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Superannuation: Assessing Efficiency and Competitiveness – Draft report

Thank you for the opportunity to provide feedback on The Productivity Commission's ("The Commission's") Draft Report into Superannuation: Assessing Efficiency and Competitiveness ("the Report").

About Colonial First State

Established in 1988, Colonial First State provides investment, superannuation and retirement products to individuals and companies. Colonial First State is the largest account based pension provider in Australia, making more pension payments than any non-government entity. We are also the third largest administrator of retail funds with $130 billion Funds Under Administration.[1]

Colonial First State (CFS) supports a more efficient and competitive superannuation system which delivers better outcomes for members, stronger governance standards, greater transparency and more competition in default superannuation.

Feedback

We commend The Commission's work and the release of the Report. In this submission we provide feedback on some of the key recommendations and findings in the Report. We have also provided input into the FSC and ASFA submissions which deliver more comprehensive responses to the Report. CFS has also worked constructively and closely with the Productivity Commission (including through industry bodies) in responding to its survey request relating to fund data, including explaining the difficulties of providing the data in the form requested.

- **Defaulting only once for new workforce entrance and a 'best in show' shortlist for new members:** CFS supports the model put forward by The Commission that default superannuation accounts should only be created for an employee without an existing fund entering the workforce for the first time. Employees would also be presented with a Best in Show shortlist to choose from while still having the option to choose from a bigger list of MySuper products or any other fund including Self Managed Super Funds (SMSF). We agree with The Commission that the current model, where default funds are tied to employers and the workplace relation system doesn't ensure members are placed in the very best funds, contributes to unnecessary account proliferation and delivers highly variable outcomes to members. The model proposed by The Commission opens up competition and correctly, in our view, links the default fund to the member not their job.
- **Superannuation performance:** Performance comparisons in superannuation can only be conducted on a 'like for like' basis and at investment option level. Both MySuper and Choice play very important and different roles in the system for members and performance comparisons between these two segments are fraught, including the use of pre-MySuper default data in MySuper comparisons. We support greater consistency regarding the use and presentation of investment option performance data. However we don't support the comparison of whole of fund performance due to the wide divergence and breadth of investment products and options within individual super funds. We don't believe that these differences can be adjusted for in a way that enables meaningful or accurate comparison of whole of fund performance. Because of these differences it's important to note that the actual investment returns members experience are always going to be different from the current published data.

1 Strategic Insight March 2018

- **The value of life-cycle products within MySuper:** The Productivity Commission makes a number of criticisms of life-cycle products and also poses a series of questions. CFS does not agree with these criticisms. We believe life-cycle products play an important role within MySuper in managing sequencing risk for disengaged members. They also avoid categorising all members into a 'one size fits all' approach which may not deliver appropriate outcomes for all members.

  We believe that life-cycle products are well suited to default members as the approach better match's members' capacity for risk therefor helping members reach their retirement goals in a safe manner. We don't believe that life-cycle products are only suited to Choice members.

  The PC has asked 3 questions in relation to life-cycle products. Our responses are in the Appendix.

Defaulting once and a best in show shortlist for new members

Recommendation 1. Defaulting only once for new workforce entrants

The Commission has demonstrated in the report that the proliferation of unintended multiple accounts across the superannuation system can, and is, unnecessarily eroding member benefits and should be addressed. According to The Commission, unintended multiple accounts cost members $2.6b per year in excess insurance premiums and administration fees.

The Government's 'Protecting your superannuation package' recently introduced into parliament goes some way to fixing this problem, but the root cause needs to be addressed. The Commission's recommendation *1. Defaulting only once for new workforce entrants* is a good solution. This addresses the root cause of the problem and will help solve the proliferation of multiple accounts.

The Commission proposes that a centralised online service should:

