have its own LRBs.

In this example, one 40 year old projected to retire with $300,000 would be in LRB 2 and be invested in the 70% growth balanced option, whereas another 40 year old projected to retire with $1,200,000 would be in LRB 6 and be invested in the 100% growth Australian equities option.

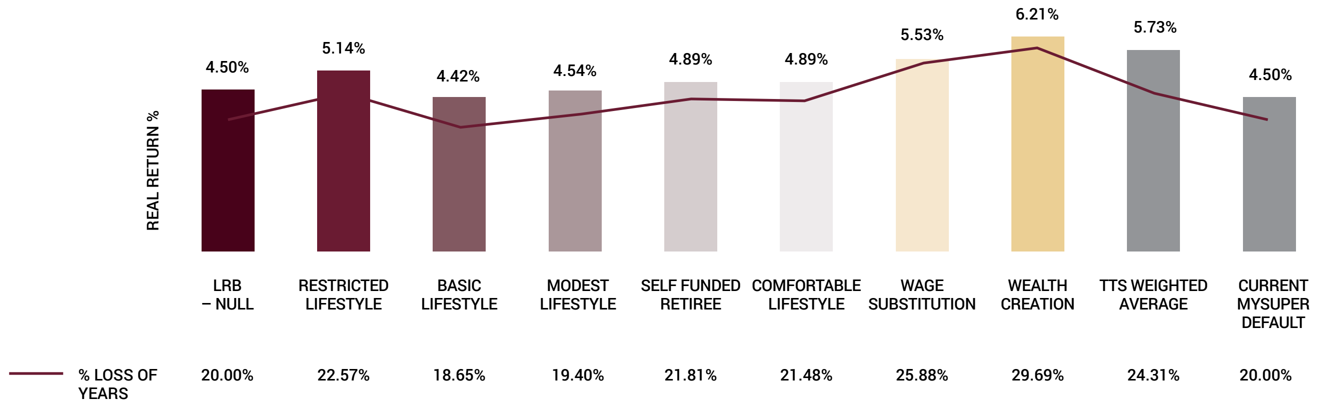
The comparison simply requires collating the member-by-member return and loss ratios per investment option for each LRB. The outcomes are calculated per LRB. In this example the current MySuper average return was lifted by 1.23% from 4.50% to 5.73% - the risk of loss also increased from 20.00% to 24.31%.

Due to the straightforward approach taken, the required build is limited, plus the return and risk of loss ratios per investment option are already known and published (to APRA or on fund websites). This enables a ready comparison against the performance of the existing balanced default or age only life-stage alternatives.

LRB - projected retirement balance $



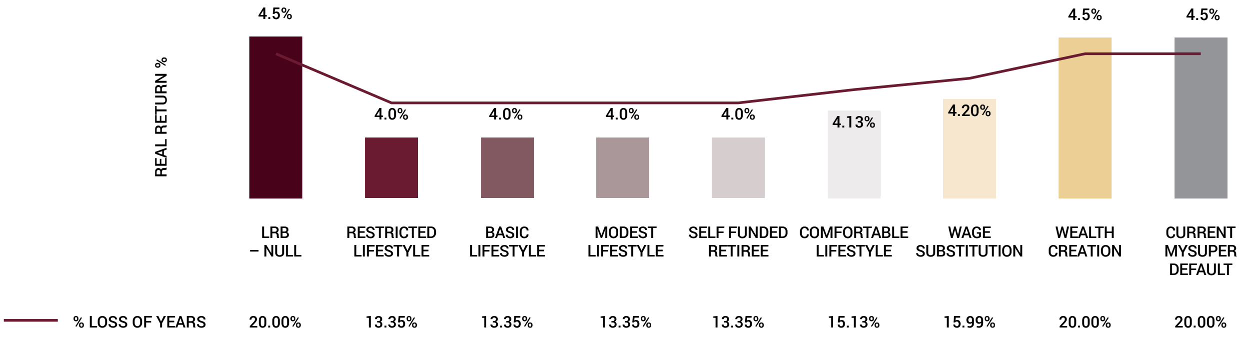
TTS Return and Loss expectations vs Current Default - All ages



The comparison can also be done for any age group, for example those approaching retirement and facing increased sequencing risk.

The graph on the next page (unlike that above) only shows those members over the age of 55 years. In this example sequencing risk - the risk of loss as retirement approaches is at or lower than the current MySuper default for all members. Those facing lower retirement lifestyle prospects have lower risk, whereas those with higher prospects are being set up to invest through retirement, not to retirement.

Sequencing Risk: As Retirement Approaches
TTS Return and Loss Expectations versus Current Default - Age 55yrs



This tailoring involves a practical yet powerful methodology and system that recognises the disengaged nature of default members and the preservation rules. It provides collectively for higher average expected retirement balances and lower risk of loss as retirement approaches. It is in essence an efficiency measure.

The existing annual statement process is used to calculate and advise members of the new details. MySuper members are advised in writing of their LRB and associated investment option, with their account balance moved some months later.

