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Ms Karen Chester
Deputy Chair
Productivity Commission
Locked Bag 2
Collins St East Melbourne
VIC 8003

25 August 2017

Subject: **Superannuation: Assessing Competitiveness and Efficiency – Issues Paper**

Dear Karen

Thank you for the opportunity to make a submission in response to the Productivity Commission's July 2017 Issues Paper relating to the Commission's assessment of the competitiveness and efficiency of the superannuation system.

Our comments are set out in the attachments:

- Attachment 1 – Investment performance benchmarking: comments responding to technical queries
- Attachment 2 – Insurance matters: comments re importance of insurance in superannuation and case study information re opt-out, claims experience and use of member information to provide default insurance cover
- Attachment 3 – Member account activity and account monitoring: case study information
- Attachment 4 – Mitigating the risks of a first timer default model: comments
- Attachment 5 – Proposal for ATO Centralised Clearing House: comments

Who is Mercer?

Mercer is one of the world's leading firms for superannuation, investments, health and human resources consulting and products. Across the Pacific, leading organisations look to Mercer for global insights, thought leadership and product innovation to help transform and grow their businesses. Supported by our global team of 22,000, we help our clients challenge conventional thinking to create solutions that drive business results and make a difference in the lives of millions of people every day.

As well as consulting services and investment advice and solutions, Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $150 billion in funds under administration locally and provide services to over 2.4 million superannuation members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 220,000 members and $22 billion in assets under management.

We would be delighted to meet with you and your team to discuss our submission and related matters. Please contact me by email if you would like to arrange a discussion.

Yours sincerely

Dr David Knox
Senior Partner

Attachment 1 – Investment performance benchmarking

Q1. On the system-level benchmarking:

(a) In the context of the approach set out in the stage 1 Study to compare long-term net investment returns to a set of passive, liquid reference portfolios, which reference portfolios would most meaningfully inform the analysis?

To measure the system wide performance of the superannuation industry on a historical basis, a liquid reference portfolio would need to exhibit the following characteristics:

- be **representative** of the industry segment to be benchmarked in terms of growth/defensive split, traditional and alternative asset mix, investment objectives (return and risk), projected time horizon and currency mix
- be **investable, replicable and relevant** for a large Australian institutional investor and represent an appropriate opportunity cost model.
- be **applicable to the member base** e.g. reflect an appropriate growth/balanced/ conservative mix or lifecycle approach based on member demographics
- be **easy to understand, explain and measure**, such as those used by CPPIB (Canada), NZSF (New Zealand) and GIC (Singapore).

(b) What is the best way to ensure that equivalent taxes are netted out of returns to a reference portfolio?

For a reference portfolio, tax rates apply on income and capital gains and franking, depending on:

- the portfolio asset mix
- the tax status (accumulation or pensioner) and
- assumptions about holding periods and franking levels

These individual asset class tax rates can be combined to create after tax reference portfolio returns.

(c) What fee levels should be applied to the reference portfolio? What are the most appropriate listed asset class benchmarks to use to calculate the returns to these reference portfolios?

For passive investments and large institutions, the actual fee level depends on the asset class in question, the fund size, and partnerships. The table below shows illustrative examples.

Asset class	**Benchmark**	**Passive fee range (bp)**
Australian shares	ASX 300	0-20
International shares (hedged/unhedged)	MSCI World ex Australia (hedged/unhedged)	0-20
Emerging markets	MSCI Emerging Markets (unhedged)	10-50
Australian fixed income	Bloomberg Ausbond Composite 0+ years	0-20
International fixed income	Barclays Global Aggregate Index (hedged)	0-20
International listed property	FTSE EPRA NAREIT (hedged)	10-50
International listed infrastructure	FTSE Global Core Infrastructure 50:50 (hedged)	10-50
Balanced Fund (60/40)		10-30

Q2. On asset-class level benchmarking

(a) In the context of the approach set out in the stage 1 Study to benchmark long-term net investment returns at the asset class level, and given the available data, what is the best way to estimate long-term net returns at the asset-class level for the system, and why?

Historical: a key element of the Commission's Assessment framework will focus on the historical investment performance of the system. Estimates of historical longer term asset class returns are available for most listed and alternative markets, at least since 1990 from various data providers, such as MSCI, Barclays, FTSE and S&P.

