first state super

First State Super - Submission

13 July 2018

Superannuation: Assessing Efficiency and Competitiveness – Stage 3

Productivity Commission, 29 May 2018

Issued by FSS Trustee Corporation ABN 11 118 202 672 AFSL 293340

Feel future ready

Contents

1 Introduction 2
1.1 Our submission 2
2 Policy context and system review 3
2.1 Industry regulation and governance 3
3 Proposed changes in default model 5
3.1 'Best in show' funds 5
3.2 Shortlist criteria 6
3.3 Investment returns and benchmarks 7
3.4 Criteria weighting challenges 7
3.5 Life-cycle products 8
3.6 Compulsory longevity products 10
3.7 Benefits and challenges of insurance 11
3.8 Fund governance and independence 13
3.9 Panel selection 13
3.10 Re-constituting the panel 14
3.11 Review of the panel 14
4 Change impact considerations 15
4.1 Prepare an impact assessment 15
4.2 Impact on superannuation members 15
4.3 Impact on superannuation funds 16
4.4 Impact on the system and government bodies 16
5 Conclusion 18

1 Introduction

First State Super is one of Australia's largest profit-for-members superannuation funds, responsible for accumulation and pension savings for approximately 770,000 members. As at June 2018, the First State Super group manages over $90 billion in funds, including the savings of accumulation members and retirees ($19 billion are retirement assets supporting over 85,000 people in retirement). We have a strong interest in the future of our members, those whose lives are often dedicated to helping others - nurses, teachers, emergency services workers and public servants. We are committed to our member community and to the national interest as we believe both are intrinsically linked.

1.1 Our submission

We appreciate the opportunity to respond to the ***Stage 3 Superannuation: Assessing Competitiveness and Efficiency Draft Report*** (Draft Report), released May 2018.

In this submission, we provide feedback on issues we identify as important, and additional information on the Commission's approach. This submission is supplementary to our submissions to Stage 2 on alternative default models, and to submissions by ASFA and AIST in response to Stage 1 on how to assess efficiency and competition. We have contributed to the submissions of AIST and ASFA to both Stage 2 and Stage 3.

In principle, we agree with the two key findings of the Draft Report as being likely to improve outcomes for many members; in particular to limit:

- Unnecessary multiple accounts, and
- The likelihood of default members going into an underperforming fund.

Our response does not attempt to answer every question raised by the Commission; we address those questions which interest us and our members. We have focused our response in the following areas:

- Enhancing the role of governance in superannuation;
- Concerns about the proposed default model, selection criteria and expert panel;
- Feedback on findings about investments and some points relating to the "best in show" reliance on investment returns;
- Importance of insurance in superannuation; and
- Impacts on participants in the superannuation environment.

2 Policy context and system review

We acknowledge the Draft Report's thoroughness, breadth and analytical rigour, and we recognise the effort that has contributed to this paper. However, the narrow terms of reference may have been unduly limiting. We believe that restricting focus to the default allocation of superannuation space, may limit the exploration of wider issues. For example, there may be contradictory forces at work between introduction of "best in show", consolidation of funds, and a requirement for all funds to offer a comprehensive income product for retirement (CIPR). A more complete system review would ideally have considered the broader policies and interactions of member needs, particularly in the following areas that intersect with superannuation services and outcomes for members:

- Age Pension levels, dependency and costs to the system (relative to international systems),
- Superannuation guarantee rate and adequacy,
- Choice sector,
- Retirement income policies, including adequacy and sustainability,
- Advice and financial planning,
- Housing in retirement and late age, and
- Health industry and aged care direction.

The Commission has acknowledged that it did not conduct deep analysis of the Choice and SMSF sectors although, where it did, the findings were most illuminating. A more comprehensive analysis, coupled with the items listed above, would have arrived at a fairer assessment of the total system. (For example, performance of retirement incomes products may sometimes appear to be weaker, but this may reflect lower risk asset allocation for retirees or "bucket" allocations where members hold high levels of cash for consumption.)

While the Commission has conducted its work within the current policy framework and setting, we think it would be useful to further clarify the implied policy directions and assumptions under which the recommendations are made, including whether there are implied fiscal targets for long term Age Pension expenditure requirements.

A challenge in superannuation is its wide-reaching impact across other policy areas. We have observed that this remains a challenge, even at government level considering the different departmental inputs that need to be sought for review.

