



Australian Government
Productivity Commission

Superannuation:
Assessing Efficiency
and Competitiveness

Productivity Commission
Inquiry Report

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Publications enquiries

Media, Publications and Web, phone: (03) 9653 2244 or email: mpw@pc.gov.au

The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).



Australian Government
Productivity Commission

Melbourne Office

Level 12, 530 Collins Street
Melbourne VIC 3000

Locked Bag 2 Collins Street East
Melbourne VIC 8003

Telephone 03 9653 2100

Facsimile 03 9653 2199

Canberra Office

Telephone 02 6240 3200

www.pc.gov.au

21 December 2018

The Hon Josh Frydenberg MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

In accordance with section 11 of the *Productivity Commission Act 1998*, we have pleasure in submitting to you the Commission's final report into *Superannuation: Assessing Efficiency and Competitiveness*.

The Commission undertook this inquiry under the twin (stage 2 and stage 3) terms of reference.

Yours sincerely

Handwritten signature of Karen Chester in black ink.

Karen Chester
Deputy Chair

Handwritten signature of Angela MacRae in black ink.

Angela MacRae
Commissioner

Terms of reference: stage 3

I, Scott Morrison, Treasurer, pursuant to Parts 2 and 3 of the Productivity Commission Act 1998, hereby request that the Productivity Commission undertake an inquiry to assess the efficiency and competitiveness of Australia's superannuation system.

Background

Today, superannuation is a \$2 trillion sector. It is important that, given the sheer size of the superannuation system, combined with its compulsory and broad nature, the system is efficient. Competition is also important as it can drive efficient outcomes for price, quality and innovation. Small changes in the system can have a real impact on people's standard of living in retirement.

Following the Government's response to Financial System Inquiry Recommendation 10 on efficiency in superannuation, on 17 February 2016 the Government tasked the Productivity Commission to develop criteria to assess the efficiency and competitiveness of the superannuation system (Stage 1) and to develop alternative models for allocating default fund members to products (Stage 2).

These Terms of Reference task the Commission to review the performance of the superannuation system against the criteria identified through the Commission's Stage 1 report, published in November 2016. This will be the third and final Stage of the review.

Scope

The Commission is to assess the efficiency and competitiveness of Australia's superannuation system and make recommendations to improve outcomes for members and system stability. The Commission is to also identify, and make recommendations to reduce, barriers to the efficiency and competitiveness of the superannuation system.

The assessment should be based on the five system-level objectives, 22 assessment criteria, and 89 corresponding indicators set out in the Commission's Stage 1 report.

In undertaking its assessment the Commission should evaluate the accumulation, transition and retirement phases of superannuation as well as the default, choice (including self-managed) and corporate fund member segments.

Whilst not out of scope, defined benefit funds should not be a key focus of the Commission's assessment.

Without limiting the Commission's assessment on the basis of the framework outlined in its Stage 1 report, the Commission should consider the following matters.

Costs, fees and net returns

The Commission is to focus on assessing system-wide long-term net returns, including by reference to particular segments. Through this assessment, the Commission should have particular regard to:

- whether disclosure practices are resulting in a consistent and comparable basis for meaningful comparisons to be made between products
- whether additional disclosure would improve outcomes for members
- whether the system is minimising costs and fees (including, but not limited to exit fees) for given returns
- what impact costs and fees have on members with low account balances, and what actions could be undertaken- whether by funds or policy changes- to ensure that these balances are not eroded needlessly
- whether tailoring of costs and fees for different member segments would be appropriate.

Default fund members

In relation to default fund members, the Commission should consider:

- whether the current default settings in the system are appropriate, or whether policy changes would be desirable
- whether an alternative default fund allocation mechanism should be introduced that would deliver net benefits.

Insurance in superannuation

The Commission should consider the appropriateness of the insurance arrangements inside superannuation, including:

- the impact of insurance premiums on retirement incomes of both default cover and individually underwritten cover funded inside of superannuation
- the extent to which current policy settings offset costs to government in the form of reduced social security payments
- whether policy changes could improve default cover through superannuation, so that default cover:
 - provides value-for-money
 - does not inappropriately erode the retirement savings of members of all ages

-
- delivers consistent outcomes across the system.
 - whether policy changes are needed to ensure that insurance is not a barrier to account consolidation.

The broader financial system

In response to the 2014 Financial System Inquiry, the Government agreed to periodic reviews of competition in the financial sector. Pursuant to this response, the Government has also tasked the Commission to conduct an inquiry into competition in the financial system more broadly.