We note that no two time periods represent the same economic, political, technological or demographic backgrounds. Hence one must be careful in comparing investment returns of different asset classes even over the same period and even more careful in using historical returns (even over long periods) as a guide to future returns.

Forward looking: various methods exist to estimate forward returns for asset classes, and these can vary widely by organisation. Mercer estimates expected returns per asset class on a quarterly basis. These are "market aware", mean reverting from current market conditions to a long term equilibrium ("steady state"). Asset classes are forecast using an Economic Scenario Generator, which ensures economic and statistical consistency in return forecasts. The following are typical inputs:

- Inflation and Economic growth
- Real and nominal bond yields
- Dividend and earnings yields
- Currency over/undervaluation

- Risk factor models

We suggest that this forward looking approach is more reliable and can provide a better guide to reasonable expectations for future asset class and portfolio returns than just relying on historical returns.

(b) Which listed benchmarks should be used for each asset class?

Sample benchmark indices were provided in the previous table for various listed markets.

(c) How can the Commission best assess the investment performance of unlisted investments?

In general unlisted asset classes are benchmarked against:

- an absolute benchmark, IRR (Internal Rate of Return) or TVPI (Total Value to Paid in Capital)
- a relative benchmark. Examples of relative benchmarks are provided below

Asset class	**Relative benchmark options**
Hedge funds	· Cash + 3-5% · HFRI Diversified hedge fund index (hedged) · 50% listed equity + 50% listed credit
Infrastructure	· CPI + 3-5% · FTSE Developed core infrastructure 50:50 (hedged)
Real estate	· CPI + 3-5% · Mercer/IPD pooled property fund index
Private equity	· Relevant listed equity index plus a 3-5% margin · Cambridge Associates Buyout / Venture Capital indices · IRRs of comparable funds with similar vintage year (e.g. from Cambridge, Preqin or Burgiss) · Public Market Equivalent (PME) · 140% listed equity (to reflect leverage and size premium)

Attachment 2 – Insurance matters

1. Importance of Insurance in Super

As we have stressed in previous submissions, insurance cover represents an important part of the Australian superannuation industry. In fact, it has been considered critical by previous Governments and hence is a compulsory part of MySuper products.

This compulsory provision of insurance does not suggest that its provision within super is perfect. As the Commission would be aware, an Insurance in Superannuation Working Group (ISWG) has been established and is working across all the groups within the super industry. This cross-industry membership highlights the importance of the topic and the recognition within the industry that the insurance outcomes for members could be improved.

Notwithstanding the work of the ISWG and the acceptance of some shortcomings, it must be recognised that insurance coverage through super funds means that millions of Australians now have better death or disability insurance than they would have had if there had been no insurance provided within super.

Despite the extensive member coverage provided through superannuation funds, underinsurance remains a much bigger problem than over insurance. However we acknowledge that there is a minority of members, particularly younger members, who are provided with default cover they may not need.

Death and disability cover within super has a number of advantages over death and disability cover provided outside super, including:

- Cost - the group risk nature of insurance, together with the fact that most super fund members are actively employed, means that premium rates are generally much lower than premium rates members could obtain outside super as an individual.
- Benefit - generous automatic cover levels generally apply within super, whereas individual insurance is generally subject to underwriting requirements or cover exclusions.

The fact that insurance cover within super is on an opt-out basis rather than an opt-in basis facilitates these attractive premium rates and automatic cover levels.

Therefore we believe any approach to default fund selection should recognise the value of insurance and take into account the contrasting prices and benefits provided by insurance from different MySuper products, notwithstanding the fact that this makes comparisons more difficult. We recognise there are significant differences in the prices and types of insurance provided by different MySuper products.

However the exclusion of this significant benefit from the evaluation of default MySuper products would represent a major omission. The resulting outcome could be that some default members do not have death and disability insurance where they need it, while others are paying premiums that are higher.

We therefore urge the Commission to recognise that the provision of insurance matters to members and the evaluation of insurance should be part of any assessment of MySuper products.