2.1 Industry regulation and governance

The total amount of money in the system and the number of people impacted attracts considerable attention from government and policy makers. Superannuation is already at $2.6 trillion in size and is on a trajectory to grow exponentially over the coming decades. Another way to look at this is, according to Challenger, more than half of today's retirees (i.e. 58%) have sufficient means to reduce or eliminate the need for government income support with growing super balances[1] and be self-

[1] Challenger, April 2018, Retirement really is different, Link: https://www.challenger.com.au/group/Retirement_really_is_different_position_paper.pdf

sufficient. (This is consistent with our analysis of our membership where the median balances for those under age 34 years appear to be on track to exceed ASFA's Comfortable standard.)

Good governance of members' retirement assets is required at both fund and government levels. The scale and importance of saving for retirement requires focus on the long-term; the size and complexity of the system indicate the need for increased and dedicated functions within government to champion a coordinated approach to managing the system.

For this reason, we suggest that a co-ordinated whole-of-system body be established, whether through the Council of Financial Regulators, a system of "guardians" or potentially even a dedicated Minister for superannuation and retirement income (potentially with additional resources in Treasury but not a new department).

This would ensure suitable focus on superannuation savings and adequacy levels (in the context of other financial considerations throughout life), and interactions with the Age Pension. It should foster consideration of macro issues of inter-generational equity, fiscal sustainability, social and ageing impacts. Co-ordination of these intersecting policy areas could reduce competing mandates and encourage dedicated policy development for the entire superannuation environment.

Having dedicated overview and greater departmental focus would raise the profile of superannuation and retirement planning, and help meet system objectives (whether the predominantly fiscal objective set out by the government, or a broader objective to ensure members retire in a dignified manner).

3 Proposed changes in default model

The Draft Report highlighted issues of proliferating multiple accounts and entrenched underperformance. We recognise the rationale for some of the key elements in the proposed default model. However, we believe the solution design still requires further adjustments to enhance the probability of success for the proposed model, and for all members, including ‘choice’ members.

3.1 ‘Best in show’ funds

We acknowledge the rationale for limiting the consideration set of funds, so that members have a better chance of:

1) making a choice decision, and

2) being confident that their choice is reliable.

Under the proposed design, the narrow number of funds selected will be punishing for many well-performing and well-managed funds which sit just outside of the top 10. This effect could be compounded if and when the industry adjusts to the proposed model, depending on the transition arrangements and timeframe. Further, there may be undesirable consequences for members of those funds outside the designated best in show.

While superannuation members have traditionally been slow to act, we think it is likely that heightened media focus on both the Productivity Commission’s findings, and the work of the Royal Commission, is intensifying members’ anxiety about financial matters and distrust of institutions. This may increase the likelihood of members making knee-jerk decisions to move funds following publication of a Top 10 list. While this may improve outcomes for early movers, it is most likely to damage the interests of laggards and those members in funds identified as “bottom of show”.

The adverse impacts experienced by these groups could include:

- Increased costs arising from a sudden decrease in scale for a fund,
- Decreasing asset values as these funds liquidate assets to pay redemptions,
- Potential market or superannuation industry instability, and
- Lower levels of trust in superannuation.

We propose that any changes to the current default model should *commence* with a broader selection set of say 20 to 30 funds, but only once MySuper requirements have been strengthened and implemented. In conjunction with this, we support the suggestion that APRA continues its increased focus on performance improvement across many measures, both qualitative and quantitative. Resolving under-performance issues could well have faster and better results than introducing sweeping changes.

We note that industry consolidation will be a time and resource consuming process, and emphasise that change of the scale proposed by the Commission will require a number of years to implement, and the focus should be on minimising disruption for members, employers and the industry.

Our experience in mergers and acquisition between similar sized, well-intentioned and well-run funds, was that it took approximately a year to negotiate each arrangement, and then at least two years to implement. (We are happy to discuss costs directly with the Commission.)

A comprehensive transition plan should be included in the Final Report to give industry sufficient information about how the proposed changes would be brought into play. We suggest the Commission considers setting three, five and seven-year expectations and communicate the targets for improvements.

By setting progress points for review, adjustments can be made along the way, minimising distraction to the industry, and also minimising disengagement of members in a complicated environment.

We see merit in further relaxation of requirements that affect merger and acquisition activities, particularly permanent relief from CGT and further easing of equivalence requirements, perhaps for a limited period to assist resolving entrenched underperformance.

3.2 Shortlist criteria

We note the preliminary outline of criteria (page 461) for selecting the "best in show", which the Commission considers will form a sound base for the deliberations of the future panel of experts.

