RICEWARNER

Insight like no other

Superannuation Efficiency and Competitiveness

Submission to the Productivity Commission

19 September, 2016

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Table of Contents

This report has been prepared in response to a call for submissions from the Productivity Commission.

1. Executive Summary

1.1 About Rice Warner

Rice Warner was established in 1987 to support superannuation funds and businesses operating in the financial services industry. It is an Australian business, owned and controlled by its key executives.

Over the last three decades, it has built a strong reputation for insightful commentary. Its independence means clients can be sure the firm always acts in their best interest and provides unbiased advice. Clients include most large superannuation funds as well as many other participants in the industry (service suppliers to funds, regulators and industry bodies).

Through its research and public policy activities, Rice Warner has built an unrivalled reputation for delivering a unique perspective across the superannuation, wealth management and life insurance industries.

1.2 Background

In its final report (November 2014), the Financial System Inquiry (FSI) commented that "*the superannuation system is not operating efficiently due to a lack of strong price-based competition*".

Amongst several significant recommendations for change in the superannuation industry, it gave notice that more efficiency is needed or a new system of allocating new default fund members into MySuper products would be required - "*unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system*".

Clearly, it is important to develop a sound mechanism for measuring both competition and efficiency or this review cannot be undertaken objectively. The FSI recommended developing criteria to assess different types of efficiency:

- Operational efficiency – where products and services are delivered in a way that minimises cost and maximises value
- Allocative efficiency –where the system allocates resources to the most productive use and optimal balance between consumption and savings over time
- Dynamic efficiency – (including services to members) where the system encourages optimum behaviour by or on behalf of consumers.

Consequently, in February this year, the Treasurer appointed the Productivity Commission ('Commission') to conduct a study in two parts, namely:

- To develop criteria to assess the efficiency and competitiveness of the superannuation system, and
- To develop alternative models for a formal competitive process for allocating default fund members to products.

The analysis will be done in two stages and on 2 August the Commission released its draft report on the first part – *How to Assess the Competitiveness and Efficiency of the Superannuation System*.

This submission is a response to that draft report.

1.3 Focus of this submission

Section 2 – We comment on the Commission's objectives for measure competition and efficiency.

Section 3 - The Australian superannuation industry is complex with several homogenous groups, namely members who are default (MySuper), Choice, SMSF and retirees. It is difficult to measure the efficiency of the whole industry without looking at the different characteristics of these groups.

Section 4 - We agree that strong net investment returns are the most valuable feature of the system. However, it is surprisingly difficult to measure this.

Section 5 – Fees are very important but there is a wide range within the industry. Measuring price alone ignores the investment prowess and asset allocation and the services provided for the fee. Conversely, measuring ***value*** is complex.

Section 6 – Life insurance is an important component of the industry. Criteria to measure its efficiency should take into account the inherently complex trade-offs between affordability, adequacy of cover amounts and the extent to which claim conditions and service standards meet members' needs.

Section 7 – Retirement is the most important part of the superannuation industry but measurement is complex due to the wide range of external factors.

Section 8 – Behavioural economics is important. We need to understand what choices members make and whether they are rational. What range of choice should be provided in a compulsory system with significant tax-concessions?

1.4 Recommendations

- Consider modifying the System Objectives to make them more relevant for the following homogenous groups:
  - Members in default funds
  - Choice members (those who have selected a strategy outside MySuper or who have selected a fund different to their employer's default fund)
  - SMSF members
  - retirees.
- We agree that the industry should be measured on net returns. However, there are a number of issues to resolve:
  - Measurement should be over long periods, whereas most published past performance is short-term and mostly irrelevant.
  - Industry benchmarking should be against passive listed portfolios. It is likely that a suitable portfolio will need to be developed for the Australian industry.
  - Returns should be net of tax and investment fees. Administration fees can be measured separately.
  - The performance of Choice members should be measured separately.
  - Net returns are backward-looking. Therefore, consider how to measure likely future investment returns without relying on past performance as a guide. Funds could assess the probability of

achieving a ten-year target by stochastic modelling. Members need to see these results to assess the veracity of the target.

- We agree that industry-wide fees are relevant but there may be issues measuring some segments. We suggest:
  - Fees should be measured across the industry with a view to recording reductions over time
  - MySuper is a commodity-product so comparisons between products are valid.
  - Products with excessive fees (above 180 bps) should need to show a health warning to members. The level should reduce by 10 bps a year until a suitable level (to be determined by the Productivity Commission) has been reached. We suspect this level will be of the order of 75 to 100 bps in time and industry average fees will be well below this for default members.
- Life insurance is an integral part of the superannuation system. We suggest:
  - Modifying the Commission's objective to state the ***superannuation system provides appropriate insurance at an affordable cost.***
  - Investigating whether Income Protection insurance in its current form is suitable as a default component for MySuper products.
- An increasing number of members are entering the pension phase and purchasing retirement products.
  - We consider the measurement of the effectiveness of these products should focus on net returns over the long term, given life expectancy at retirement exceeds 20 years for most Australians.
  - Retirees are subject to several risks, including investment risks (not protecting against inflation), longevity risks (outliving savings) and liquidity risks (not having funds available for pension payments as they fall due). Funds should show how their products take account of these risks.

  We note Treasury's forthcoming review of CIPRs which might lead to the need for different metrics for measuring efficiency.
- A large number of members exercise choice of fund and/or investment strategy. We suggest there is a need for a greater involvement of Behavioural Finance to observe decisions made in order to minimise those likely to lead to poor outcomes.

1.5 Rice Warner Consultants

This report was prepared and peer reviewed for the Productivity Commission by the following consultants.

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19 September 2016

2. System Level Objectives

2.1 Government objectives

2.1.1 Primary objective

After consultation with the superannuation industry, the Government released a document at the May Budget accepting the FSI objective for superannuation, namely:

> *to provide income in retirement to substitute or supplement the Age Pension.*

2.1.2 FSI Subsidiary objectives

The FSI also listed a number of secondary objectives to which the government has yet to respond.

We are also broadly supportive of the subsidiary objectives[1], but in a submission to Treasury, we made the following comments:

Subsidiary Objective	**Comment**
Smoothing of consumption	This is problematic given varying incomes needs over retirement with likely spikes due to unforeseen circumstances. We do not believe that this is a viable objective. An objective to allow retirees to meet income needs as they occur would be more practical.
Managing risks	We agree that supporting risk management is an appropriate objective. However, the opportunities to pool and manage longevity risk efficiently are limited at the moment.
Pre-funding	We support this objective as it provides more security. It has served Australians well through past high real earnings rates for the superannuation industry as a whole.
Best Interests of Members	This is a sensible objective.
Alleviate fiscal pressures	We accept that there need to be limits as to the economic impost of the retirement incomes system. We broadly support the proposal from ASFA that there be a targeted cap for the cost to Government of direct outlays and tax concessions. The issue will be determining what the cap target should be.
Simple and efficient	We agree that this is a worthy objective, but are sceptical as to whether it is achievable given the long experience of grandfathering complex arrangements.