2. Ease and Extent of Members Opting Out of Insurance or Amending Cover

Given that default death and Total and Permanent Disablement (TPD) cover are provided within super on a compulsory basis, it is important that members are aware that they can opt out or amend their cover at any time. However, the adverse consequences of opting out or amending their insurance cover such as underwriting or additional cover exclusions must be explained clearly to members. Often there are provisions that the Fund's Trustee may have negotiated with the insurer to preserve (such as grandfathered arrangements) which may be lost.

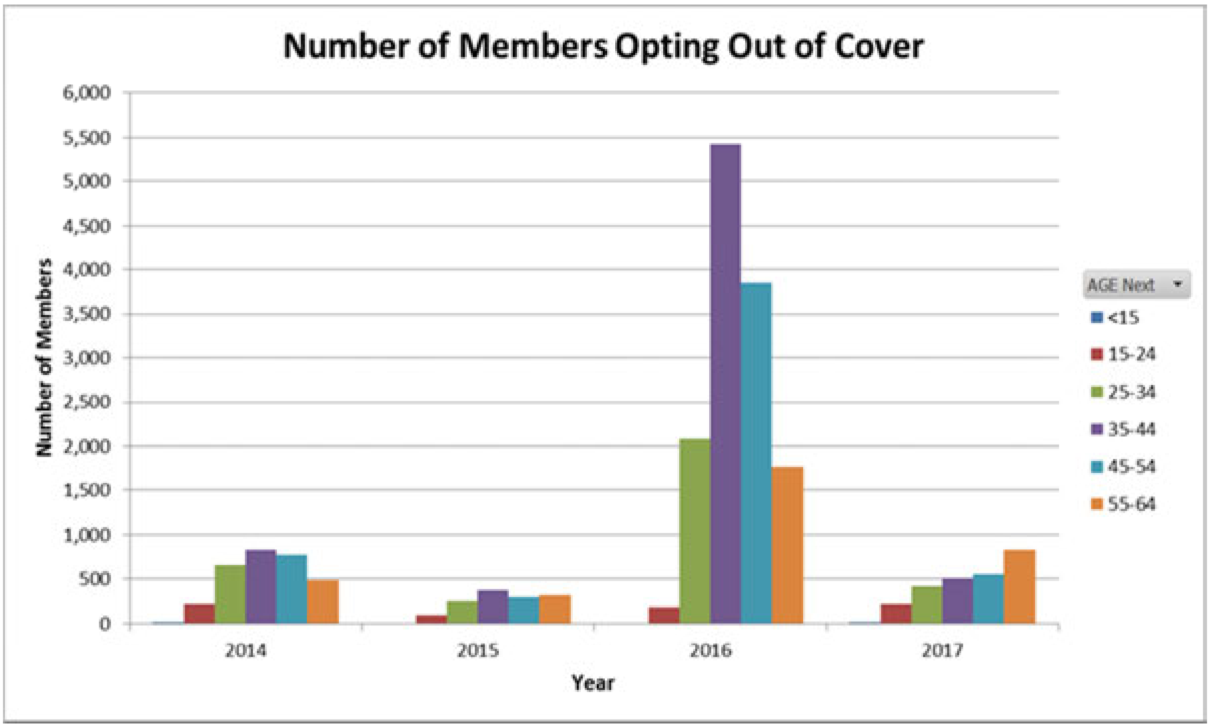
In the Mercer Super Trust, members can opt out or amend their insurance cover by simply calling the helpline or completing an opt-out form.

3. Number of Members Opting Out of Cover Each Year

From the Mercer Super Trust's most recent membership data, we have done some analysis of the prevalence of members opting out of insurance cover. While we cannot easily isolate members opting out of insurance cover alone, we have identified the number of members with nil insurance cover, and excluded members:

- over age 65 with no insurance,
- with a 'Declined' insurance status (due to underwriting or non-receipt of information)
- who have exited employer, but are still in the Fund.