The two inquiries should not duplicate analysis or reporting.

Process

This review will commence on 1 July 2017.

Surveys involving industry participants should be tested with stakeholders before being implemented, to limit collection costs and ensure respondents consistently interpret data requirements.

The Commission should consult widely and undertake appropriate public consultation processes, including inviting public submissions and holding public hearings.

The Commission should release a draft report in January 2018 and provide its final report to the Government within 12 months of the commencement of the review.

Scott Morrison
Treasurer

[Received 30 June 2017]

Terms of reference: stage 2

I, Scott Morrison, Treasurer, pursuant to Parts 2, 3 and 4 of the Productivity Commission Act 1998, hereby request that the Productivity Commission conduct: a study to develop criteria to assess the efficiency and competitiveness of the superannuation system; and an inquiry to develop alternative models for a formal competitive process for allocating default fund members to products.

Background

An efficient superannuation system is critical to help Australia meet the economic and fiscal challenges of an ageing population. The superannuation system has accumulated over \$2 trillion in assets. Given the system's size and growth, the system is of central importance to funding the economy and delivering retirement incomes.

MySuper has been a strong step in the right direction but more needs to be done to reduce fees and improve after-fee returns for fund members. The Financial System Inquiry noted that fees have not fallen by as much as would be expected given the substantial increase in the scale of the superannuation system, a major reason for this being the absence of consumer driven competition, particularly in the default fund market.

These Terms of Reference follow from the Government's response to Financial System Inquiry Recommendation 10 on efficiency in superannuation. The Government committed to tasking the Productivity Commission to develop and release criteria to assess the efficiency and competitiveness of the superannuation system, including the choice and default markets and to develop alternative models for allocating default fund members to products.

This work will inform a review of the efficiency and competitiveness of the superannuation system, which the Productivity Commission will be asked to undertake following the full implementation of the MySuper reforms (after 1 July 2017).

Process

The Productivity Commission is to develop criteria to assess the efficiency and competitiveness of the superannuation system and release the criteria within nine months of receiving these Terms of Reference. The release of these criteria is intended to provide

transparency and certainty to the superannuation industry about how it will be assessed ahead of the full implementation of MySuper.

The Productivity Commission is to develop alternative models for a formal competitive process for allocating default fund members to products. In developing alternative models, the Productivity Commission should be informed by the criteria it develops to assess the efficiency and competitiveness of the superannuation system. The Productivity Commission should report on alternative models within 18 months of receiving these Terms of Reference.

For both elements, the Productivity Commission should consult widely and undertake appropriate public consultation processes, including inviting public submissions and conducting industry roundtables. The Productivity Commission is to provide both draft and final reports and the reports will be published.

Scope of study: Development of criteria to assess efficiency of super system

The Productivity Commission should develop criteria to assess whether and the extent to which the superannuation system is efficient and competitive and delivers the best outcomes for members and retirees, including optimising risk-adjusted after fee returns.

In determining the criteria to assess the efficiency and competitiveness of the superannuation system, the Productivity Commission may have regard to:

- operational efficiency, where products and services are delivered in a way that minimises costs and maximises value, which can be enhanced by competition and innovation from new entrants and incumbents
- allocative efficiency, where the system allocates resources to the most productive use and optimally allocates risks
- dynamic efficiency, including services to members, where the system induces the optimal balance between consumption and saving over time
- the extent to which the system encourages optimal behaviour on the part of consumers, including consideration of the learnings from behavioural finance.

The Productivity Commission should consider the nature of competition in the superannuation industry, the effect of government policy and regulation on the competitiveness and efficiency of the system and relevant international experience.

Scope of inquiry: Development of alternative models

The Productivity Commission is to examine alternative models for a formal competitive process for allocating default fund members in the superannuation system to products and to develop a workable model, or models, that could be implemented by Government if a new model for allocating default fund members to products is desirable.

These model(s) would provide viable alternatives for the Government's consideration, depending on the outcomes of the review of the efficiency and competitiveness of the

superannuation system, which the Productivity Commission will be asked to undertake following the full implementation of the MySuper reforms.

The developed model(s) should enhance efficiency in the superannuation system in order to improve retirement incomes, including through optimising long-term net returns to members, and build trust and confidence in funds regulated by the Australian Prudential Regulation Authority (APRA). The models developed should consider default fund selection across the superannuation system as a whole.