In broad terms, we agree that long term net (risk adjusted) returns are part of a sound basis for selection, bearing in mind there are substantial limitations to using returns as a sole key determinant, for example:

- A mantra in advice is "past performance is not a good indicator of future performance". The FOFA framework explicitly excludes past performance as a criterion for investment recommendations but it is a key driver of the "best in show" concept.
- Investing tends to be cyclical and it is rare to see either a small set of funds or a style of investing to remain dominant indefinitely; even within a four year cycle, we would expect to see variability in the funds that moved in and out of a top 30 list.
- Natural member churning issues are likely to arise with this approach (and may bring associated costs to members as they "purchase" the new fund at the top of the cycle and "sell" the old fund at the bottom of the cycle); we acknowledge that churning levels may be dependent on increasing members' engagement. A single fund for life might offset this trend, but has other issues (see page 15).
- Positioning net returns as the key criterion for "best in show" is likely to create a greater impost on funds' ability to invest with a longer-term view:
  - There will be greater focus on short term investment returns, and
  - Reduced interest in investment in very long term, capital intensive and slower-to-yield assets (utilising the illiquidity premia that have benefitted profit-for-member funds).

We think a wider range of quality criteria associated with MySuper accreditation could reduce the need for a limited set of "best in show". Any "best in show" or "health tick" should also be conditional on funds delivering high quality performance on factors such as:

- Demonstrated good governance (not necessarily based on ratio of independent directors),
- Member services including intra-fund advice,
- Scale and the capacity to absorb further scale, and a track record of delivering good member outcomes:

- While the Commission is interested in opening up competition, offering default status to a fund which is not set up to administer and manage large inflows for investment is not likely to result in success.

Further, we note there needs to be a process for removing a fund which is failing to retain its best in show status, whether for poor performance, increased costs, or behaviour which is not acceptable to the community (in addition to APRA's capacity to remove the fund's MySuper status, which is likely to be a lengthy process).

We suggest consideration be given to ability to remove funds from the best in show list.

3.3 Investment returns and benchmarks

Ref: Information Request 2.1

We welcome the Commission's efforts to construct investment benchmarks that consider asset allocation, and agree with most of the benchmark indexes used by the report.

We have two comments relating to the currency hedging assumption in the benchmark portfolio (BP1) and the benchmark index assumption for assets where an appropriate benchmark index is not straightforward or easily available (BP2):

1. Both BP1 and BP2 have assumed hedging ratios for overseas assets. For example, 80% hedge/20% unhedged strategy is assumed for international fixed interest.

   We find this assumption could lead to biased results for funds that have a currency hedging ratio that is materially different from the assumption. The assumed hedging ratio in both BPs may be a result of industry average, but it is not supposed to be the 'default' hedging strategy for funds.

   For this reason, we recommend that **fully hedged index returns** should be used instead, with residual unhedged currency exposure being added to the benchmark portfolios as a separate asset class.

2. We acknowledge that there is not a readily available benchmark for assets whose benchmark indexes are not straightforward, such as unlisted assets and other assets. We are aware that there might not be good proxies for these asset classes.

   We recommend the Commission to use the **industry average** (wherever possible) returns for those asset classes as the benchmark, rather than trying to construct 'objective' benchmark portfolios. In this way, the assessment is at least fair in the sense that it compares to the performance of the peers instead of to potentially inappropriate benchmark portfolios.

3.4 Criteria weighting challenges

The Draft Report notes that a "key focus on the selection process should be on a fund's likelihood of producing high net returns for members". In addition, we believe assignment of any meaningful weight will need to consider some of the following challenges in the overall assessment of the weights placed against each category:

1. Aside from the Draft Report's key identification of data inconsistency between performance databases, care must be taken in the interpretation of a single approved database for performance comparison. This is evident in the variability of investment rankings depending on the chronology of returns sampled for assessment, indicating strong bias in results.

   A specific fund's returns for 10-year investment period will vary, according to changes in investment strategy, and the performance of a few individual years. For example, as a general principle, the 5-year investment return for a fund will generally look better post-GFC versus those periods including the GFC (i.e. selection of the time period of performance review can be critically influenced by specific market events).

2. We suggest the selection criteria should allow for consideration of both long-term investment return performance and current investment strategic direction, which can be evident in a shorter-term investment return performance and indicate likely trends.

   Long term investment return has always been a key component of members' benefit outcomes; attention should also be given to short-term investment returns. Long-term investment returns often do not capture current changes in investment strategy propelled by a fund's ambitions to improve outcomes for members. We suggest that any weighting in relation to investment should consider the merits of both long-term and short-term performance.