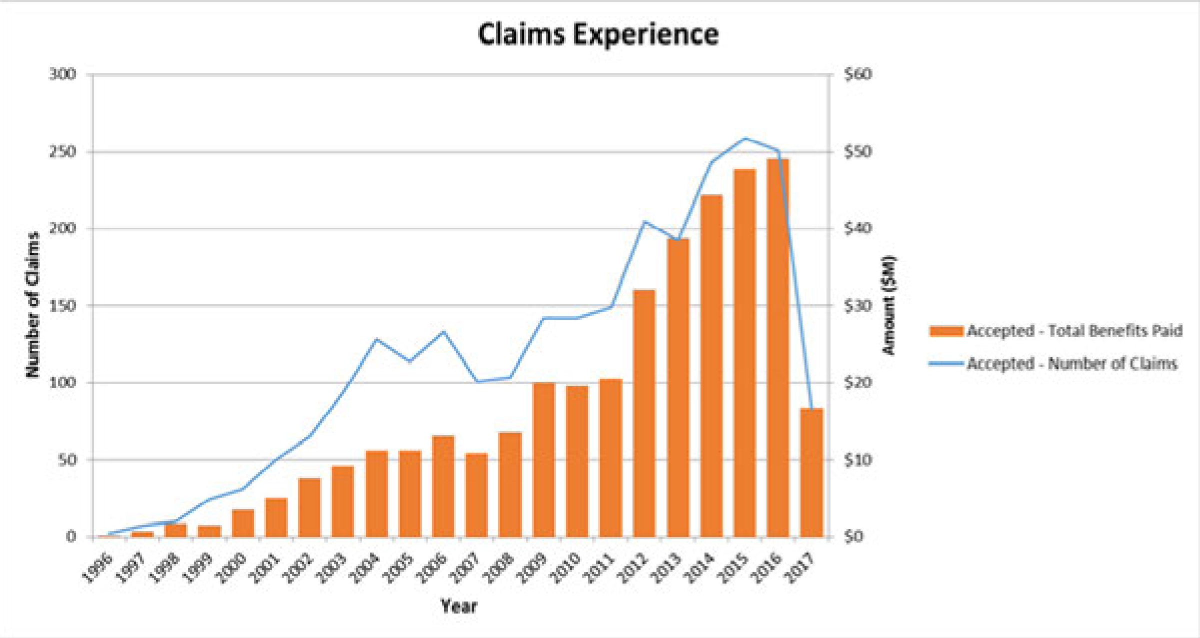
The total resulted in about 21,000 out of 170,312 'eligible' members (or 12.3% of members) who have no insurance.



We note that there was a significant number of opt out requests received in 2016 due to increased media coverage relating to insurance within superannuation.

4. Number of Claims Made and Admitted Each Year

Since inception, the Mercer Super Trust has paid over $378 million of group life claims for over 2,500 cases.



Note the 2017 claims figures only relate to the 6 months to 30 June 2017.

5. Setting Default Insurance Cover Levels

Mercer's flagship superannuation product is the Mercer Super Trust (MST), which has 220,000 members and $22 billion of assets.

The majority of members have death and TPD cover. There are a number of different default insurance arrangements for different employer plans within the MST.

Rather than discuss them all we will focus on the process adopted for determining default cover levels for new individual MySuper members applying to join the MST for the first time.

However before doing so it is worth noting that similar processes are followed for setting default cover levels in other parts of the MST, but in the employer plans the insured benefits are generally salary-related, as we collect current salary information from employers and this allows the cover to be better tailored to the members' needs. Table 1 below provides an overview of sums insured by age as well as average salary information for the Corporate Superannuation Division (employer plans) of the MST.

Table 1 - Average Sum Insured by Age
Mercer Super Trust Corporate Superannuation Division (CSD)

Age	# of CSD Members	Death Cover	TPD cover	TTD cover	Average Death	Average TPD	Average Salary
15-19	300	$48,495,147	$48,495,147	$1,675,816	$161,650	$161,650	$33,693
20-24	5,051	$1,382,010,098	$1,368,652,980	$32,643,605	$273,611	$270,967	$48,833
25-29	13,488	$4,584,816,305	$4,516,278,924	$136,526,550	$339,918	$334,837	$67,133
30-34	19,714	$7,114,903,254	$6,962,263,130	$262,538,320	$360,906	$353,163	$86,829
35-39	21,455	$7,776,076,214	$7,511,555,268	$344,737,521	$362,437	$350,107	$99,072
40-44	21,784	$7,564,952,194	$7,273,935,589	$408,112,416	$347,271	$333,912	$111,884
45-49	19,636	$5,810,969,100	$5,572,179,942	$380,717,721	$295,934	$283,774	$110,204
50-54	16,435	$3,599,051,610	$3,427,891,423	$339,233,219	$218,987	$208,573	$112,984
55-59	12,471	$1,792,574,416	$1,690,010,978	$283,036,987	$143,739	$135,515	$113,525
60-65	7,917	$504,052,799	$445,363,600	$159,484,349	$63,667	$56,254	$96,515
66+	2,640	$21,164,899	$11,905,527	-	$8,017	$4,510	-