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

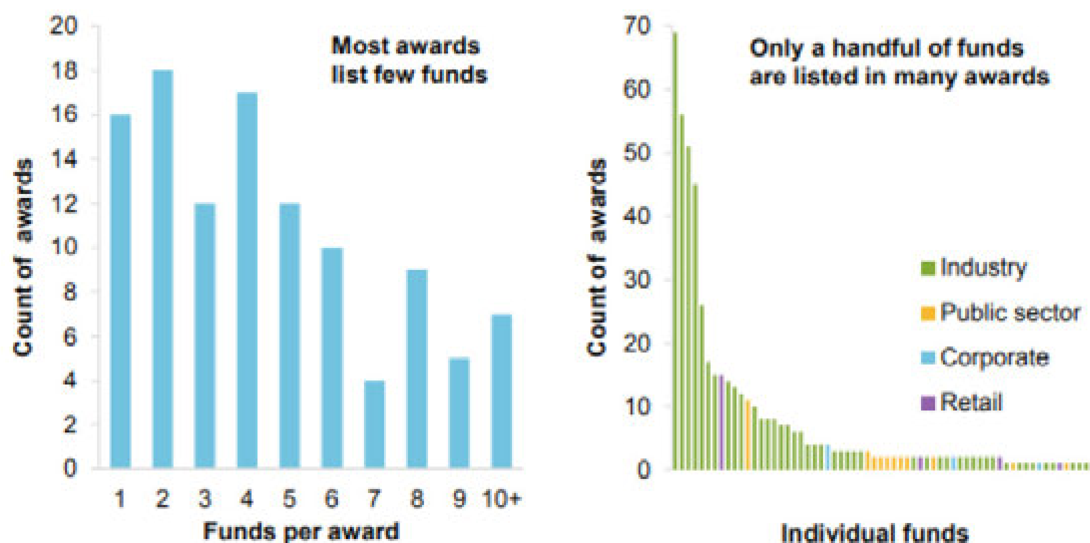
This service would be achieved by enhancing Single Touch Payroll (STP) and MyGov. We have been working with the ATO on the design for STP and believe this solution will provide better outcomes for employees. CFS is a leader in providing technology solutions for customers. We already integrate some members' superannuation accounts into Netbank. This is a natural extension for employees to interact with their superannuation.

This solution will also provide benefits to employers as it will reduce the administrative effort in capturing choice of fund details from employees. This information would automatically flow from the ATO's MyGov system into an employer's payroll system.

Recommendation 2. 'Best in Show' shortlist for new members.

In conjunction with a new member only defaulting once, The Commission also makes the recommendation *2. 'Best in Show' shortlist for new members*. The Report (p462) states "The best in show shortlist is about putting members first- regardless of their employer or industry of employment". The Report also correctly identifies the current workplace relations system acts as a barrier to competition in the default market stating that (p458) "While embedding the choice of default super products in the workplace relations system may have made sense in the past, the existence of different lists of funds in different awards is fuelling the creation of unintended accounts (by having different funds for different industries), and poses barriers to new funds entering the default market (chapter 7). Moreover, enterprise and workplace agreements that restrict an estimated 1 million individuals from exercising their own choice of fund serve no purpose in a modern super system, and should be prohibited by legislation (chapter 12)".

Figure 7.9 Award listing is concentrated[a,b,c]



a The Fair Work Commission lists 122 modern awards on its website. **b** Not all superannuation contributions made under awards are made to default funds listed in awards. 'Grandfathering' clauses in all modern awards allow employers to continue to contribute to funds to which they were contributing before 12 September 2008 (FWC website; PC 2012). **c** This figure includes six funds that have now merged or appear to no longer be in operation, but where it is unclear whether a successor fund is able to be selected as a default fund within each award.

Source: PC analysis of the 122 modern awards listed by the Fair Work Commission (2017)

We strongly agree with The Commission that default superannuation fund selection is due for reform. We have previously argued for the law to be amended to allow employers to select any MySuper product as the default superannuation fund for their award employees.[2] This position is not inconsistent with the direction proposed by The Commission in presenting the "Best in Show" model and we think the model has merit. CFS supports further consideration of the model, including how it can be effectively implemented. Some issues for consideration as part of the consultation could include:

- Whether 10 funds is the right amount - if more than 10 funds can meet the increased MySuper standards as proposed (which CFS supports) could they also be included in the shortlist?
- What are the selection criteria to be adopted? We believe that criteria should reference the member's experience and include amongst other things, cost to member, performance, governance, investment approach, insurance and member services.
- How would the various selection criteria be weighted by the Independent expert panel; and
- What attributes would a potential panel member possess in order to be considered for selection (how would they demonstrate impartiality)?

One of our key concerns in considering policy reform relating to default super has been to ensure a truly competitive market emerges, one in which all MySuper products and providers can compete for the right to be a default for members. Analysis by the Financial Services Council shows that the fees paid by Australian consumers could reduce by 13 per cent (or $292 million) across 14 million superannuation accounts if competition was allowed in this part of the sector[3]. One of the key advantages of the Best in Show proposal is the introduction of open competition in the market. It brings to bear competitive pressures in the default market that do not currently exist given providers would attempt to compete to be on the shortlist. CFS supports the direction offered by the Best in Show proposal and believes there is merit in the Government undertaking consultation on how to best implement such a model.