3. Overall administrative cost is certainly another area which has a significant impact on member's net benefit.

   A fund's operational environment should be taken into account when interpreting administration costs, as these can increase in response to legislative change, regulatory requirement; or a fund's long-term projects designed to improve services and products offered to members; and costs of mergers. Therefore, we suggest that any interpretation of costs should be reviewed alongside a fund's strategy and the policy environment.

There needs to be sufficient acknowledgement of how various selection criteria contribute to the delivery of members' retirement outcome.

3.5 Life-cycle products

Ref: Information Request 4.1

In the Draft Report, the life-cycle product example starts to de-risk as early as age 30 years and we agree that such designs may not be in the interest of members. The example in the report which de-risks to a 2.5% fixed return option is an example of poor design, in the same way that a badly designed diversified investment option could detract value from members.

A life-cycle investment option does not necessarily lead to an extraordinarily defensive portfolio, where only bonds and cash are held, as depicted in the Draft Report. We agree that the product designs used as examples within the Draft Report are not suitable to be MySuper products. However, such low risk products are not necessarily the best example of the value which a life-cycle product may bring to a member.

Critical elements to the design of a life-cycle product for consideration are shown over the page.

1. **Value of human capital** as part of the overall investment portfolio (Bodie et al., 1992[2]; Coco et. al, 2005[3]) should be recognised even though it did not form part of the Draft Report's initial consideration.

   By recognising the value of human capital, we can design a dynamic investment allocation which takes into account changing income generating capabilities as a member matures through the workforce. In comparison, a traditional balanced fund is designed based primarily on the risk preferences of a large cohort of members where there is potential for members to have extreme variability in risk preferences.

   It is arguable whether a risk-based static balanced option would be suitable for a cohort of default members with diverse risk preferences, where those members are approaching a major decision point such as retirement. This potentially realises sequencing risk and is especially critical on the downside.

2. A pure **risk preference perspective** should also be considered. As noted in the Draft Report, the loss of expected return in life-cycle options works as an insurance premium and is more valuable for risk averse individuals.

   Research has shown that on average, risk aversion increases with age (Morin and Suarez, 1983[4]; Pålsson, 1996[5]; Albert and Duffy, 2012[6]) and compounds. Research finds that people are more risk averse in high-stake problems like retirement savings (Holt and Laury, 2002[7]); caution should be undertaken in making assumptions on a group's risk appetite.

   These results provide the rationale for the need to decrease growth exposure of the fund as members age in a life-cycle product design, in contrast to a static asset allocation approach in a traditional risk-based balanced option.

3. Trend of **gradual reduction in growth exposure** should also be accounted for. As members age and realise their bond-like human capital, the design should provide sufficient return with appropriate risk levels. The final growth exposure allocation upon retirement is dependent on the characteristics of the membership base. Our modelling shows that considering the existence of the Age Pension, which is another bond-like asset, the growth exposure of the portfolio should at least be 50% even at retirement for most First State Super members (available upon request).[8]

---

[2] Bodie, Z., Merton, R. C., & Samuelson, W. F. (1992). Labor supply flexibility and portfolio choice in a life cycle model. Journal of economic dynamics and control, 16(3-4), 427-449

[3] Cocco, J. F., Gomes, F. J., & Maenhout, P. J. (2005). Consumption and portfolio choice over the life cycle. The Review of Financial Studies, 18(2), 491-533

4 Morin, R. A., & Suarez, A. F. (1983). Risk aversion revisited. Journal of Finance, 38(4), 1201-1216

5 Pålsson, A. M. (1996). Does the degree of relative risk aversion vary with household characteristics?, Journal of Economic Psychology, 17(6), 771-787

6 Albert, S. M., & Duffy, J. (2012). Differences in risk aversion between young and older adults. Neuroscience and Neuroeconomics, 2012(1)

7 Holt, C. A., & Laury, S. K. (2002). Risk aversion and incentive effects. American economic review, 92(5), 1644-1655

8 For a typical single First State Super member at retirement, the actuarial value of the Age Pension is around the same amount as, if not more than, the superannuation savings

This also implies that the life-cycle investment strategy would allow members to have more growth exposure (and hence the risk premium), when they are in their 20s and 30s.

We believe the Draft Report's argument that life-cycle funds do not reward the reduction of risk does not necessarily hold if the de-risking is properly designed.

Therefore, we recommend that a carefully designed life-cycle product may be a better MySuper option than a traditional risk-based static balanced option. A well-designed life-cycle product is better equipped to provide the necessary income replacement at retirement with design considerations for a membership's broad risk preference.