Notes:

1. Most members have death and TPD cover but only a minority have TTD cover (income benefits payable for a period on total and temporary disablement). The TTD cover shown is the annual benefit payable while TTD.
2. Also note that the table shows the insured cover component only, which would be payable in addition to the member's balance on death or TPD.

Determination of default cover levels for new individual MySuper members

Let us now turn to the process adopted for determining default cover levels for new individual MySuper members applying to join the MST Trust for the first time.

Step 1 is to analyse the demographics of the membership. In this particular case members typically join between ages 18 and 65 and can come from a wide range of occupations and insurance risk profiles, representing a broad cross section of the population.

Step 2 is to analyse the members' insurance needs. In doing this we partner with our insurer who in turn partnered with Rice Warner, who have done a significant amount of research in this area. The research indicated as expected that insurance needs vary by age, marital status and whether the member has children. Death cover needs differ from TPD cover needs. By and large insurance needs are lower at younger and older ages, and peak at around ages 35-45.

The MST does not generally have information about individual section default members' marital and dependant status or their salary, and so the trustee needs to set default cover levels based on the key variable it does have, which is age.

The trustee decided to set the *shape* of the default cover by age based on the Rice Warner needs analysis. In Step 2 the trustee needs to take account of any constraints its insurer may impose. For example at young ages members typically need more TPD cover than death cover, however some insurers are not prepared to offer a TPD benefit which is higher than the death benefit.

Step 3 is to carry out actuarial calculations to determine what *level* of cover (based on the *shape* of the cover by age determined by Step 2) strikes a reasonable balance between:

a) Providing cover which goes a reasonable way towards meeting the member's insurance needs; and

b) Ensuring that premium rates do not unreasonably erode members' retirement balances.

Regarding (b), Table 2 below shows an example of our analysis based on the projected reduction in retirement benefits using 9.5% as the contribution level, 65 as retirement age, 2.5% pa real investment return and the default level of insurance cover (default cover scale and cost provided in Table 3 below). With these assumptions, our projections indicated that the higher the salary, the higher the contributions and therefore the cost of this type of cover (i.e. dollar-based rather than salary-related) has less impact on retirement accumulation which is demonstrated in Table 2 below.

To ensure the cost is fair and reasonable, we took the view that the cost of default insurance should not generally erode the member's retirement benefits by more than 15% for most members. While the table below shows that some members on lower salaries would have a higher than 15% impact on their retirement accumulations, the member demographics of the MST generally show that the average salaries are in the higher ranges so few members will exceed the 15% level. Members may choose higher levels of cover to suit their personal circumstances and can balance the cost against their needs.

Table 2 - Percentage Reduction in Retirement Benefits

Entry Age	Salary	20000	30000	40000	50000	60000	70000	80000	90000	100000
15		10.6%	7.1%	5.3%	4.3%	3.5%	3.0%	2.7%	2.4%	2.1%
20		12.1%	8.1%	6.1%	4.9%	4.0%	3.5%	3.0%	2.7%	2.4%
25		13.7%	9.2%	6.9%	5.5%	4.6%	3.9%	3.4%	3.1%	2.7%
30		15.7%	10.5%	7.9%	6.3%	5.2%	4.5%	3.9%	3.5%	3.1%
35		18.3%	12.2%	9.1%	7.3%	6.1%	5.2%	4.6%	4.1%	3.7%
40		21.2%	14.1%	10.6%	8.5%	7.1%	6.0%	5.3%	4.7%	4.2%
45		23.6%	15.8%	11.8%	9.5%	7.9%	6.8%	5.9%	5.3%	4.7%
50		25.0%	16.7%	12.5%	10.0%	8.3%	7.1%	6.3%	5.6%	5.0%
55		25.1%	16.7%	12.5%	10.0%	8.4%	7.2%	6.3%	5.6%	5.0%

Of course, it should be recognised that at the lower and middle income levels, many individuals will have a lower superannuation balance and are therefore likely to receive a higher age pension. This outcome reduces the ultimate effect on these members' retirement income of the higher reduction in superannuation retirement benefits.