We also noted that there was no objective for life insurance and we noted that this is a significant omission. Many superannuation members will be prevented by death or disablement from working

[1] *Rice Warner, Objective of Superannuation, 2016* http://ricewarner.com/wp-content/uploads/2016/04/Objective-of-Superannuation-The-Treasury-2016.pdf

through to retirement age. They will not be able to provide for themselves before and after retirement without the supplement of an insurance benefit. A subsidiary objective should be added to provide for life insurance to ensure comfortable retirement incomes even if the member cannot work to retirement.

2.2 Productivity Commission Objectives for system efficiency

The Commission has set out its own system-level objectives *for measuring competitiveness and efficiency:*

- Competition in the superannuation system that drives efficient outcomes for members
- Maximising net returns on contributions and balances over the long-term
- Meeting member preferences and needs, in relation to information, products and risk management, over that member's lifetime
- Providing insurance that meets members' needs at least cost
- Complementing a stable financial system and not impeding long-term improvements in efficiency

2.2.1 Competition driving efficient outcomes for members

We agree with this objective.

2.2.2 Maximising net returns

We agree that this is a sound objective and we discuss this in detail in section 4. We suggest some modifications:

a. There is an economic argument that risk and return are highly correlated. It would be worthwhile inserting a clause about taking on acceptable risk.

b. We question whether this is the right metric for retirees as it is also necessary to balance liquidity, sequencing and longevity risks.

2.2.3 Meeting member preferences and needs

a. Default members have relatively homogenous needs – in the absence of them making choices, their preferences have no influence on how their super is managed.

b. Choice members and retirees make decisions based primarily on their preferences

c. The self-employed population have different characteristics and may not be adequately covered by the SG system

d. Superannuation is based on individuals whereas families look at household income and wealth. For this reason, we have previously argued for Joint Superannuation Accounts for married couples[2].

e. The needs of females may not be addressed well in our superannuation system[3]

2.2.4 Providing insurance needs at least cost

a. We suggest this be changed to 'appropriate insurance at an affordable cost'

b. We should consider what levels of default cover are appropriate within superannuation.

2.2.5 Not impeding long term improvements in efficiency

We agree with this objective.

[2] *Rice Warner, Joint Superannuation Accounts, 2014* https://ricewarner.com/wp-content/uploads/2015/10/Joint-Superannuation-Accounts_April-2014.pdf

[3] *Rice Warner, Economic Security for Women in Retirement, 2015* https://ricewarner.com/wp-content/uploads/2015/12/Economic-security-for-Women-in-Retirement-Submission-to-Senate-Encomics-References-Committee.pdf

3. Structure of system

3.1 Characteristics of different groups

The population is not homogenous and it is sensible to measure efficiency for several different groups. The different demographics and needs of these groups means it makes sense to place different emphasis on the importance of different efficiency criteria.

The main differences in the market structure can be attributed to the divide between MySuper, Choice, SMSFs and the Retirement segments. These groups show large differences in distribution of account balances, age, engagement and needs.

Table 1. MySuper, Choice, SMSFs and Retirement assets at 30 June 2015

Market segment	Pre-Retirement				Retirement	Total	
	Choice	MySuper	ADAs	MySuper and ADAs	Choice	All	MySuper
	($m)			(%)	($m)	($m)	(%)
Not for Profit Funds							
Corporate Funds	44,857	17,000	1,900	29.6	5,319	69,076	27.4
Industry Funds	161,162	278,700	700	63.4	15,843	456,405	61.2
Public Sector Funds	163,162	97,200	900	37.5	61,966	323,228	30.4
Subtotal	**369,180**	**392,900**	**3,500**	**51.6**	**83,128**	**848,709**	**46.7**
Commercial Funds							
Employer Master Trusts					0	145,941	
Personal Superannuation	282,715	35,400	55,700	24.4	0	222,888	24.4
Eligible Rollover Funds					0	4,986	
Commercial Post Retirement Products	0	0	-	-	208,345	208,345	-
Subtotal	**282,715**	**35,400**	**55,700**	**24.4**	**208,345**	**582,160**	**15.6**
Self-managed Funds							
Self-managed Funds	252,661	0	-	-	339,374	592,035	-
Subtotal	**252,661**	**0**	**0**	**-**	**339,374**	**592,035**	**-**
Total Superannuation Market	**904,556**	**428,300**	**59,200**	**35.0**	**630,847**	**2,022,904**	**24.1**

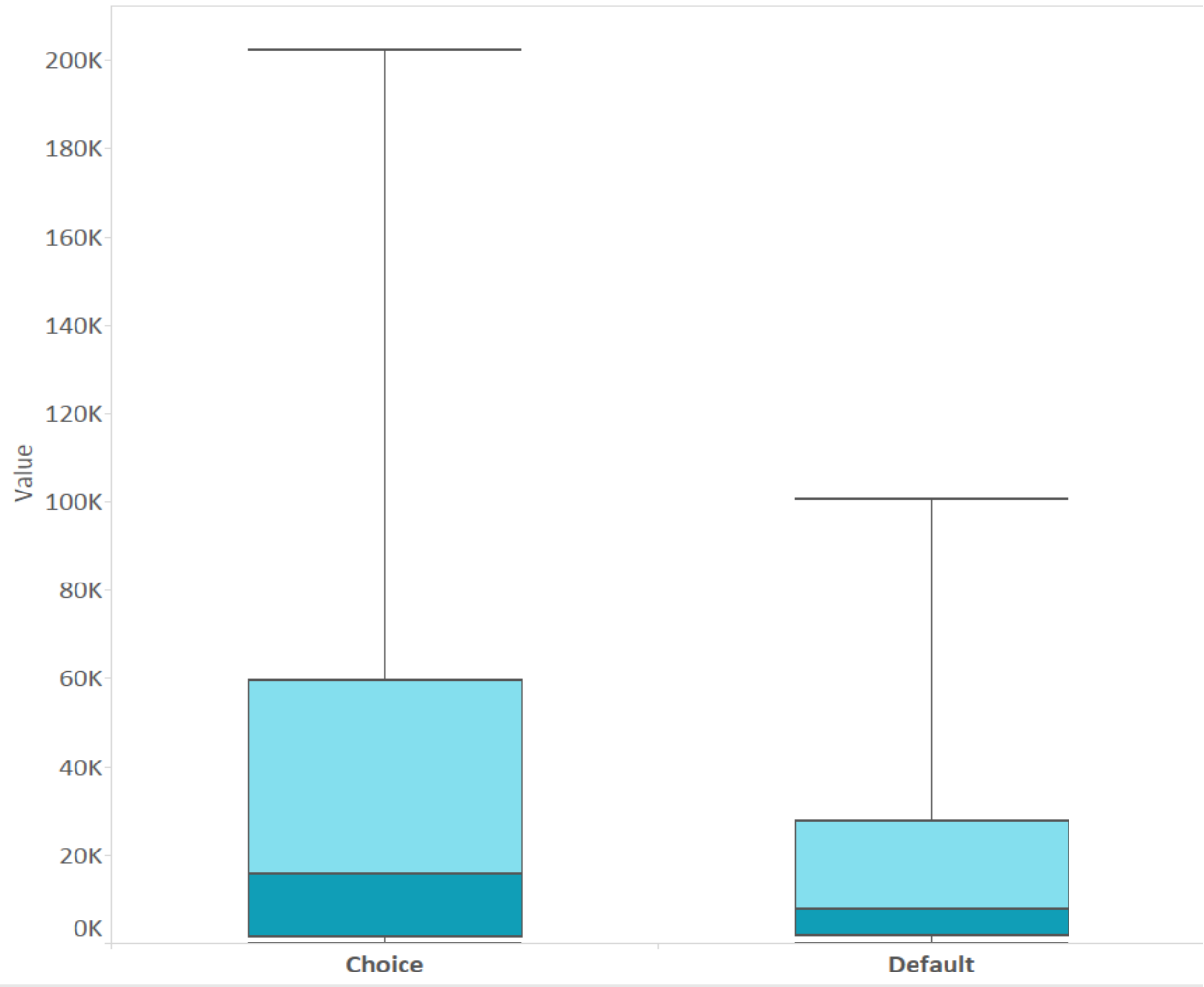
Accrued Default Amounts (ADAs) are amounts held for superannuation members which must be transferred to MySuper by 30 June 2017.