2 Colonial First State Investment Limited submission, Productivity Commission review into superannuation: Assessing competitiveness and efficiency, stage 3 issues paper, 4 September 2017, p1.

3 Deloitte Access Economics, Choice and competition in the Australian default superannuation system, April 2017, p3.

Superannuation performance

The measurement and presentation of net superannuation investment performance data is critically important to members as they seek to understand how the funds they have invested will deliver an adequate income in retirement. Consistency of understanding, transparency and comparability is therefore paramount. At present, however, this is a complex task. There are a range of different products and member segments and structures within the system. In addition there is no universally observed methodology. Data reported to the regulator and the performance reported by the key research houses are all very important components in the presentation of performance, however, a consistent approach does not currently exist.

CFS acknowledges the enormous amount of work that the Productivity Commission has put into developing an approach to benchmark super fund and product investment performance for the purposes of the Report. Given The Commission's approach is a new methodology we have enquired into certain aspects of the benchmark (including its construction and the process of applying it) to understand how it operates including in relation to our funds.

We are concerned that the results and associated findings reached through the use of the data may be impacted by the limitations and assumptions of the sources used. We have engaged with the PC, including through the FSC, to understand more about the approach used.

We are of the view that the underlying assumptions used for performance analysis of funds does not provide an accurate comparison of a fund's performance.

We understand that the PC in its analysis has:

- Applied the ratio of the default asset allocation to the whole of fund asset allocation following the introduction of MySuper (i.e. post-2014) to periods pre-MySuper;
- the ratio was used to determine the fund's benchmark performance; and
- the whole of fund performance was compared to the fund's constructed benchmark.

Our concern is that these assumptions do not hold for CFS, as the mix of members and investment strategies has materially changed with the introduction of the life-cycle approach for default members. The table below show the asset allocation for the whole of fund, the default funds (pre and post MySuper) and the ratio as it changes through time.

	(A) 2017	**(B) 2014**	**(C) Pre 2014/ MySuper (assumed)***
Whole of fund growth allocation	60%	56%	56%
Default growth allocation	83%	84%	70%
Ratio default/whole of fund	1.38	1.51	1.26

The data used is the quarterly APRA data and APRA's definition of "growth" (i.e. equity, property, infrastructure, commodities and "other").

* Pre-MySuper, CFS had 8 different default options. The 3 largest default options had exposure to growth assets ranging between 60%-80%. For the purpose of our analysis here, we have assumed an average asset allocation of 70% for default members. We have also assumed that the whole of fund growth component was similar to the value of 56% measured in 2014.

The change in ratio between (C) and (B) is explained by:

- the change in CFS's default strategy from a balanced option to a life-cycle approach with the introduction of MySuper.; and
- our member demographic in the default option - younger cohorts with higher growth allocation.

The change between (B) and (A) is explained by changing member demographic and the total assets in MySuper increasing from $1.4bn in 2014 to $8.6bn in the most recent quarter. This is largely due to ADA transfers resulting in the default MySuper being a higher proportion of the fund.

The ratio of growth assets for 'default' members to growth assets for the whole of fund prior to 2014 is therefore estimated at around 1.25, materially lower than the ratio post MySuper. Our position is that any analysis that assumes a constant ratio of growth assets in default to growth assets for the whole of fund will be flawed.

Understanding the role of the superannuation segments

To understand existing performance comparisons in the superannuation industry it is critical to understand the purpose and importance of each of the key segments or sectors in the system and how they have developed. Further it is also critically important to understand the role each plays so that comparisons can be made based purposefully, on a like for like basis. The Draft Report reflects the different member and product segments accurately in Box 1.3 on page 74. Importantly, in doing so (Box 1.1, page 69) the Report makes reference to the introduction of MySuper.

Introduced in July 2013, MySuper was a step change for default super in Australia. 'These reforms put in place a set of regulatory standards for all default accumulation products. The intention was to provide a low-cost, transparent and comparable set of products that achieve better outcomes for default members — members who do not choose their own fund or investment strategy.' MySuper products are prohibited from charging conflicted remuneration and the requirement to provide a single diversified investment strategy. From a retail fund perspective the introduction of MySuper was more significant than for other sectors of the industry.