Typically, members have an opportunity and time to choose another investment option. However, if no selection is made (and these are largely disengaged individuals) the funds are automatically transferred. It is an opt-out, rather than opt-in process.

In that regard, the annual assessment process and automatic administrator bulk investment option switching is similar to what already occurs on major birthdays within age-only lifecycle defaults.

Due to this process being run yearly, members changing circumstances (promotion, maternity leave, additional contributions) are reflected in the LRB, glide path and hence tailored investment option on a regular basis. Over time, these customised annual reminders not only build the member-trustee relationship, they also manage member retirement expectations, drive outcomes and nudge engagement.

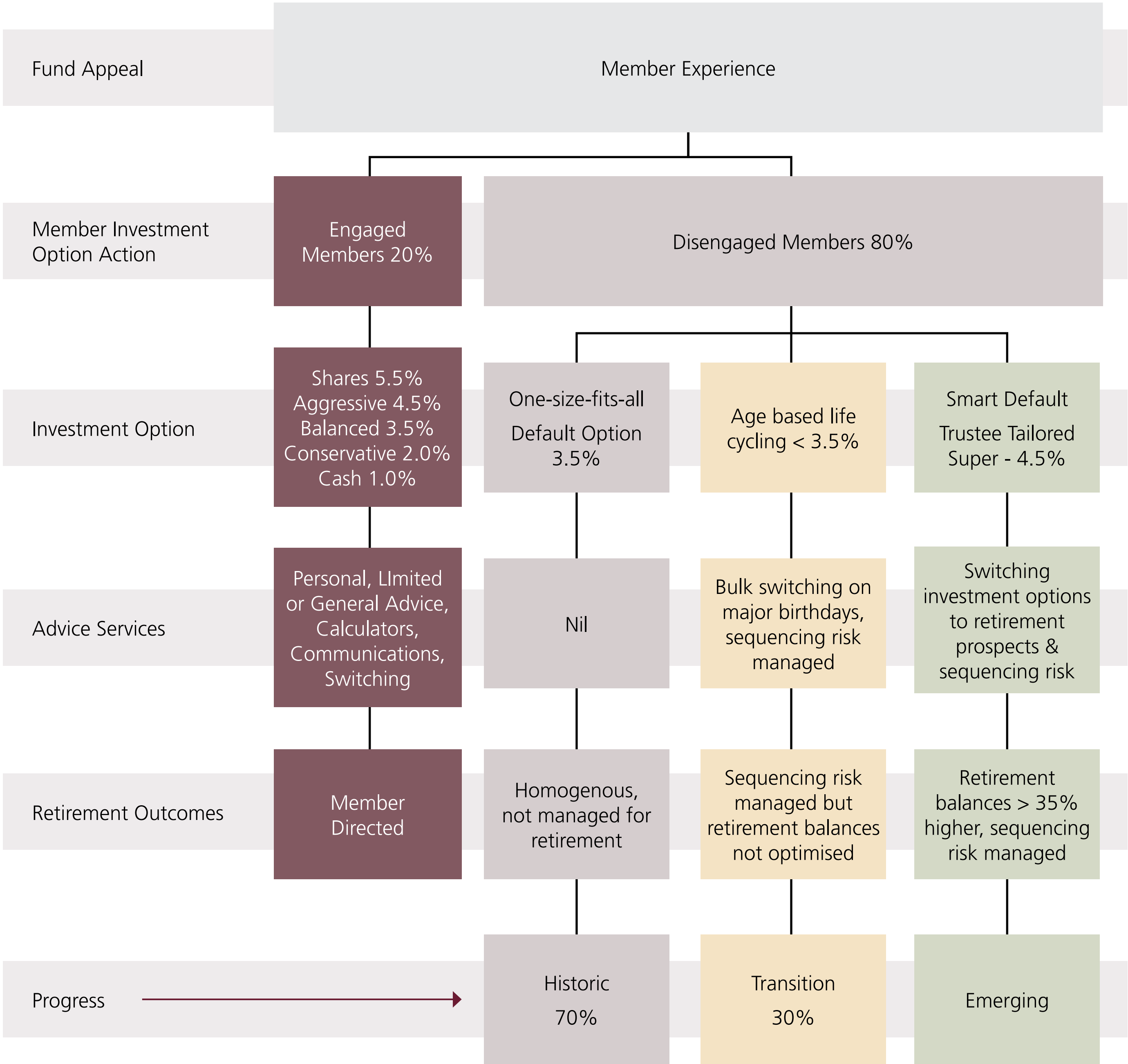
This approach currently relies on Projected Retirement Balances as the 'mass customisation' factor. Using projected retirement balances is considered the most logical, efficient and appropriate starting point given the purpose of superannuation and its retirement objective. Further, the calculation of this information is already part of the annual statement process.

Additional 'TTS method' criteria can include using gender and extending it throughout the retirement phase. The efficiency improvements achieved by those additional approaches will in the future incrementally assist in fixing other industry issues; female retirement gap (women live longer/retire later), and MyRetirement products (matching Age Pension/Annuity products to LRB's).