3.1.1 Default members

Default members tend to have low balances, are younger and are more likely to be female. The median balance for default members is under $10,000.

Graph 1 has a boxplot which shows the minimum balance, upper and lower quartiles and median for default and choice members of APRA-regulated funds. The upper limit has been capped at the 95th percentile.

Graph 1. Default vs. Choice balances



Source: Rice Warner, Superannuation Insights, 2015

Default members are interested in maximising their balance prior to retirement. However, their balances are smaller making them more susceptible to erosion from fees and premiums. As they are disengaged, they are less likely to make use of member services (like financial advice). Therefore, the key measures of efficiency for these members relate to:

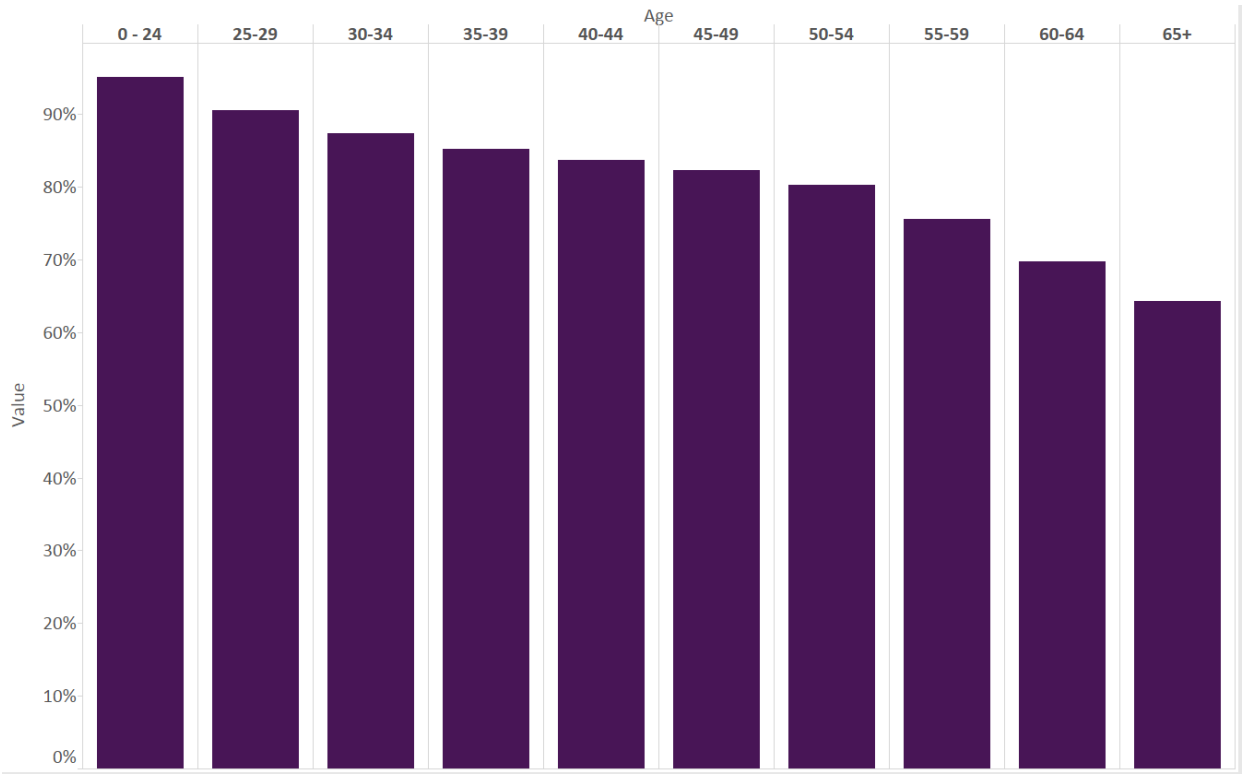
- Net returns
- Fees, and
- Insurance premiums.

3.1.2 Choice members

Members choosing their own investment strategy tend to be older, with higher balances and are also more likely to be male. These members tend to invest more conservatively than default members.

Graph 2 shows that Choice increases with age. This reinforces that engagement is correlated to age (and size of account balance). However, default members still make up the majority of the accumulation (pre-retirement) market at all ages. Retirees are generally Choice members.

Graph 2. Percentage of members in the default strategy by age



Source: Rice Warner, Superannuation Insights, 2015

These members have much higher account balances and are much more likely to take on additional services. In particular, they might require as increased insurance cover and financial advice. They will have similar objectives of targeting high balances at retirement so net returns and fees will still be important.

It is important to note that trustees do not have control over the investment choices made by these members, so a factor to consider is whether these members have the expertise to make informed choices. Obviously, we have a system allowing full Choice of fund and investment strategy and people must take responsibility for their own actions. However, these members need some protection against making poor decisions.

3.1.3 SMSF members

SMSF members have the highest average balance of any segment and represent close to 30% of all superannuation assets. These members are also much more likely to be retired (or transitioning to retirement) with over half the SMSF assets in the retirement stage.

SMSFs have taken the responsibility for managing their superannuation into their own hands; some SMSF members do this under the advice of financial planners or accountants. Measuring efficiency for this segment could be done by benchmarking SMSFs against APRA regulated entities. This comparison can then show whether the segment is efficient relative to large providers which should be able to access economies of scale and tap into investment opportunities in the wholesale market.

Due to the high fixed cost of running an SMSF, one measure of efficiency for this segment would be the ratio of costs to account balances. This would show the number of funds which have balances which are insufficient to make the management of the SMSF competitive against APRA regulated funds. Rice

Warner previously provided research to ASIC on this issue[4] which concluded minimum balances of $200,000 - $500,000 were required depending on the level of administration the trustees were willing to undertake.

We accept that any additional cost should be weighed against any potential out-performance or risk reduction which the member expects to obtain in an SMSF. However, APRA and SMSF funds have access to a similar wide range of investments. The key differences are the availability of unlisted investments in APRA funds and the access to geared property investments in SMSF funds.