The Productivity Commission may consider auction, tender and other types of competitive processes. The Productivity Commission should consider the merits of different approaches, the metrics for conducting them and their frequency. This should include consideration of:

- the strengths and weaknesses of competitive processes used internationally, such as Chile, New Zealand and Sweden, as well as those used in large corporate tenders by the Northern Territory Government and in other jurisdictions
- the costs and benefits of different mechanisms, including:
 - optimising long-term after fee returns
 - the administrative, fiscal, individual and complexity costs.
- and in examining different processes, consider:
 - the robustness of the process, including against gaming and collusion
 - whether the structure achieves efficient outcomes and facilitates ongoing innovation over the long run
 - the effect on system stability and market concentration
 - who should run the process
 - the extent to which the process promotes the interests of consumers.
- regulatory impediments to optimal competition under the preferred model(s).

Principles for designing a model for a competitive process should include:

- **Best interests:** ensure incentive compatibility with meeting the best interests of members, encourage long-term investing, and encourage a focus on expected after-fee returns based on asset allocation and investment strategy.
- **Competition:** drive pressure on funds to be innovative and efficient, diversify asset allocation and optimise long-term after-fee returns by rewarding best performers. Facilitate new superannuation fund entrants to the market.
- **Feasibility:** ensure the process is low-cost and easy to administer and minimises regulatory costs on industry, including business and employers.
- **Credibility and transparency:** make relevant information public; avoid room for gaming the process; and ensure metrics are clear, simple, difficult to dispute and difficult to manipulate.

-
- **Regular assessment and accountability:** regularly conduct a repeat process that requires default funds to earn their right to receive new default members, and ensure funds are accountable for the outcomes they deliver members.
 - **Fiscal implications:** the extent to which the process can reduce reliance on the Age Pension and/or give rise to other risks or costs to Government.

The Productivity Commission should draw on expertise in the field of competitive models.

Scott Morrison
Treasurer

[Received 17 February 2016]

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Inquiry timeline

Due to delays in data collection and consultations, the release of the draft report for the inquiry into the efficiency and competitiveness of Australia's superannuation system was delayed to 30 May 2018. This led to a consequential delay of the final inquiry report.

Acknowledgments

This inquiry has benefited from discussions, submissions and perspectives from a wide spectrum of participants across industry, academia, government and the broader community. The Commission is grateful for the valuable contribution of all those who participated in this inquiry.

The Commissioners would also like to express their thanks to the staff who worked on the inquiry across its stages 2 and 3.

Stage 2 was managed by Mary Cavar. The team included: Peter Garrick, Roger Hassan, (the late) Ellie Jepsen, Alex Maevsky, Joseph Moloney, Aaron Morey, Brad Ruting, Carl Toohey, Hans Zhu and Yvette Goss.

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Abbreviations

ABP	Account-based pension
ACCC	Australian Competition and Consumer Commission
ACTU	Australian Council of Trade Unions
AFCA	Australian Financial Complaints Authority
AFSL	Australian Financial Services Licence
AIST	Australian Institute of Superannuation Trustees
APL	Approved product list
APRA	Australian Prudential Regulation Authority
ASFA	Association of Superannuation Funds of Australia
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
ATO	Australian Taxation Office
AUSTRAC	Australian Transaction Reports and Analysis Centre
BP	Benchmark portfolio
BP1	Listed benchmark portfolio
BP2	Blended benchmark portfolio
CFR	Council of Financial Regulators
CGT	Capital Gains Tax
CIPR	Comprehensive Income Product for Retirement
DB	Defined benefit
DC	Defined contribution
DHS	Department of Human Services
DSS	Department of Social Security
EBA	Enterprise Bargaining Agreement
ERF	Eligible Rollover Fund
ETF	Exchange-traded fund
FoFA	Future of Financial Advice
FSC	Financial Services Council