Step 4 is to design additional cover, for which members can apply on a voluntary basis. This is generally available without underwriting if requested within a window period or through occurrence of a significant life event such as marriage, birth or adoption of a child, taking out a mortgage, etc. Otherwise, election for higher amounts of cover can be made at any time subject to underwriting.

It is also worth noting that all super funds are required to have an Insurance Management Framework which requires them to have policies and procedures governing how they set default cover levels, but we believe additional regulator guidance along these lines may be useful.

Table 3 – Default cover levels for individual MySuper members

The following table 3 shows the default cover levels that have been formulated using a dollar based approach and the methodology set out above. Maximum insurance cover is between ages 30 and 50, when a member generally has the greatest insurance needs. The equivalent of 3 units of cover is above the average insurance needs determined from Rice Warner's research at the younger and middle years when cover is accessible at a reasonable cost and slightly below at older ages when premiums are more expensive.

Members can generally opt out or reduce their cover at any time to align the amount of cover to their needs.

Age Next Birthday	Cost of Cover (Light Blue Collar)		Whole of Life Bell Curve (Default Cover Levels)	
	Dth only	Dth & TPD	Death & TPD ($) (1 Unit)	Death & TPD ($) (3 Units)
15	0.240	0.300	50,000	150,000
16	0.240	0.300	50,000	150,000
17	0.288	0.348	50,000	150,000
18	0.336	0.420	50,000	150,000
19	0.360	0.480	50,000	150,000
20	0.372	0.492	50,000	150,000
21	0.372	0.492	55,000	165,000
22	0.372	0.480	60,000	180,000
23	0.360	0.468	65,000	195,000
24	0.336	0.432	70,000	210,000
25	0.324	0.420	75,000	225,000
26	0.300	0.396	75,000	225,000
27	0.300	0.396	75,000	225,000
28	0.300	0.396	75,000	225,000
29	0.300	0.408	75,000	225,000
30	0.300	0.408	77,500	232,500
31	0.324	0.432	77,500	232,500
32	0.336	0.444	80,000	240,000
33	0.336	0.456	80,000	240,000
34	0.336	0.480	82,500	247,500
35	0.360	0.516	82,500	247,500
36	0.360	0.528	85,000	255,000
37	0.372	0.564	87,500	262,500
38	0.408	0.612	90,000	270,000
39	0.420	0.660	92,500	277,500
40	0.456	0.720	95,000	285,000
41	0.504	0.792	100,000	300,000
42	0.540	0.888	100,000	300,000
43	0.612	0.984	97,500	292,500
44	0.660	1.092	95,000	285,000
45	0.708	1.212	92,500	277,500
46	0.780	1.368	90,000	270,000
47	0.852	1.536	85,000	255,000
48	0.936	1.728	80,000	240,000
49	1.020	1.932	75,000	225,000
50	1.116	2.160	70,000	210,000
51	1.236	2.436	65,000	195,000
52	1.356	2.736	60,000	180,000
53	1.476	3.072	53,000	159,000
54	1.644	3.480	47,000	141,000
55	1.800	3.924	41,500	124,500
56	2.004	4.476	36,500	109,500
57	2.244	5.136	31,500	94,500
58	2.496	5.892	27,500	82,500
59	2.784	6.744	24,000	72,000
60	3.120	7.764	20,500	61,500
61	3.492	8.928	18,000	54,000
62	3.936	10.308	15,500	46,500
63	4.416	11.868	13,500	40,500
64	4.992	13.680	11,500	34,500
65	5.604	15.780	10,000	30,000

Attachment 3 – Member account activity and account monitoring

The engagement of individuals with their superannuation is important as for many Australians it represents their largest financial asset. It is also critical that members understand their insurance arrangements and the size of their superannuation balance as they begin to plan for retirement. However, we also recognise that many members are not actively engaged with their superannuation fund. Of course, this does not mean that all these individuals are unaware of their super – they may receive and read their annual statement and decide that no further action is required, at least for the moment.