Colonial First State took the opportunity to strategically rethink our approach to offering a default. Previously we had offered a range of trustee default options but MySuper allowed us to introduce a life-cycle approach that aimed to differentiate the investment strategy for our default members (permitted under the new rules) to ensure that members are not placed into a single one-size-fits-all strategy. Cohorts designed for younger members have a high exposure to growth assets reflecting their long investment horizon. Older cohorts will have a more conservative asset allocation which will be more likely to produce lower comparative returns with lower volatility compared with the younger cohorts or traditional balanced/growth default investments. While this makes comparative performance across funds more difficult we believe that the outcome is better for all members.

For funds that previously offered a single default option, the change was less significant or complex. These funds were able to 'rebadge' their existing default options, meaning the existing default option could now be classified as a MySuper option. While this was convenient for many funds, it resulted in funds having all their default members invested in a single investment strategy without regard to their members' age or capacity for risk. Recent experience has seen some funds moving away from the single investment strategy and adopting life-cycle investing.

Comparing like with like

APRA produce fund level performance data which aggregates the returns of all investment options within the fund into a weighted average. For a retail fund which potentially has hundreds of investment options (only one, or a very small number, of which will be MySuper options) this data point is effectively irrelevant to members. It is not a return that a single member could possibly receive. Unfortunately, despite APRA's warnings, these data points are still cited in the media as representative of member superannuation returns. They have also been used to aggregate and publicise sector level performance.

APRA's public cautioning relating to its fund level return data has been strong and clear. In a 2017 Senate Economics Legislation Committee, referring to claims on industry fund outperformance of retail funds, APRA Deputy Chairman, Helen Rowell said:

> "I disagree with that analysis as providing a meaningful comparison. I have put on the record on a number of occasions, and we have published various letters and other material that indicates this, why we don't think that average sector-to-sector comparison is meaningful."… "There are a number of ways that you can provide comparisons and do analysis, but you have to do it at a more granular level that seeks to compare products or options with similar risk-return objectives, or where the members, for example, have similar demographics and risk preferences rather than lumping everyone in together by sector. Analysis is possible and can be done but it needs to be meaningful."

The Productivity Commission has also expressed concerns about using aggregate data. In response to claims that industry funds have consistently outperformed "bank-owned" super funds, Deputy Chair Karen Chester (giving evidence to the Senate Estimates Committee in 2017) stated comparisons of this nature are like 'comparing apples and zebras'.

4 Report p69

The returns on superannuation depend on the assets and investment mix of the fund and how those investments perform over time. Retail funds such as CFS have a much higher proportion of older members who are more conservatively invested, which means that, compared to funds with younger members, they will have lower returns over the long term. Further, aggregate retail fund asset allocations are driven mainly by financial adviser recommendations which are in turn determined by a member's needs and objectives, and tolerance for risk. Hence the fund asset allocation is a product of thousands of decisions made by investors and their advisers when they are constructing their own asset allocation based on their individual circumstances. It is therefore meaningless to compare fund or sector level returns.

While the Productivity Commission has sought to adjust the APRA performance data in order to compare returns, we believe that this has required too many assumptions and that the resultant comparisons are not appropriate or meaningful.

Productivity Commission supplementary survey – performance and investment fees by asset class

Noting the limitations of APRA whole-of-fund data in conducting a meaningful analysis of superannuation industry performance, we appreciate The Commission's intent in requesting further data from superannuation funds to assist in its analysis of the industry.

However, despite our best endeavours to obtain meaningful and relevant data to answer The Commission's further questions in respect of asset class investment performance and investment fees for each of the funds under our trusteeship, this data is not available for many of the investment options offered within our superannuation funds, nor could we in some cases calculate reliable estimates in response to these questions.

Whilst the trustee monitors investment performance and fees for each of the investment options available within our funds, this information is not aggregated by asset class nor at the whole-of-fund level as it does not represent the return any individual member would receive, nor is it meaningful in the context of the trustee's ongoing monitoring of investments. Furthermore, for externally managed multi-sector funds, this granular level of detail is not published by fund managers or made available to the trustee.

Notwithstanding these limitations, we attempted where possible to estimate the investment performance and investment fees by asset class to assist The Commission with its analysis.
The estimated figures provided in our survey responses cover approximately 60% of funds under management for superannuation funds under the trusteeship of Colonial First State Investments Limited (comprising Colonial First State First Choice, Commonwealth Essential Super, and the closed Colonial First State Rollover and Superannuation Fund). However, it was not possible to estimate these figures in respect of the five superannuation wraps under the trusteeship of Avanteos Investments Limited due to the structure of these funds.