Life-cycle product measurement approach

The Draft Report has taken the 'expected number of loss years' approach to test the effect of life cycle options. However, care should be taken in interpreting the results. The 'expected number of loss years' approach does not effectively capture the lowered volatility inherent in the later stages of a life-cycle option design.

We recommend the Commission consider key tail risk measures, such as 95% value at risk. The tail risk measure approach can measure the risk reduction value of a life-cycle option design.

3.6 Compulsory longevity products

The Draft Report noted that a MyRetirement default product is not warranted on the basis that there is no single retirement product that would adequately meet everyone's needs, also that needs vary depending on the household / family profile situation and aspirations.

In our submission to the Treasury on the "Retirement income covenant position paper" (Position Paper), we support the intention of providing a better retirement outcome for members. However, we observe that there are substantial difficulties with mass-customisation of inherently complex solutions for retirement needs. We support the conclusions drawn by the Draft Report that there is no single retirement product that could adequately provide a semi-default or default solution for the majority of retirees, given members' and households' unique needs as noted above.

The Draft Report suggests that government bodies should have a role in helping members identify retirement options and suitable solutions. Both funds and government bodies will be challenged in trying to provide relevant retirement information, when they try to guide members as they reach the age of 55-60 years, and over, across the entire population.

If the guidance—whether by providing information, or nudging customers by positioning retirement offers—is too broad it may run the risk of being irrelevant to certain groups, or be so generic that members fail to respond to the nudge on the information and take no action or inappropriate action (such as reverting entirely to cash).

To provide a relevant and sufficient retirement solution, the following factors should be considered for a member:

- Occupational status,
- Family situation,
- Health (and if possible, family history of health to indicate longevity prospects),

- Home ownership and debt,
- Life stage,
- Financial situation and plans, and
- Information preference (likelihood to respond to nudges).

For these reasons, we believe that any retirement solution should be based on member segmentation. These may be only financial and demographic segments, or could include attitudinal or preference dimensions. Therefore, different products or combinations of products should be designed to cater for specific segment needs. We acknowledge that not all funds may be able to provide segmented solutions due to scale or other issues; however, we note that regulations should not constrain a fund from implementing the best solutions that meet members' best interests.

Consistent with Treasury's paper, the Draft Report recognises the importance for financial advice on retiring. We support the role of advice as a core component of successfully offering retirement products and solutions. We acknowledge that personal financial advice provides the optimum solution, but that such advice cannot be made available to all members due to cost and resource implications; we expect to see continued introduction of digital advice or guided interactive questionnaires to help as many members as possible to make better retirement decisions.

We prefer trustees be responsible for developing their own retirement income framework. This allows trustees to develop the best form of guidance suited to segments' needs, and allow for appropriate product or solution designs rather than comply with an externally imposed default product design.

3.7 Benefits and challenges of insurance

We recognise the scope limitations of the Draft Report in this inquiry, and understand that the recommendation to conduct an inquiry into insurance within superannuation is to address an identified gap in the terms of reference.

3.7.1 Proposed insurance inquiry

Group insurance, when appropriately designed for the membership, should always be offered in superannuation as it is a cost and tax-effective wholesale offering. The pooling of lives under a group insurance policy allows insurers to more effectively price risk, which means members typically pay less for cover under a group policy than they would in the retail insurance market. As our members include nurses, teachers and emergency services workers these benefits are seldom achievable on the same terms outside the fund.

These community service industries form the core of our membership; our members have joined their professions to pursue a vocation. This is reflected in our consumer research and focus groups, and in our members' identification with our advertising messages (see box). Our members have chosen to support others. A large proportion of our members (nurses, fire officers, ambulance and police officers) work in environments which expose them to physical danger and injury.

"It's not in your job description, but it's in everything that you do. You don't do it to be remembered, but it's not easily forgotten. Everyday your support makes a world of difference."

Our group insurance pools risks by industry group, so that risks are to an extent projectable and the risk pool can be priced based on known claims experience. This helps make

our insurance offer relevant and valuable to our members. Assessing the life-long value of insurance as opposed to the cost of cover at a point in time is complex; sometimes the value of insurance is intangible, providing members with peace of mind against the threat of adverse events.

Areas of concern, such as claims management, have already been examined by the Insurance in Superannuation Working Group (ISWG) and solutions are being implemented in accordance with the Insurance in Super Code to address these issues.