The Mercer evidence is that engagement with superannuation is increasing. The following table shows the percentage of members in the Mercer Super Trust who have contacted the Helpline (ie call centre) or accessed the website during the last five years. It should be stressed that these are unique members as some members contact the fund several times during the year.

Year	Percentage of members who contacted the fund via	
	Helpline	Website
2012-13	23.2%	17.7%
2013-14	28.2%	22.6%
2014-15	30.5%	23.7%
2015-16	29.5%	24.6%
2016-17	31.5%	33.5%

It is worth noting that:

- Member activity has increased during the last five years with the doubling of the percentage of members who access the website;
- Notwithstanding the increased website activity, the percentage of members who use the Helpline has also increased.

Other interesting findings are that:

- Of those members who accessed the website during 2016-17, the average number of “activities” per member during the year was 21.0 for males and 12.0 for females;
- Not surprisingly, older members access the website more often than younger members with the average activity count ranging from 8.8 for 20-24 year olds to 28.7 for 60-64 year olds.
- Of those members who used the Helpline during 2016-17, the average number of calls during the year was 2.3 for males and 2.1 for females;
- Older members who used the Helpline also used it more often than younger members with the average number of calls for these members increasing from 1.7 for 20-24 year olds to 3.0 for 60-64 year olds.

Attachment 4 – Mitigating the risks of a first timer default model

As indicated in our April 2017 submission, one of the problems of a first timer default model is that it will substantially erode the large corporate funds (both standalone and sub-funds in a master trust) which are the part of the market where competition is at its fiercest, innovation is driven and the most competitive arrangements for members are secured. Under a first timer default model, corporate funds will be largely or entirely reliant on engaging new employees to the extent that they actively consider superannuation and then opt-in to the employer fund.

Further, where an employer negotiates superior arrangements with a new fund, transfer of existing default employees to that new fund would no longer be automatic but would require all members to individually opt in. This is likely to mean that the benefits currently achievable by large employers would disappear, as the ability of these employers to negotiate favourable arrangements, by virtually guaranteeing a large new membership and asset base, would be substantially reduced, at best.

We also note that the present process avoids exacerbating the duplication of accounts issue, because when an employer chooses a new default fund it applies not only to new employees but also to the future contributions for all existing default employees and it is standard practice for their existing balances in the previous default fund to be successor fund transferred into the new fund.

Although we do not support the the first timer model, we would note that if this approach is adopted, the transition risk of existing (pre-first timer model) default members remaining in an underperforming fund could be reduced if there was a mechanism that continued to allow the employer to change the default fund for these members. This would also assist in maintaining strong competition at the large corporate end of the market for a period, although this would be expected to diminish over time due to the likely significant reduction in new member flow.

We suggest a mechanism along the following lines be considered:

- employers be permitted to change the default fund for new contributions for employees who defaulted into their current fund under the existing (pre-first timer model) default arrangements
- the new fund trustee could be required to tell all previous default fund members about the new default fund; and
- unless the member notifies the trustee they don't want to move, their future contributions and their existing account balance will be automatically moved to the new default fund chosen by the employer.

The above mechanism could be extended to default members who joined under the first timer model, though this is likely to be of limited relevance unless Model 2 (Assisted Employer Choice) is adopted, and even then only if the employer employs significant numbers of first-timers.

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Attachment 5 – Proposal for ATO Centralised Clearing House

Mercer does not support a centralised clearing house administered by the ATO.

The industry, including Mercer and our client funds, has invested heavily in getting SuperStream up and running. This includes the building of tailored client solutions designed for use within one of the SuperStream channels we use (Mercer Spectrum). For example, this significant development work allows us to capture the extra data needed for each of our defined benefit funds and map it correctly to member accounts and balances via straight through processing.

We are very concerned that a new centralised clearing house would require a further very large investment by the industry with potentially little gain, possible delays in contributions being credited to member accounts and, very likely, less flexibility.

Mercer agrees with ASFA that the introduction of a centralised clearing house would involve new and substantial risks and costs to government, employers and funds (and therefore members). The focus should instead be on continuing to leverage the benefits of SuperStream.