We would welcome the opportunity to continue our discussions with The Commission on alternative, available, and meaningful data which may further assist in The Commission's analysis of investment performance or investment fees.

Choice segment and performance comparisons

The Colonial First State FirstChoice Superannuation Trust provides members with a choice of over 150 investment options across super and pension, managed by a wide range of investment managers. These investment options can be both single-sector (e.g. Australian shares) and multi-sector investment options (e.g. 'Growth' or 'Balanced').

There are also seven 'products' (e.g. FirstChoice Wholesale Personal Super) within FirstChoice, representing different fee and tax structures. Our MySuper defaults represent around 10% of the funds under management in the trust. The remaining funds under management represent Choice options, made available by the Trustee on its menu for use by individual members or financial advisers with their client/members in implementing a retirement savings or retirement income strategy.

A member's financial adviser may recommend them to invest their balance and/or future contributions in a diversified multi-manager, multi-sector choice option such as the FirstChoice Wholesale Balanced Option or one or more single manager, single sector options such as: Cash, Australian Share, Property or Fixed Interest, in order to construct a diversified portfolio of investments through the superannuation trust. It is also common for a financial adviser to consider a member's non-super investments (to the extent relevant) including property investments, when recommendation a superannuation investment portfolio.

The trustee's purpose in offering choice is to make available a broad range of good quality investments for superannuation members to choose to invest in either directly or with the assistance of their financial adviser. Unlike the MySuper default the trustee is not involved in asset allocation decisions for the member's total portfolio. Choice options are important for those who exercise fund and investment choice. Choice options also become more important for members as they progress in their working life and get closer to retirement. Generally individuals will then become more engaged in ensuring they are appropriately invested and will have enough income in retirement. At this time the member may look to different investment options and / or another super fund and beyond the default investment style they have invested in previously.

Choice options are also critical for members in an allocated pension. At this stage, there is no concept of a default pension strategy and hence all options for members in the pension phase are considered to be Choice.

If the choice segment within registered superannuation funds were not able to provide this important role in the superannuation system, members who do not wish to be in a default would only have Self-Managed Superannuation Funds (SMSFs) as an option. SMSFs play an important role for many members who want full direction and control over their superannuation savings. However, members must have significant savings to justify an SMSF. Acting as trustee comes with certain obligations and responsibilities that many individuals would prefer not to carry out. ASIC considers that in the majority of cases an APRA-regulated fund with be more appropriate than an SMSF[5]. Choice funds are therefore an important vehicle for those who want some control over their superannuation investments but do not wish to carry full responsibility for all aspects of operating a super fund.

Limitations of comparing performance across segments

Given the roles played by the different sectors in the system it is often misleading to attempt to compare performance data between the MySuper, Choice and SMSF segments. Colonial First State's MySuper options now have five year performance data and there is an ability to start to make an assessment of the effectiveness of life-cycle products. Choice (including existing default investment options) contains a significantly broader range of investment styles (from cash to geared investment options) and options and will also contain different fee structures, including the existence of grandfathered adviser fees such as commissions. Depending on which research firm presents the data, there could be inconsistent treatment of certain fees such as dollar based member or administration fees (some firms may exclude these). All these factors mean simple performance comparisons cannot be made easily across and within the segments and are likely to mislead members as to the true performance of their investment.

When considering MySuper investments, returns can be compared if, irrespective of the investment label attached to the product, the split between growth and defensive assets is comparable (for example: if both funds have around a 70:30 split). It is not, however, enough to rely on the label attributable to the fund e.g. – 'Balanced' or 'Growth' as, again, depending on the research firm issuing the performance tables, there may be different constructions of what can be considered a balanced fund, and the range of investments considered growth or defensive for these purposes may be different. For example, Chant West considers a Growth fund to contain growth investments of anywhere between 61-80% whereas Lonsec's SuperRatings classifies Growth as between 77-90% growth assets and its 'Balanced' category as 60-76%. Further, the labelling used by funds themselves doesn't necessarily match up with these definitions, meaning a fund labelled as balanced by the super trustee could fit into both Growth and Balanced categories above. There is clearly opportunity for confusion by members in this complexity.

Colonial First State believes more could be done to help standardise the publication of performance data across the industry, including in the media and by research houses. Any taskforce created for this purpose should include representatives from super funds themselves.