In terms of the Commission's proposed inquiry, we agree that the scoping of the inquiry will require input from the industry to achieve a considered approach in the interest of members; and that the inquiry should be launched in approximately four to five years' time to assess the efficacy of the Insurance in Super Code and whether such changes have delivered improved value to members.

3.7.2 Default insurance design

We submitted feedback about insurance within superannuation in our submission to Treasury's request for feedback on the 'Protecting your super package.' As the recommendation within the Draft Report corresponds with some sections of the package, we have provided our condensed view here.

Overall, in principle, we support that insurance should be designed in a manner so as not to inappropriately detract from a member's retirement outcome. However, we are concerned about the perception that members do not value or require insurance cover at all. We provided the following feedback in relation to insurance, and see it as applicable to the Draft Report:

- In the interests of many of our members, who are likely to commence in a career where they are exposed to medium to high risk, and are in permanent full-time employment before the age of 25 years, we suggested a lower age for automatic insurance cover (i.e. 21 years of age) recognising that at this age, some of our members are marrying, and taking on mortgages etc.
- Cessation of cover reforms should be limited to default insurance which has been provided by a trustee on an opt-out basis, and not on voluntary cover which has been applied for by the member.

3.7.3 Insurance Code

The Insurance in Super Code is newly introduced and demonstrates the willingness of the industry to address issues linked to insurance. There has not yet been an opportunity to assess the benefits brought on by collaboration between insurance and superannuation industries.

Following implementation of the Code, a period of time will be needed to demonstrate its effectiveness. Therefore, as noted by the Commission, it is not yet feasible to test whether additional oversight of the Code's requirements will deliver additional value to members.

The introduction of changes with the Federal Budget for 2018-19 has added further complexity to this picture and the timeframes for these changes will put pressure on insurers, funds and administrators alike.

We accept that costs and benefits for members should continue to be assessed, including additional regulatory expenses for reporting and operational changes. This will help determine whether insurance in superannuation is suitably regulated, whether premium costs are competitive, are balanced against long term retirement balances, and identify whether additional regulatory oversight is needed.

Additional oversight should follow an assessment of accumulating costs to members versus benefits gained, and should only be required only if no demonstrable progress emerged following full implementation of the Code.

3.8 Fund governance and independence

We continue to support the current equal representation principles on the basis that representation from employers and members helps align interests.

A number of commentators identify the presence of nominated Board representatives as conflicted or indicative of inappropriate skills. We argue that the concept of "independence" can have limitations, and may lead to unhelpful "group think" or homogeneity of skills in certain circumstances. This could occur, for example, where a board was over-represented by people from a particular background or with a similar set of skills. It should be acknowledged that all parties bring a set of cognitive biases and blind spots to the task of governance, and that diversity helps overcome concentration of bias.

Each trustee's executive and board should have the responsibility to work collaboratively and constructively to fill appropriate skills, experience, qualifications and personal attributes in forming a cohesive board team.

Greater emphasis should be placed on a fund's approach to ensure the formation of an effective board. We consider that continued demonstration of good governance, and the ability to deliver to strategy, goals and members' needs, is far more important than the argument as to design of formal board structures. Our view is based on strengths and failings observed in all sectors, including those that have adopted the proposed 'independent' board structures.

Fund boards can maintain equal representation ensuring alignment to members' needs and interests, and still ensure that all directors meet the identified skills requirements. We consider that success of a fund relies on its governance framework and long term performance, as opposed to the technical structure of its board.

3.9 Panel selection

The Draft Report proposes an expert panel be formed to select the 'best in show' funds every four years, and then be disbanded, to be re-formed four years later. We consider there are both policy and practical concerns with the Panel, starting with the concept of independence.

There has been a lot of focus around the formation of an expert panel and there are already proposed candidate criteria within the Draft Report. The Commission suggested at the public hearings that a potential candidate to select the panel could potentially be or look like the Reserve Bank of Australia's (RBA) governor, as the governor is deemed to be completely independent of the superannuation environment or political influence.

While recognising this suggestion has the merit of using the RBA as an exemplar of independence, we suggest this task would be a distraction to the RBA which does not have relevant experience to take on the selection. We consider this suggestion to have less merit than retaining the Fair Work Commission, with a renewed process, as the default selection panel (our preferred position).

We note the following concerns with "independence" and the selection panel:

- There will be challenges in finding potential panel members who can be regarded as independent, who bring knowledge and expertise, and are not beholden as advisers, consultants, suppliers or participants in the superannuation industry,
- There is a concern that any such independent and knowledgeable participants may jointly contribute to confirmation bias, and
- It is unclear how the group of participants can be formed to hold sufficiently diverse views, or have direct connections with members, to make selections based on members' interest.