SMSFs should also be evaluated on their ability to earn returns relative to APRA regulated entities. Much has been made of the concentration of asset allocation for SMSF members. However, it is difficult to measure this precisely. For example, international equity exposure might be achieved through managed vehicles or ETFs listed in Australia.

Table 2 shows historical comparative performance of SMSFs vs. APRA regulated funds. Surprisingly, SMSFs have outperformed APRA funds over a ten-year period

Table 2. Comparative performance of SMSF vs. APRA funds

Year end 30 June	APRA (%)	SMSF (%)
2005	13.2	17.3
2006	14.0	15.9
2007	15.6	20.0
2008	-7.6	-4.0
2009	-11.9	-4.5
2010	9.8	8.3
2011	8.7	5.9
2012	1.0	1.8
2013	14.9	10.9
2014	12.6	13.6
CAGR 2005 - 2014	**6.6**	**8.2**

Source: Rice Warner analysis of APRA Annual Super Bulletin and ATO SMSF Statistics

The key reason for the out-performance is asset allocation. SMSFs are usually criticised for having a narrow range of investments and concentrated holdings of assets. It could be that the funds (collectively) have taken on higher levels of risk and this has led to higher returns over the decade to 2014. In reviewing the asset allocation of the SMSFs and the growth of smaller funds in this segment, it is possible that returns for the next two years will be relatively poorer than APRA funds.

It does suggest that measuring net return without looking at appropriate risk levels could be misleading. Nonetheless, it is permissible for Choice members to take on additional risks if they are well-informed about the potential consequences.

[4] *Costs of Operating SMSFs, Rice Warner, May 2013* http://download.asic.gov.au/media/1336058/cp216-RiceWarner-cost-of-operating-smsfs.pdf

A further area which the Commission has recognised is the management of tax. SMSFs manage tax at the individual member level which provides additional flexibility. For example, members move into retirement without triggering a tax event. Therefore, the deferred tax liabilities held on the accumulation accounts are voided on moving into pension phase.

APRA funds are increasingly starting to move towards this model (for example, both QSuper and Sunsuper offer members a bonus on the transfer of assets to pension phase to reflect the release of deferred tax that will not need to be paid by the fund).

3.1.4 Retirees

Retirees represent roughly one third of all industry assets and have very different needs compared to accumulation members, primarily due to the fact that they are drawing down on benefits rather than focusing on accumulating as large a benefit as possible. Retirement is discussed in further detail in Section 7.

4. Net returns

4.1 Benchmarking

One of the most difficult benchmarking exercises will be that of comparing 'net returns'. This needs to be done over a reasonable timeframe and it will involve components such as investment-related fees, investment risk and asset allocation.

Net returns are always backward-looking and this can be misleading. Past investment performance has been shown not to be a strong indicator of future performance and funds are required to tell their members this. However:

- Members do rely on past performance when evaluating funds
- Data on past performance is readily available and is reported in the media
- It can identify funds that consistently underperform due to poor investment management and internal processes.

The significant revamp of some products with the introduction of MySuper means that several superannuation funds do not have a measurable track record for assessing past long term performance.

4.2 Measurement period

We welcome the Commission's proposal of applying three sets of indicators to assess whether net investment returns are being maximised over the long term[5] benchmarking against a passive, liquid reference portfolio and potentially supplemented with comparisons against CPI + X benchmarks.

We note that there will be a number of remaining questions and complicating factors that will need to be taken into account when interpreting the results of such benchmarking.

One of the conundrums for members is that target returns are often expressed over rolling ten year periods but the media focuses on short term performance – often the results for the last calendar month! The obsession with short-term performance is likely to be a contributor to poor decisions by some members.

4.3 What reference portfolio to use?

There are two primary issues that arise with constructing a passive reference portfolio with which to benchmark returns:

- What asset allocation should be used for the reference portfolio?
- What approach should be taken to allow for alternative asset classes with no passive equivalent benchmark?

[5] Long term (5, 10 and 20 year) historical net returns at a system-wide level (and for some market segments) compared to various benchmarks, long term (5, 10 and 20 year) historical net returns to specific asset classes at the system level compared to asset class benchmarks and dispersion of funds and products from a frontier of best performing funds and products (based on historical long-term net returns).

The Commission is considering using a benchmark allocation equal to the current system aggregate allocation or a reference 70% growth/30% defensive portfolio (or both). In our view, neither of these methods will determine whether the industry is optimising its asset allocation for members over the long term. This may also result in peer risk in that funds will gravitate towards the benchmark rather than attempt to outperform it.

In order to address this, it may be sensible to construct a number of benchmarks on the risk/return spectrum. These could form a 'frontier' against which the industry could be benchmarked.

Given that some asset classes do not have listed equivalents, the reference portfolio will need to be constructed from listed benchmarks only. This should allow the industry to be able to outperform the reference portfolio where it is able to access an additional illiquidity premium above the reference rate for the listed equivalent.

It is likely that this reference portfolio will need to be developed anew rather than using existing indices. This will allow tailoring to Australian conditions and avoid distortions which can be caused by changes in published indices over time.

We note the difficulty in choosing an appropriate level of X% for CPI + X% benchmarking. The superannuation industry has had great returns over the last 25 years but many commentators believe this was a golden period and may not be repeated.

Another metric would be measuring the excess return of the industry above GDP Growth. If superannuation returns grow at a higher rate than GDP, then the industry will become a greater share of the economy.

Finally, it is worth noting that Australian superannuation funds have few limitations on their investment powers. Members can be thankful that the 30/20 rule forcing superannuation funds to invest in government bonds was disbanded in 1983. Many members of pension funds in Europe have lower returns due to mandatory investments in these assets, which are poorly performing due to monetary policy and, in some cases, involve high levels of credit and duration risk.

4.4 Future returns

It would make more sense for funds to show members their expected return over the future and we consider this should be disclosed in all PDS documents and marketing material.

Members will want to know what future performance might be. In order to measure this, we will need to find a way to measure investment strategies, governance and processes as those funds which do this well will end up with the best long term outcomes for members. It will also lead to questions about suitable asset allocation in both the accumulation and pension phases.

Funds should be analysing their investment processes and portfolio and they should be able to undertake stochastic modelling to form an estimate of the expected future returns for members, together with the spread of results at different confidence levels. Funds should then show the probability of achieving the target CPI + X% over the next 10 years.

If the analysis shows a probability of achievement of less than (say) 60%, the target should be revised downwards.