FSRC	Financial Services Royal Commission (<i>Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry</i>)
FSS	First State Super
FUM	Funds Under Management
FWC	Fair Work Commission
GDP	Gross domestic product
GFC	Global financial crisis
HILDA	Household, Income and Labour Dynamics in Australia
IFT	Intra-fund transfer
IP	Income protection
ISA	Industry Super Australia
ISC	Insurance and Superannuation Commission
ISWG	Insurance in Superannuation Working Group
LRBA	Limited Recourse Borrowing Arrangements
LRM	Longevity Risk Management
OECD	Organisation for Economic Co-operation and Development
OTE	Ordinary time earnings
PAYG	Pay-as-you-go
PAIRS	Probability and Impact Rating System
PC	Productivity Commission
PDS	Product disclosure statement
PJCCFS	Parliamentary Joint Committee on Corporations and Financial Services
RBA	Reserve Bank of Australia
ROA	Return on assets
ROR	Rate of return
RSE	Registrable Superannuation Entity
SCF	Standard Choice Form
SCT	Superannuation Complaints Tribunal
SFT	Successor fund transfers
SG	Superannuation Guarantee
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>
SMSF	Self-managed superannuation fund

SOARS	Supervisory Oversight and Response System
SR	SuperRatings
SRF	Standard reporting framework
STP	Single Touch Payroll
TAIM	Tax Aware Investment Management
TER	Total Expense Ratio
TFN	Tax File Number
TPD	Total and permanent disability

Glossary

Account-based pension	A regular retirement income stream, purchased with money an individual has accumulated in their superannuation after they have reached the preservation age.
Annuity	A retirement income product that provides a guaranteed stream of fixed payments made at regular intervals.
APRA-regulated fund	Any superannuation fund with more than four members regulated by the Australian Prudential Regulation Authority (APRA), also known as a Registrable Superannuation Entity.
Asset allocation	The distribution of funds in an investment portfolio (for a fund or individual member) between different asset classes.
Asset class	A category of assets that a superannuation fund can invest in, such as cash, fixed interest, shares, property or unlisted infrastructure.
Bulk transfer	The process whereby multiple member accounts are transferred to a different superannuation fund without the member's consent. This process follows 'successor fund transfer' rules set out in legislation.
Comprehensive income product for retirement	A hybrid retirement income product that combines a stream of broadly constant real income (an annuity of some kind) with some flexible access to capital through an account-based pension
Corporate fund	A superannuation fund sponsored by a single employer or group of usually related employers for the benefit of company employees.
Corporate tender	A tender for the right to become the default superannuation fund of a particular group of employees.
Default fund	A superannuation fund to which an employer's Superannuation Guarantee contributions are paid if the employee does not choose an alternative fund.
Deferred annuity	An annuity where payments commence after a nominated period.
Defined benefit fund	A superannuation fund where contributions are pooled rather than allocated to particular members, and where retirement benefits are determined by a formula based on factors such as salary and duration of employment.
Defined contribution fund	A superannuation fund where the value of the final retirement benefit payable is based on contributions made plus investment returns less any fees and taxes.

Exempt public sector superannuation scheme	A superannuation fund providing benefits for government employees, or schemes established by Commonwealth, State or Territory law, that are not directly subject to the <i>Superannuation Industry (Supervision) Act 1993</i> (Cth) and APRA regulation.
Industry fund	Funds originally formed to provide access to superannuation for employees working within a particular industry.
Institutional funds	All APRA-regulated funds (with more than 4 members) and exempt public sector superannuation schemes.
Investment risk	One of a number of risks to the value of an investment, including market, interest rate, inflation, credit, liquidity and asset-specific risk.
Legacy product	A superannuation product (held by some members) that is no longer available for issue to new members.
Life-cycle product	A product available in the accumulation phase of superannuation that increases the relative weight of defensive assets (such as cash) versus growth assets (such as equities) as the member ages.
Lifetime annuity	An annuity payable over a recipient's remaining lifetime.
Longevity risk	The risk of a person outliving their savings.
MySuper product	A default defined contribution superannuation product. Superannuation funds must meet requirements set by APRA to be permitted to offer a MySuper product. All default products in APRA-regulated funds are MySuper products since 1 July 2017.
Non-concessional contributions	Contributions drawn from an individual's post-tax income that are made into a superannuation fund.
Outsourcing	The process whereby a superannuation fund trustee contracts another entity to provide services to the fund, such as administration or investment management.
Peer risk	The risk of an individual superannuation fund performing below the market average.
Preservation age	The minimum age prescribed by law at which a member can withdraw their superannuation benefits from the superannuation system.
Product dashboard	Product and performance information (specified by APRA) regarding MySuper products that must be made available on superannuation fund websites.
Registrable Superannuation Entity	An APRA-regulated superannuation fund, a small APRA fund, an approved deposit fund or a pooled superannuation trust.
Retail fund	A superannuation fund that offers superannuation products on a commercial 'for profit' basis.