Therefore, we recommend considering the merit of selecting experts, where independence is valued, but alignment with members' interests (which creates a member champion effect) is also valued. This could broaden the selection pool to include experts who may have, or have had, connection with the superannuation environment.

3.10 Re-constituting the panel

We also have concerns with the proposed process of re-electing and establishing the expert panel every four years, which we believe would be time consuming and expensive without any persisting value for members. The process should be structured to minimise costs, and the introduction of another layer of scrutiny in superannuation, with a process that needs to be renewed constantly could eventually have cost implications carried by the members themselves. The four-yearly renewal process could also see loss of expertise and experience.

We recommend considering a more stable, cost-effective process which identifies a single body, with a secretariat, and experts retained on a *pro tempore* basis or as required. Such a body could be formed under the auspices of the minister or the Council of Financial Regulators, and reside either within the Treasury, or in the Fair Work Commission.

3.11 Review of the panel

Considering the issues of independence and cost review, there could be merit in considering a permanent solution, with a review and renewal process to ensure the integrity of the panel. This would help ensure a reasonable cost structure and good performance, and would avoid the risk of removing the panel every four years, regardless of performance. (This would be more like a well governed board review and renewal process.)

This review and governance of the panel itself is a key element of consideration which has not been addressed within the Draft Report. One of the key benefits of ensuring the Panel itself is subject to review will be to demonstrate greater integrity in the process of decision making and ensure that costs to members are justified.

We consider that a governance framework for the expert panel should be established to ensure that experts remain champions of the members' best interests.

Overall, we request that the need for rapid change be reconsidered and a "hasten-slowly" approach be adopted (aside from the immediate need to take steps to reduce multiple accounts and unwarranted benefit erosion). In an environment such as superannuation, where issues and risks tend to surface only in the long-term, there is potential for damage as well as gain, along with the additional complexity of compounding negative and positive effects over time.

4 Change impact considerations

The Draft Report has made some very strong recommendations as to required improvements to the system, and proposes radical changes to the default selection and allocation of default members. These proposals are designed to bring about structural change to the industry, and have the potential to cause significant disruption during the period of change.

Our experience of organisational change suggests that thorough planning, risk and impact assessment contribute to successful outcomes. The proposed model and expected industry consolidation should be tested against systemic risk and projected impacts.

4.1 Prepare an impact assessment

While the report provides a strong conceptual view of the system, success in implementing changes to meet the objectives of greater efficiency and competition will be achieved with the collaboration of the entire superannuation environment – government bodies, superannuation funds and members. We acknowledge that the timing and sequencing of recommendations has yet to be addressed and will be addressed in the final report.

This will ensure members' interest are considered and changes to the environment can be conducted in a timely and sequenced manner. We suggest development of a toolkit to assess and track the requirements from multiple government and regulatory bodies. This toolkit could include mapping of legislative requirements, and assist with monitoring for duplication or gaps in oversight. The assessment would contribute to consistent recommendations or legislative changes, cognisant of the impacts on all layers of the system, and also monitor for the costs of change. (A similar change assessment toolkit could be developed to monitor change impacts in funds and their administrators.)

The impact assessment could consider the interactions between government departments, and the impact on industry. Understanding the impact of legislative developments and recommended changes would help to identify gaps and overlaps, and identify where changes would most benefit member outcomes.

We suggest that a thorough impact assessment, complementing government's current superannuation governance framework, would provide greater clarity around areas where there are constraints and challenges for different parts of the superannuation environment.

4.2 Impact on superannuation members

The Commission has proposed a new default selection and member allocation process, with the intention of improving outcomes for members. It has also proposed that a single default for life be the norm for members who do not choose their own fund.

While there are merits to these arguments, we have concerns with the potentially monopolistic (or at least oligopolistic) features inherent in this proposal. There is a potential reduction in members' powers to exercise choice, and consequently reduced competition.

We prefer to see potential for default renewal, using the ATO's member onboarding and choice forms at change of job. This would be a measure against growth of monopolistic powers. It would also allow

members to navigate a number of options (similar mechanism to the Centralised online service proposed by the Commission):

- Stay with the original default,
- Consider a new employer's default (which could potentially remain in place for large corporate funds or government funds where there are specific workplace needs, such as defence),
- Consider another fund, or
- Consolidate funds.