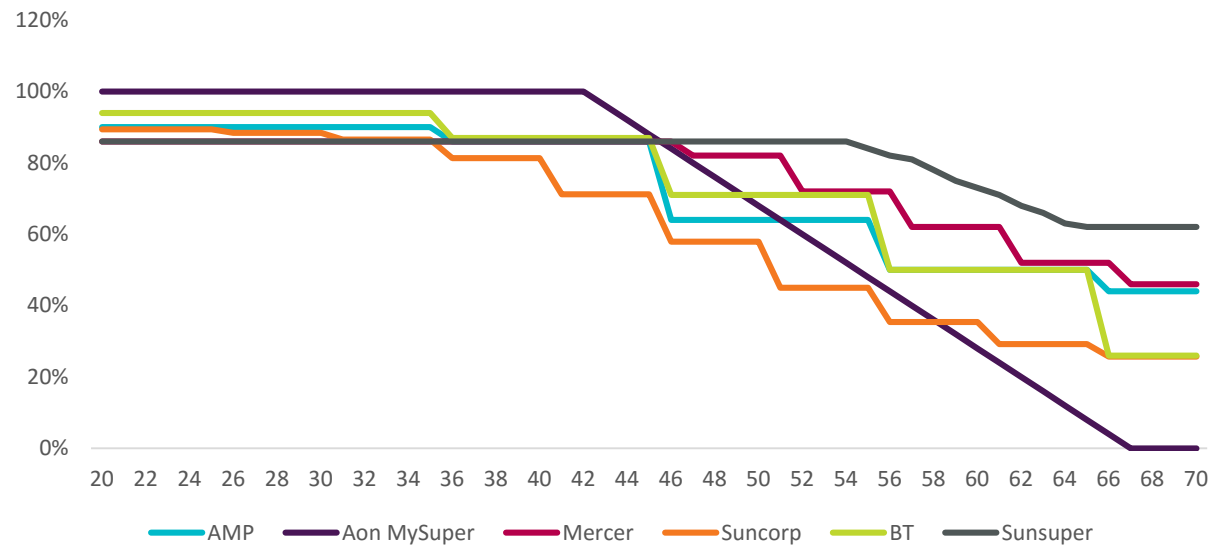
Amongst other things, this will address the perennial philosophical issue of active versus passive portfolios in listed markets. Passive portfolios provide market returns at low cost, whereas active portfolios aim to out-perform markets. We would expect funds with predominantly passive portfolios to set lower target returns than those with active portfolios. After all, active investments are taking on more risk, so they should be aiming for a higher return to reflect this. Our review of existing MySuper products suggests this does not happen today.

4.5 Lifecycle products

There is now a significant number of funds which have created 'Lifecycle' glide paths within their default structures. It is arguable whether this is optimal as it reduces exposure to growth assets as members age.

There is a great diversity in the design of these products in terms of when they begin to de-risk the portfolio and how aggressively they de-risk. The structure of five funds is illustrated in Graph 1.

Graph 1. Difference in lifecycle approaches for select funds



One of the advantages of measuring the likelihood of achieving target returns is that funds would need to consider whether the glide path of a lifecycle fund is reducing the likely retirement benefits for members.

4.6 The impact of choice members on system (or fund) efficiency

One issue of benchmarking system level returns will be the lack of industry control over the asset allocation of Choice members (including SMSFs). Rice Warner analysis demonstrates that Choice members within APRA regulated funds select portfolios which are typically more conservative than those of the default options. Over the long run, it is expected that this will reduce the long term performance of the system. Given many of these Choice members invest this way without financial advice, it can be assumed that many individuals do not understand the long term risk / return trade-off and are more likely to use the media to help inform their investment decisions.

Another issue that hampers this decision is the way funds are required to disclose risk using the 'Standard Risk Measure' (SRM). The SRM requires funds to disclose the likely number of years with a negative

return over 20 years. The issue for risk-averse members is that this makes cash look attractive as a long term investment without disclosing the likely risk of long-term investment underperformance relative to CPI.

A more useful metric would balance short term risks (volatility) against longer term risks (inadequate retirement income).

This issue could be more problematic if the comparison of the dispersion of funds from the frontier of best performing funds is undertaken using a whole of fund level return. The level of Choice within a fund and the underlying demographics would have a significant influence on the result. For this reason, it would be more appropriate to restrict this analysis to investment options which are 'like-for-like', for example, MySuper investment options or specialist asset class options such as Australian Equities.

Graph 2 shows the current asset allocation of default and choice members within APRA-regulated funds.

Graph 2. Comparison of asset allocation Default vs. Choice members

Source: Rice Warner, Superannuation Insights 2015

4.7 Measuring returns – gross or net?

Another issue is whether the measurement of returns will be on a gross or net basis. If using a net basis, should the return be measured net of both investment and administration fees as well as tax?

We make the following comments:

- Net returns are more meaningful for consumers as they reflect the actual impact on their superannuation balances, however:

- Being able to measure different components on both a gross and net basis can be useful in order to do an attribution analysis of the underlying performance, impact of fees and tax management
- Availability of data net of administration fees can be an issue for options other than MySuper. As noted by the Productivity Commission, there are over 40,000 investment options in the Australian superannuation system
- The measurement of investment fees and tax impacts has a direct relationship with the generation of investment returns. However, administration fees do not and they are better related to the level of services provided by the fund

- Most funds report returns for each option net of investment fees and taxes. Funds will often also report data on a gross basis to data aggregators.
- APRA does record returns net of administration fees for MySuper products. However, this information is not readily available for Choice options. There will be further issues related to the collection of data at this level given consumers could make multiple Choices. The behaviour of individuals can only be observed by directly surveying funds. Of course, the funds do not have data on what choices members are making in other funds or outside superannuation.

5. Fees and expenses

One of the Commission's stated Objectives for the system is to measure costs.

5.1 Fee comparisons

The last published report Rice Warner produced for the FSC on Superannuation Fees showed total industry fees of 110 basis points (bps) (also expressed as 1.1% of assets). Relatively, the investment management component is the largest at 59 bps with administration costs only making up 37 bps and the remainder being attributed to advice (14 bps).

We expect that fees are now trending downwards and there will be a further reduction with the transfer of the remaining ADAs before 30 June 2017.

There is also a great level of variation between different sectors of the industry, for example:

- Not for profits had an aggregate fee rate of 85 bps (96 bps for Industry funds)
- Retail funds had an aggregate fee of 148 bps (but as low as 86 bps for large Corporate Super Master Trusts)
- SMSFs had an average expense ratio of 112 bps.

We note that the UK now has a maximum fee of 75 bps on all pension products used for auto-enrolment of employees into funds on an opt-out basis. However, there is no cap on choice products, presumably on the grounds of *caveat emptor*.

International benchmarks for costs are difficult to establish due to the unique characteristics of the Australian system.