The value of life-cycle products within MySuper

The Productivity Commission makes the following criticisms of life-cycle products and then states that they are then better suited for Choice products:

- life-cycle products don't reduce the variation of outcomes across default strategies
- that members in life-cycle products can expect lower retirement balances
- that higher returns are foregone from adjusted asset allocations "as early as 30 years of age"
- life-cycle products are mostly suited for members who want to lock in a lump sum at retirement

5 ASIC, Report 575: SMSFs: Improving the quality of advice and member experiences, para 276.

While the life-cycle approach doesn't reduce the variation in outcomes, it is but one of many variations to outcomes. The life-cycle approach has a range of positive benefits for default members particularly that it avoids the one size fits all approach of a single balanced option. While lifecycle is not perfect, offering the same strategy to all members in a fund regardless of age, gender, account balance or income is not a superior approach.

The modelling we undertook in establishing the glide path for our FirstChoice Employer Super life-cycle option was specifically designed to produce an expected balance at retirement that was equal to or greater than that produced by a balanced option. The purpose of the modelling was to achieve the same outcome at retirement while better managing the path of member returns over their working life.

As a consequence, we (and we understand most lifecycle providers) don't start reducing the risk profile at age 30 as claimed by The Commission. In fact we maintain it until age 50 and members' allocation to growth assets will be higher than an equivalent balanced option until members are well into their 50s. This has the effect of increasing the expected balance of members account through the majority of the accumulation phase when compared to a member in an equivalent balanced option.

It is incorrect to state that life-cycle products are mostly suited for members who want to take a lump sum benefit at retirement. What the life-cycle approach does recognise is that retirement is a key decision point for members and we look to reduce the volatility of members' returns leading to that point. Our modelling aimed to ensure members have the same or higher outcome at retirement.

If the balance at retirement is higher for a member in life-cycle, then the member will be maximising "retirement and lifetime income" relative to a member in a balanced option.

Finally, life-cycle is specifically designed for default members. It is intended to guide a disengaged default member through their working life, taking more risk when they have a higher capacity for it and less as they approach retirement. If a member is approaching retirement and engages in their superannuation arrangements, we expect them to move out of life-cycle. This is, in fact, our actual experience with older members.

Below highlights the actual experience of our members in FirstChoice Employer Superannuation with the five year returns (pa) to 30 June 2018. The cohorts designed for younger members have delivered higher returns but with higher volatility in comparison to the cohorts designed for younger members.

	Returns net of fees and tax	**Standard deviation of monthly returns (annualised)**
FirstChoice Lifestage 1945-49	5.72%	2.9%
FirstChoice Lifestage 1950-54	5.65%	2.9%
FirstChoice Lifestage 1955-59	6.40%	3.6%
FirstChoice Lifestage 1960-64	8.22%	5.3%
FirstChoice Lifestage 1965-69	9.32%	6.3%
FirstChoice Lifestage 1970-74	9.33%	6.4%
FirstChoice Lifestage 1975-79	9.27%	6.4%
FirstChoice Lifestage 1980-84	9.28%	6.4%
FirstChoice Lifestage 1985-89	9.29%	6.4%
FirstChoice Lifestage 1990-94	9.30%	6.4%
FirstChoice Lifestage 1995-99	9.35%	6.4%

It's entirely appropriate that someone in their 70s (Lifestage 1940s) would be in a more conservative option than that of someone in their 20s (Lifestage 1990s).

We welcome the opportunity for further discussion with The Commission.

Yours sincerely

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Colonial First State

Appendix A: Response to The Commission's information request 4.1

Should life-cycle products continue to be allowed as part of MySuper?

Life-cycle products should be allowed as part of MySuper as they allow RSE Licensees to provide portfolios that are tailored to the needs of their members rather than a one size fits all approach. The alternative is to offer one strategy to all members regardless of their age, gender, account balance or income.

If so, do they require re-design to better cater for the varying circumstances of members nearing retirement, and how should this be achieved?

Life-cycle products seek to address the sequencing risk that members experience as they approach retirement. We acknowledge that members have varying circumstances as they near retirement (and at all other stages of life) but this is not something that is solved by offering a single balanced option.

What information is needed on members to develop a product better suited to managing sequencing risk?

To better manage sequencing risk, the RSE Licensee would need to know a member's age, gender, account balance and income. Some of these factors are starting to be used in some lifecycle strategies and the lifecycle approach provides an RSE Licensee the opportunity to improve sequencing risk management in a way that is not offered if the default option is a balanced option.

However to properly manage sequencing risk, a financial adviser would take into account many more factors such as a member's other assets, the health of the member, the salary of the member's partner, home ownership status, retirement income expectations and debt.