Retail level	The level of the superannuation market that provides services directly to members.
RSE Licensee	The trustee of a Registrable Superannuation Entity.
Self-managed superannuation fund	A superannuation fund with fewer than five members, all of whom are trustees or are directors of a corporate trustee.
Selection bias	Bias in a sample of data that arises when the process for collecting data favours certain funds or products, leading to a non-representative sample. For example smaller funds may tend to underreport and the sample would then under-represent smaller funds.
Sequencing risk	The risk of experiencing poor investment returns just prior to drawing on funds in retirement.
Small APRA fund	Any APRA-regulated fund with fewer than five members.
Small fund	Any superannuation fund with fewer than five members.
Superannuation Guarantee	Compulsory superannuation contributions paid by employers on behalf of employees, and equal to a percentage (currently 9.5 per cent per year) of each employee's ordinary time earnings.
Superannuation system	The collection of participants and activities involved in superannuation, including members, employers, funds, upstream suppliers, ancillary service providers (including insurers) and regulators.
SuperStream	An Australian Government package of measures designed to enhance administrative processes for superannuation, especially the way that Superannuation Guarantee payments are transferred from employers to funds.
Survivor bias	Bias introduced when the sample excludes products or funds that have exited the system.
Trustee	A person or company holding property on behalf of another party with a fiduciary duty to the beneficiaries.
Unlisted asset	An asset for which there is no public exchange for listing, quotation or trading.
Wholesale level	The level of the superannuation market that involves the interaction between trustees/funds and other service providers.

OVERVIEW

Key points

- Australia's super system needs to adapt to better meet the needs of a modern workforce and a growing pool of retirees. Structural flaws — unintended multiple accounts and entrenched underperformers — are harming millions of members, and regressively so.
 - Fixing these twin problems could benefit members to the tune of \$3.8 billion each year. Even a 55 year old today could gain \$79 000 by retirement. A new job entrant today would have \$533 000 more when they retire in 2064.
- Our unique assessment of the super system reveals mixed performance.
 - While some funds consistently achieve high net returns, a significant number of products underperform, even after adjusting for differences in investment strategy. Underperformers span both default and choice, and most (but not all) affected members are in retail funds.
 - Evidence abounds of excessive and unwarranted fees in the super system. Reported fees have trended down but a tail of high-fee products remains entrenched, mostly in retail funds.
 - Compelling cost savings from realised scale have not been systematically passed on to members as lower fees or higher returns. Much scale remains elusive with too few mergers.
 - A third of accounts (about 10 million) are unintended multiple accounts. These erode members' balances by \$2.6 billion a year in unnecessary fees and insurance.
 - The system offers products that meet most members' needs, but members lack simple and salient information and impartial advice to help them find the best products.
 - Not all members get value out of insurance in super. Many see their retirement balances eroded — often by over \$50 000 — by duplicate or unsuitable (even 'zombie') policies.
- Inadequate competition, governance and regulation have led to these outcomes.
 - Rivalry between funds in the default segment is superficial, and there are signs of unhealthy competition in the choice segment (including product proliferation). Many funds lack scale, with 93 APRA-regulated funds — half the total — having assets under \$1 billion.
 - The default segment outperforms the system on average, but the way members are allocated to default products has meant many (at least 1.6 million member accounts) have ended up in an underperforming product, eroding nearly half their balance by retirement.
 - Regulations (and regulators) focus too much on the interests of funds and not members. Subpar data and disclosure inhibit accountability to members and government.
- Policy initiatives have chipped away at some problems, but architectural change is needed.
 - Default should be the system exemplar. Members should only be defaulted once, and move to a new fund only when *they* choose. Members should also be empowered to choose their own super product from a 'best in show' shortlist, set by a competitive and independent process. This will bring benefits above and beyond simply removing underperformers.
 - All MySuper and choice products should have to earn the 'right to remain' in the system under elevated outcomes tests. Weeding out persistent underperformers will make choosing a product safer for members.
 - All trustee boards need to steadfastly appoint skilled board members, better manage unavoidable conflicts of interest, and promote member outcomes without fear or favour.
 - Regulators need clearer roles, accountability and powers to confidently monitor trustee conduct and enforce the law when it is transgressed. A strong member voice is also needed.
- Implementation can start now, carefully phased to protect member (not fund) interests.