5.2 Further analysis

We need to measure the cost and value of various additional services:

- Insurance
- Financial advice (intra-fund)
- Choice of fund
- Choice of investment strategy

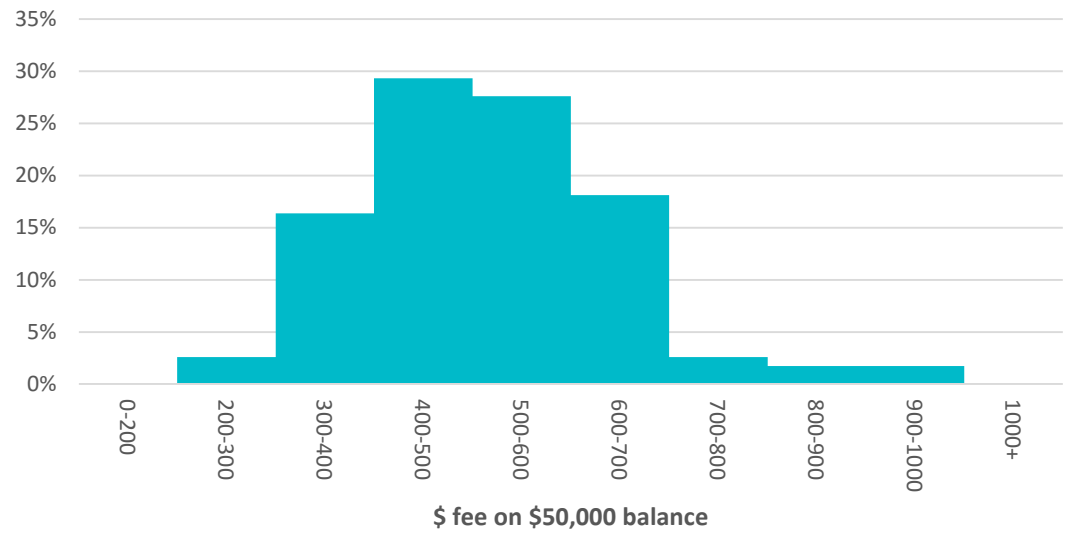
For some smaller funds, simply providing a MySuper service might be more efficient than providing the same range of services as larger funds which have more resources.

5.3 Fee variation

Superannuation is compulsory and has tax concessions. Therefore, it is important that members receive value for money. There is a great level of variation in the amount of fees charged between the different superannuation segments and the individual funds themselves. In many cases, the difference is not caused by a different value proposition but more likely by lack of scale, high profit margins or inefficiency.

Take for example the distribution of MySuper fees which should be a commodity-like product. Graph 3 shows the results for a $50,000 balance based on the APRA MySuper statistics at June 2016. Where the MySuper is a lifecycle strategy we have based our analysis on a member aged 45.

Graph 3. Distribution of total MySuper fees on $50,000 balance ($ p.a.)



The results show that fees for default products can range up to 2% p.a. of the member balance for a $50,000 account.

Fees for some Choice products may be even higher (see Section 8) which show fees for some products in excess of 2.2% p.a. on a $50,000 balance.

We consider that all funds should have fees below a reasonable threshold (say, 180 bps) or the fund will need to provide a good explanation to the regulators (APRA and ASIC – or the ATO in the case of an SMSF). The fund should also be required to advise members that it fails on fees.

We consider this threshold should be reduced by 10 bps a year, until it reaches a predetermined level at which the industry could be considered to be cost-effective, perhaps when typical fees fall and the highest fees will be of the order of 75 to 100 bps.

5.4 Disclosure and measurement

One issue with fee disclosure is the measurement of indirect costs. ASIC provides guidance on the definition and disclosure of indirect costs in its regulatory guide RG97. Recent changes to the disclosure of these costs have improved disclosure. However, there is still room for further work and fees may still be undisclosed if overseas managers refuse to provide information to funds on the 'look through' basis. It is also unclear whether all transaction based costs or margins (say in areas such as FX, or margins on cash accounts) are fully reflected in the fees disclosed.

For example, one bank-owned superannuation provider advertises that the product has 'zero fees' for the balanced option – which is invested 50% in cash which presumably earns an interest margin for the bank. This product would not fare well if it was required to provide an estimate of future returns on the same basis as competing products.

Another disclosure issue relates to the underlying cost of different types of assets. Currently, funds are not required to disclose the level of passive investments in their portfolios nor the relationship between fees and passive investments. This could lead to members overpaying for some investments. It could also lead to a view that some asset classes such as infrastructure are expensive if viewed purely on cost.

5.5 Unhealthy competition

The Commission noted that competition should not be a means unto itself, but rather a means of achieving efficiency in the market and passing on the benefits to members.

One area of contention is fund expenditure on advertising. In particular, should funds be able to collect fees from default members to then spend on advertising campaigns to attract new members?

In some instances, this advertising has formed part of a concerted strategy to grow fund scale. For funds which have achieved this strategic objective, it would be possible to justify the expense if the benefits have been passed on to all members in the form of reduced fees or access to higher returning asset classes. For funds which have lost market share over time but have spent considerable sums on advertising, it is much more difficult to justify the expense for default members.

We note however, that there is a deficiency of data when it comes to advertising expenditure. APRA has only recently started collecting advertising expenditure as part of its Superannuation Reporting Framework which means there is no longitudinal dataset. Further, there are deficiencies in the current reporting, many well-known funds with visible advertising campaigns have reported zero expenditure on the APRA forms.

6. Life Insurance within superannuation

6.1 Insurance objective

One of the proposed system-level objectives states that ***the superannuation system provides insurance that meets members' needs at least cost.***

We agree that life insurance is a valuable part of the superannuation system. Further, there is a balance between providing members with a reasonable amount of life cover against charging them premiums which reduce their account balance (and their eventual retirement benefit).

Consequently, superannuation funds strive to provide universal life insurance coverage at a reasonable cost. Default insurance cover is usually provided for a flat weekly premium and the benefit amounts reduce with age.

Trustees have an obligation to ensure that there is an appropriate balance of adequacy and affordability of benefits. It is not always appropriate to select cover at the ***least cost*** as the cost needs to be balanced against other criteria, for example service standards, product features and claim payments.

Members' insurance needs vary considerably and, unless a "fact-find" were carried out for each member, it would be impossible for a superannuation fund to determine these for each member. Further, insurance needs change over time. It would be costly and impractical to carry out a fact-find for large numbers of members and to update this regularly to take account of the changes in personal circumstances.

Consequently, when designing a default level of insurance cover, the Trustee will provide cover which is unrelated to any particular member's needs. However, members are able to cover their own needs by purchasing voluntary additional cover within the superannuation fund, or they can obtain cover in the retail insurance market, provided they are in good health.

We consider that a better objective would be that ***the superannuation system provides appropriate insurance at an affordable cost.***

6.2 MySuper opt-out insurance

Trustees are required to provide minimum levels of life and TPD insurance to their members. These are lump sum benefits, though some TPD benefits are paid in instalments. The insurance offered must incur a premium of at least 50c a week[6]. In practice, most MySuper products carry life insurance cover costing $3 a week or more.

The life insurance is provided on an opt-out basis which means it is automatic unless a member formally opts out of receiving the cover.

Trustees are also able to provide income protection insurance on an opt-out basis. This insurance provides replacement income when someone is off work. Income protection is a difficult benefit to offer within superannuation since:

[6] or a minimum level of cover, see *Superannuation Guarantee (Administration) Regulations 1993 – Reg 9A*

- It is relatively expensive – so there is a trade off between providing this cover without diminishing retirement benefits
- It is only suitable for those still working since it is designed to replace income. Therefore, members who are temporarily off work through unemployment or maternity leave may not be covered
- It is usually limited to 75% of salary (plus SG contributions) so cover through more than one fund and/or Workers Compensation benefits could lead to a reduced claim even though full premiums have been paid
- It is best as a benefit paid through to retirement but most funds limit it to two years cover due to its high cost

The Commission should consider whether this form of benefit is better placed outside superannuation, noting that such premiums are tax-deductible.