It should be no surprise that there is a way to use digital and big data to improve MySuper retirement outcomes, as has occurred in numerous other industries (e.g. tailored medicines / robo advice).

Industry Impact of Trustees Tailoring MySuper

The member experience graphic below, highlights existing member channels (Choice, One-Size-Fits-All, Age-Only Life-Cycling and TTS) and how that may transition to overcome the current stalemate on member engagement.



Surviving and thriving in the new operating environment requires a clear understanding of the member experience.

To date, this has largely been about those members who make their own choices each year and are at least somewhat engaged, be that by selecting an investment option or using financial advice models. Funds have expended much of their marketing resources on this limited population (possibly just 1% to 3% of the total) through direct advertising or through employers.

In contrast, the needs of MySuper members have been largely ignored, leading to a stark dichotomy.

A key to success in this new environment, simply because of the weight of numbers, must be MySuper member attraction and retention strategies. Maintaining the status quo, particularly for those many (large and small) funds facing negative net contributions flows, is not an option. With aging demographics, most funds will need to change - some more quickly than others.

MySuper member needs are reliant on the actions of the trustee until the point they engage. Those MySuper members who have simply been dumped in a one-size-fits-all investment option by their trustee can hardly be expected at the 'point of engagement' to be enthralled by any offering. This is all about behavioural economics and building trust.

The MySuper members who are in a first generation age-only life cycle may be somewhat more inclined to believe their trustee was looking after them. However, that is just a transition step to providing a tailored solution that allows not only for customised digital marketing solutions at the point of engagement, but also a tailored investment option beforehand.

Conclusion

A dynamic and competitive industry, with efficient small and large players is in the interest of the entire industry.

CEO's, directors and executives, should be encouraged to seek new differentiated product offerings that provide member attraction (direct or through default employer status) and retention (from members leaving to another fund or SMSF) strategies.

It is all the better if these products and strategies can be readily audited as both outstripping economy of scale merger benefits, nudge engagement and more effectively convert contributions into the objective of improved retirement outcomes.

The status quo is not providing solutions to the industry's issues or to improve individual funds. Trustees looking for a point of difference - a reason to continue to exist - will find it in their niche member demographic profiles, as has occurred other regulated industries (e.g. credit unions).

Smart defaults provide the vehicle for trustees to uniquely customise their MySuper offering to their MySuper member's circumstances, in a similar way to engaged choice members.

To date, the superannuation industry has been poor at innovating, leaving one well- respected industry stalwart to recently publicly comment that it would only take a Google or global company with a half decent product to come along… and many funds wouldn't be able to compete.

Given the $550 billion which has been built up using current 'one size fits all' and age-only based life cycling, it's time to consider smarter default option alternatives.

Many funds will be forced to change their current approach and innovate using digital technology, especially for attracting members, retaining members or merging.

While there is no precedent, it reasonable to foresee that the standard of care may be interpreted to include the consideration of Smart Defaults and tailoring analysis in making MySuper investment strategy decisions.

Given digital technologies with increased tailoring have become available, care should be exercised by trustees and investment managers when considering default options to ensure the provision of retirement benefits for each member is the overriding consideration behind the investment strategy.

With such significant individual and national benefits at stake, it is reasonable to forecast that once the 'first mover' adopts a Smart Default, there will be pressure for others to either follow suit or explain their inaction in better fulfilling their fiduciary duties.

Superannuation trustees should be increasingly providing an efficient mechanism for financial intermediation, focused on improved retirement outcomes for members, as distinct from concentrating on one, three and five year return benchmarks.

The current short term (yearly) return and fee focus needs to evolve into a more sophisticated longer term mechanism, based on the purpose of the superannuation system – to provide better retirement outcomes for members.

It is time for the industry to respond to emerging pressures, adopt new technologies and compete to deliver the best outcome for superannuation consumers.

About the FSC

The Financial Services Council (FSC) has more than 110 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, licensed trustee companies and public trustees.

The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the third largest pool of managed funds in the world.

The Financial Services Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

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FSC FINANCIAL SERVICES COUNCIL

About TTS

TTS is Australian. The owner of TTS, Tailored Superannuation Solutions (TSS), holds the implementation ready, IP protected TTS application and process. TSS aims to introduce the product through trustees own investment strategy committees as a sublicensed white branded SAAS offering. TSS has been established as a public company with a view to broad industry ownership over time.

TTS is an internal trustee product. The TTS implementation process for regulatory, data privacy and operational reasons is undertaken by a trustee, overseen by the Investment Strategy Committee, and implemented by existing investment operations, transition and member engagement teams.

TTS has been and is being run on numerous individual funds data. Further fund involvement is being sought. This includes using de-identified member demographic details (age, current balance and projected retirement balances) and the fund's investment option return and loss ratio criteria.

TTS has the capacity over-time to lift the majority of Australians retirement prospects by over 35%, reduce sequencing risk and in the process nudge member engagement.

trustee tailored super