Overview

Superannuation is a significant financial asset for many Australians. It sits alongside the Age Pension, the family home and other household savings as a pillar of the retirement income system. Super is compulsory for most workers and, with over 15 million members collectively owning over \$2.7 trillion in assets, it will play a central role in funding Australians' retirement into the future.

The super system's performance therefore matters for the wealth and wellbeing of Australians — and its role in intergenerational wealth means it will play a growing role in wealth inequality. The system is both complex and compulsory. Not everyone has the time, inclination or capacity to keep a constant eye on their super. Government plays a role in regulating the system so that people can trust it with a significant portion of their savings (and for many, their primary source of savings).

The system has come a long way since 1992 when compulsory super was introduced. It arose as a de facto pay rise, which tied Australia's retirement savings policy to the workplace relations system. Super funds were linked to employers and unions, with industrial awards cementing the relationship. Workplace relations have since changed, and the role of unions in the workforce has diminished. But vestiges of that old system live on with specification of super funds in awards, and workplace determination of default funds.

Now that the system is well on the way to maturity — with many Australians retiring with substantial balances after contributing for many years — it is timely to ask whether it suits its members' needs. Much more is at stake today in financial terms than at the system's inception. Australians are much more likely to move between industries and occupations throughout their careers, and to hold multiple jobs. At the same time, the 'gig' economy and technologies such as automation are starting to break down some of the industry and occupational boundaries we once had. Australians are also working longer, retiring later and living longer — which means super balances are higher but also need to last for longer.

In this inquiry, we have examined the efficiency and competitiveness of our super system — and whether better ways to allocate defaults are needed — with an eye to making it work better for all members (box 1). We have not looked at the broader role of super in funding retirement incomes or the impact of super on national savings, public finances or intergenerational equity — broader questions that should be answered by an independent inquiry ahead of any increase in the Superannuation Guarantee rate.

Box 1 **Our approach**

The Australian Government tasked the Commission with three sequential pieces of work on the super system, falling under two terms of reference.

- **Stage 1** involved developing a framework for assessing the efficiency and competitiveness of the super system. The final study report was released in November 2016 and the framework comprised 5 system-level objectives, 22 assessment criteria and 89 unique indicators (PC 2016a). The assessment framework set out the prospective attributes of a competitive and efficient super system that are within the scope of influence of the system. It covered the system's contribution to members' retirement incomes, how it meets members' needs over their lifetimes, gains in efficiency over time, whether the system provides value for money insurance, and how competition drives the outcomes members need.
- **Stage 2** entailed developing a set of alternative models for allocating default members to products (PC 2017d). Following publication of the draft report in March 2017 and a round of public hearings, the stage 2 inquiry was rolled into the stage 3 inquiry.
- **Stage 3**, the current inquiry, derives from its own terms of reference. It has assessed the efficiency and competitiveness of the system, drawing on the stage 1 framework, and identified areas for improvement. It also provides final advice on default models.