6.3 Value of default group insurance in superannuation

We know that there are high levels of under-insurance in the community. Rice Warner's latest underinsurance report showed that there was an aggregate deficit sums insured in the community of:

- $471 billion for basic life cover
- $3,435 billion for income replacement life cover
- $10,870 billion for TPD cover, and
- $611 billion for income protection cover per annum

One of the main benefits of life insurance within superannuation is the much wider coverage of life insurance in the community with cover provided regardless of health status. Many claimants and their beneficiaries have received payments in times of great need when no other cover was in place. This occurs as a result of life insurance being provided as part of the default structure of MySuper products.

Members are able to 'opt-out' of cover if they don't need it. If cover were to be offered on an 'opt-in' rather than 'opt-out' basis, many members would not take up cover either due to disengagement or because they do not think they need it at the time. Some members might delay taking up cover and find that they are then unable to obtain it due to ill-health. Further, 'opt-in' cover would require underwriting and costs would be much higher.

6.4 Value of group insurance relative to retail

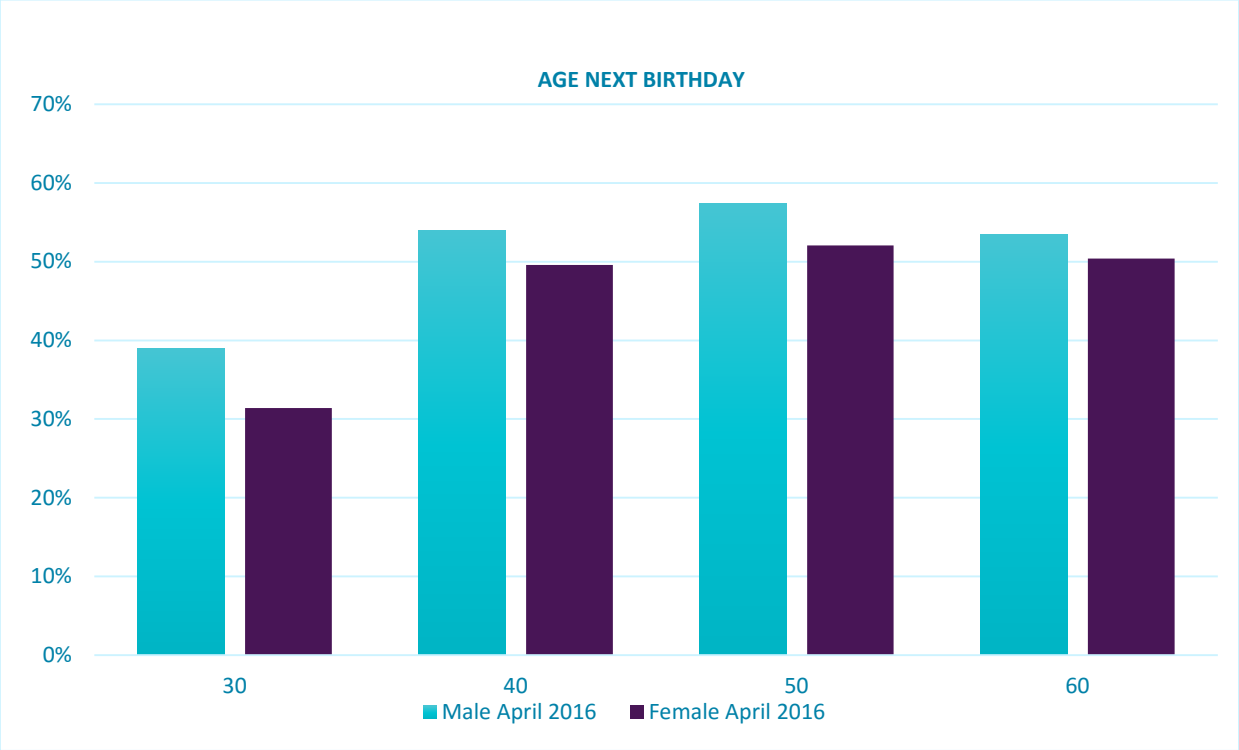
Group insurance is generally cheap compared to similar cover held outside superannuation as it can be offered at much lower margins for several reasons including:

- Auto-enrolment, with low-cost administration
- Little underwriting (if any)
- No commissions paid
- No need for fact-find to be carried out for most members.

Most funds carry out regular group insurance tenders which means that members are able to benefit from competition (price/ policy terms/ servicing) as it changes over time. Many group insurers offer early intervention and rehabilitation to assist in returning claimants to work.

Graph 4 shows the attractiveness of group insurance relative to retail cover, with the cost reduction ranging from 20% to 60% for the scenarios considered. The example is based on an accountant (professional occupation) with $1m sum insured for Death and TPD (any occupation).

Graph 4. Superannuation fund insurance prices relative to retail fund prices



6.5 Improvements

However, whilst improvements are being seen there is still much to be done to make the group market efficient particularly in relation to:

- Management of data
- Policy terms and conditions, particularly adequacy of disability definitions
- Quality of service - claims management and underwriting
- Role of litigant lawyers charging a consumer a high fee over all forms of compensation via the superannuation benefit

The Commission has also identified duplicate cover as an indicator of over-insurance resulting in unnecessary erosion of retirement balances. This raises several practical issues to consider:

- Some members deliberately maintain cover in more than one fund to maximise cover
- Funds do not know what insurance members have in other funds
- There can be a reputational risk for trustees if they turn cover off
- Income protection generally lapses when contributions cease which gives some protection against inappropriate duplication

6.6 Group insurance indicators

We consider the relative cost of life insurance against retail products is the best indicator.

It is worth considering efficiency by measuring efficiency of processes, such as disability claims handling.

Some other indicators have been suggested but are less useful:

- Caution needs to be used when considering ***loss ratios*** as they are subjective and sensitive to assumptions particularly where there are long delays in claims notification and processing.
- It is unlikely that ***unclaimed insurance*** will be able to be determined because generally the member needs to submit a claim request before the fund is aware that an insurance benefit will become payable.

7. Retirement

7.1 Retiree Needs

Pensioners have two primary needs:

- Certainty of cash flows and cash values to meet current consumption (living expenses) and contingencies
- Growth of their capital so future cash flow is sufficient to meet future expenditure needs no matter how long they live

Neither of these needs or their associated risks can be avoided and both must be managed concurrently. They impose competing investment objectives which cannot be met through a traditional investment strategy. The requirement for short term income demands investment in liquid assets that cannot produce sufficient growth. Long term growth demands investment in growth assets that have inherently volatile market prices. Consequently, asset values could be depressed when cash is needed.

Efficiency measures for this segment of the market need to focus on the efficient conversion of assets into income whilst also recognising the interaction between superannuation and the Age Pension. While net returns and cost are still appropriate measures, the metrics will need to be adjusted for this segment.

7.2 Suitable retirement products

Generally, the optimal solution requires a separation of needs and an allocation of the assets being used to satisfy those needs. This allocation might be nominal or it could be by separation into 'buckets'. Assets must be matched to liabilities and this cannot be done with a composite investment approach. Existing products can be easily tailored to meet these requirements.