The Draft Report does not identify any specific timing considerations in relation to superannuation members. However, as the main beneficiaries of the superannuation system, any element of structural change should take specifically take their interests and behaviours into account.

This principle should guide the timing and sequence of implementation of any changes, together with communication of the proposed changes, assuming they are adopted. We note that failure in delivery of one process usually has a domino effect on the rest, impacting members' experience with superannuation, increasing disengagement and dissatisfaction.

We suggest that impact on superannuation members should underpin final policy design and implementation planning, including the timing and sequencing of recommendations.

4.3 Impact on superannuation funds

First State Super is committed to its members' best interests and broadly believes in the objective principles of the Draft Report. A key challenge for superannuation funds is balancing the speed of implementing required legislative changes, with delivering quality services which are meaningful and cost efficient for members.

A rapidly implemented solution could have negative outcomes, leading to remediation costs to the detriment of members' benefits. In a climate where trust in financial industries is at an all-time low, delivering a well-planned and meaningful solution will be critical to system wide success. Increased demand for service providers under a tight timeframe could encourage a surge in costs to get the best talents and services for members.

We believe that there are merits to consider participants' concerns around timing in the interests of collaboratively pursuing a better outcome for members.

We recommend a planned transition approach would allow funds to stagger and spread the cost in an appropriate manner as well as implement solutions that best cater to member needs.

4.4 Impact on the system and government bodies

Regulators and government bodies hold key roles in both regulating the superannuation industry and delivering services that will enhance its competitiveness and efficiency.

APRA is seeking greater powers and is likely to require additional resources to maintain effective oversight if these changes are implemented. ASIC will be similarly affected.

We have been working with the ATO for some seven years on major projects introducing system wide changes. ATO is now a crucial part of the entire superannuation industry's operating model, and the success of its initiatives can be seen as a template for any future changes under consideration.

The ATO has become an organisation which not only generates government revenue, it regulates the SMSF sector; has regulation forming powers; provides network, database and validation services to the superannuation industry; and implements policy changes.

By providing such broad ranging and centralised services, ATO will be facing the following challenges:

1. Insufficient timeframes and high costs to build additional capability and capacity, providing optimal services and appropriate systems for its multiple roles, including delivering:
    - The Centralised online service,
    - Proposed product dashboard comparison for members,
    - Account consolidation and lost super for members,
    - Proposed retirement guidance to pre-retirees (along with ASIC),
    - Administration of first home super savers, and homeowner downsizing contributions,
    - Determination of early release of super on compassionate grounds.

    The combination of roles and tight implementation timeframes could increase the potential for risk of failure or error—costly to both the government and efficiency of the industry.
2. Balancing the need to deliver systems and platform changes in a timely manner, with intuitive services for consumers: when services are poorly delivered, they frustrate and disengage members from superannuation, and compromise efficiencies for the entire system.
3. Ensuring rigorous information security while implementing and expanding the system at a rapid pace: we note there is potential for both members' information security and superannuation funds' digital environments to be compromised if insufficient planning comprehensive needs assessments are not undertaken.

As highlighted above, there are many challenges faced in just one government body. These are not challenges faced by ATO alone. The complexities may be magnified depending on the technical maturity of each government body, and highlight the importance of planning.

If transition planning does not take into account the challenges and timeframe needs of these bodies, the expected efficiency gain in the superannuation industry will be dissipated, and further challenges may arise to limit members' engagement with superannuation.

We propose that transition planning be undertaken on a multilateral basis, with implementation spread in stages over five to seven years for the benefit of all participants in the superannuation system.

5 Conclusion

We would like to thank the Productivity Commission for the opportunity to provide feedback to the Draft Report. First State Super supports the Draft Report's focus on reducing the number of multiple accounts and improving performance of the system.

Our response focuses on issues we identify with proposed default model. Where applicable we have also suggested alternative solutions such as governance issues within the policy context and overall impacts on participants of the superannuation environment.

In summary, our major concerns are:

- Potential conflicts between policy settings and the Review's findings and recommendations,
- The need for a Minister of superannuation and retirement incomes,
- Concerns with the "best in show" proposal, including shortlist criteria and some methodological points on performance,
- Challenges with the treatment of insurance,
- Fund governance and the concept of "independence", and
- The need for a thorough impact assessment and staged transition planning if any of the proposed changes are implemented.

As a final note, we reiterate that we think there is more to be gained by addressing the worst of the inefficiencies and underperformance in the system, than there is by seeking a new world order.

We are happy to discuss this paper with the Productivity Commission and to provide further information which would contribute to the design of better solutions for all members.