An alternative is to use a lifetime annuity to provide all needs in a single product. However, the cost of the guarantee makes these products financially unattractive except at advanced ages.

The Commission should focus on how products help retirees meet these needs as a measure of effectiveness. In this regard, it should be noted that Treasury is looking into the development of Comprehensive Income Products in Retirement (CIPRs) with a view to assisting trustees to set up sensible default retirement products.

7.3 Measuring effectiveness

For most people, a retirement product is supplemented by the Age Pension, their spouse's superannuation and by other income. Consequently, it will have a different utility value depending on the personal circumstances of the retiree. This makes it difficult to measure the effectiveness for any particular individual.

If the existing product is an account based pension (these currently make up the majority of the market), it is possible to measure the net return. However, some retirees will be prepared to accept a lower investment return in order to have greater security of income – a lifetime annuity being the extreme example of this.

We do consider that many superannuation funds are too conservative with account-based pensions; they focus on minimising short-term negative returns but do so by reducing overall investment returns – and the future retirement benefits.

With increased life expectancy, there is a long investment horizon in retirement and this needs growth assets to provide inflation protection and make the funds last a long time. Ideally, this must be done in a way that does not force the realisation of assets at depressed values to meet pension payments. The key is to use the tools which maximise long-term investment performance while delivering returns in a way that supports the short term income requirements.

7.4 Example of an effective product

The RetireSmart product offered by the Australian Catholic Superannuation Retirement Fund takes a long-term investment approach but uses a bucketing approach to ensure there is sufficient cash to make pension payments.[7]

The product maximises long term growth by investing in a Growth Pool to:

- Harness the equity risk premium
- Harness the extra returns from the illiquidity premium from investing in unlisted assets
- Utilise the valuable franking credits from investments in Australian tax-paying businesses

The product meets a retiree's short term income need by operating the Growth Pool as a distributing trust. This results in all dividends, interest and rents being moved into the member's cash account. The value of franking credits are also transferred as the dividends are paid (even though the franking credit will only be repaid to the fund after the tax return for the financial year is lodged). As the running yield on the pension assets will be between 4% and 5%, the cash built up will be very close to the member's withdrawal requirements.

The key to this solution is that the volatility of capital movements is largely irrelevant to the member – they are not being forced to draw their capital down. Another advantage is that the capital can be invested long-term and can access infrastructure and other unlisted assets without worrying about liquidity.

This core strategy can then be enhanced by building a nest egg to meet extra expenditure commitments and contingencies. This is best done by transferring money from the Growth Pool into cash following periods of strong performance.

Finally, later in life, when lifetime annuities provide better value and making financial decisions becomes more difficult, pensioners who want to lock in certainty could convert part or possibly all their accumulated assets to a lifetime annuity at, say, age 85.

This approach is discussed in detail in Rice Warner's submission to the Financial Systems Inquiry[8].

[7] http://www.catholicsuper.com.au/retirement/our-retirement-income-offer/retiresmart-pension/
[8] *Rice Warner, Retirement Income Solutions, 2014* http://fsi.gov.au/files/2014/09/Rice_Warner.pdf

8. Behavioural Finance

8.1 Behaviour of Choice members

As we have a system where most members can choose their own superannuation fund and their own investment strategy, we need to ensure that poor decisions are minimised. This can be a function of increasing financial literacy and access to financial advice. However, there is currently no structure available to measure the decisions of those who exercise Choice.

A material proportion of Australian superannuation members do not exercise any decision making, from just under 90% for those aged under 24 to 47% of those approaching retirement[9]. Of course, many workers have no ability to choose their Superannuation fund as they are restricted by their employment arrangements. Both of these groups should be excluded from any analysis of the decision making of superannuants.

Generally, when examining issues related to the financial well-being of individuals, there is an underlying assumption that they will approach decisions rationally. In the case of superannuation, we would expect that this would lead to a focus on the maximisation of retirement outcomes, and decision making that is conducive to this goal. On this basis, individuals should be expected to attempt to maximise their expected returns according to their own risk profile and minimise costs where possible.

The growth of SMSFs in Australia is a result of members wishing to have greater input into their investment returns. However, there is little measurement of whether they make rational decisions or not. The prevailing view appears to be that they can do what they want with their own money. However, the growth in Choice members and in SMSF funds suggests that their financial decisions should be monitored.

With this in mind, we would expect that many superannuants would gravitate to the lowest cost producers, and any providers which were unable to compete on price or which did not have enough additional services to offset the differentials would be squeezed out of the market. Some small funds have been rationalised due to a combination of providing poor value for money and pressure from APRA. However, examples still remain of funds which provide a poor value proposition for members and are made up almost entirely of Choice members.

8.2 Case study of poor funds

8.2.1 Selling emotion not value

One of the examples of funds which could be considered inappropriate have been a few of the 'social impact' superannuation funds which have entered the mainstream in the recent past. They market Socially Responsible Investments (or SRI products). We recognise that there is utility attached by members for the ability to take up socially responsible investing and affect change in the world through their financial decisions.

However, some funds are selling an emotional decision without alerting potential members to the high cost of making these decisions (and with no consideration of likely investment outcomes). We question

[9] *Rice Warner, Superannuation Insights 2015*

the extent to which a member is acting rationally and in their own best interests by opting to move their superannuation to a higher cost provider of SRI when lower priced SRI alternatives exist.

Table 3 sets out the fees applicable for two niche (ethical) products which operate as sub-plans of other superannuation funds compared with other social responsible options provided by larger providers.

Table 3. Comparison of SRI fees

	Poor Fund 1	Poor Fund 2	MySuper average*	AustralianSuper	SunSuper	FSS
$ Admin Fee	$52 p.a.	$78 p.a.	$80	$78	$78	$52
% Admin Fee	0.91%	0%	0.89%	0%	0.10%	0.15%
Investment Fees	1.09%	0%		0%	0.68%	0.51%
Indirect Costs	0.15%	2.0%		0.65%	0%	0.16%
Buy/Sell Spread	0.10%/0.10%	0.21%/0.22%	N/A	0%/0%	0%/0%	0%/0%
Cost of $50,000 account	$1,127	$1,078	$523	$403	$468	$462

* Analysis of APRA Quarterly MySuper Statistics June 2016

Unsurprisingly, these two funds are extremely expensive compared to the general MySuper market. However, the table includes three industry funds which provide socially responsible investing options to their members, all three of which are materially cheaper than both Fund 1 and Fund 2.

8.2.2 Disclosure

Legal disclosure documents, such as the Member PDS and fee explanations may not necessarily be read by prospective members before transferring into a fund. For this reason, many good funds are proactive about demonstrating their value proposition to members through marketing materials and their websites. In particular, they show the cost of superannuation and the investment returns of the fund.

In the case of more expensive funds like the examples shown, these details are omitted from websites and marketing materials (and the PDS is buried amongst a number of other documents on the website). This is because the core value proposition and sales pitch is an emotional one rather than something that is necessarily in the best financial interests of the member. On one fund, where the investment returns are shown, they are out of date – perhaps because recent performance is worse?