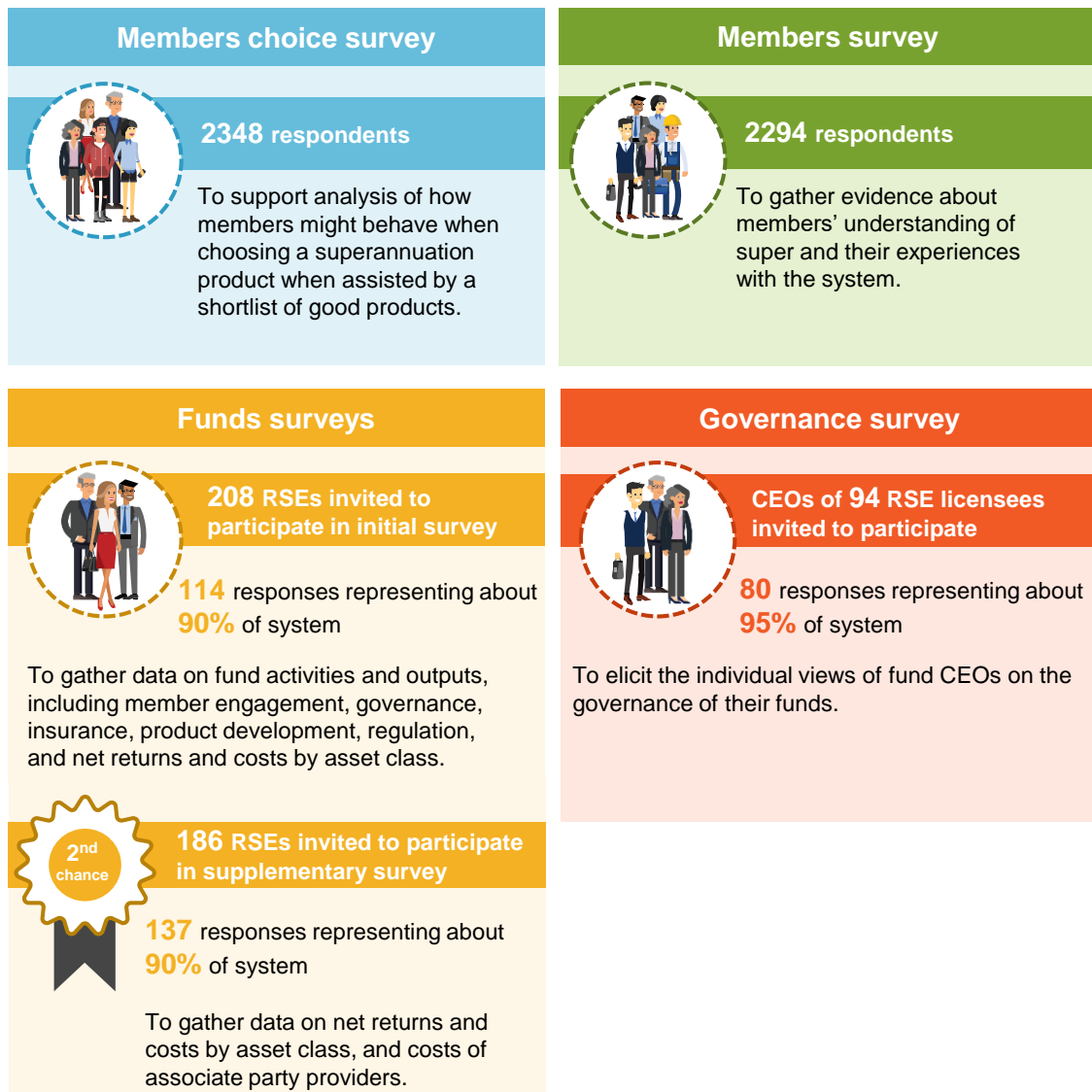
This stage 3 inquiry is focused on the outcomes for members in the super system, consistent with our remit to make recommendations that promote the wellbeing of the Australian community. It is a broad endeavour, spanning institutional and self-managed super funds, wholesale providers, the regulators and, foremost, members. But, broad as it is, the inquiry has not looked at the overarching retirement income policy architecture, the adequacy of retirement incomes or the impact of super on national savings. Nor has it produced league tables of individual funds.

There is little precedent in Australia and internationally for reviewing the efficiency and competitiveness of a superannuation or pension system in its totality. The inquiry has also been unique in its breadth and use of evidence — drawing widely on both existing data (held by regulators and research firms) and new data (gathered through a series of five surveys, covering super funds and their members — detailed in figure 1). The evidence we gathered was used to undertake several novel analyses. We have:

- constructed benchmark portfolios to compare investment performance across the system
- compared and benchmarked returns at the individual asset-class level
- developed cameos to illustrate how retirement balances can be eroded by poor practices
- simulated sequencing risks that members might face (to evaluate life-cycle products)
- quantified the cost savings from economies of scale and pass-through to members.

This inquiry has taken place in the context of other inquiries — indeed, its genesis is in a recommendation of the 2014 Financial System Inquiry. In May 2017, the Commission commenced a parallel inquiry on *Competition in the Australian Financial System*, which was completed in June 2018. In December 2017, the Government initiated a *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (hereafter, the 'Royal Commission'), which is expected to be completed by February 2019. We have developed our findings and recommendations in this inquiry in light of relevant evidence that has emerged through these other reviews.

Figure 1 **Our five surveys to address data gaps**



What outcomes are members getting?

The super system exists to support its members in retirement. In the long term, members need strong investment performance and a balance that has not been eroded by unnecessarily high fees or insurance premiums. They also need access to products that meet their individual requirements (especially once they have retired) and the right information to make decisions.

The system delivers good outcomes for many members, but not all. The industry's peak body submitted that 'the Australian superannuation system is not broken, and is in fact a world-class private pension system' (ASFA, sub. DR148, p. 3). The evidence suggests otherwise.

Members earn very different investment returns

Investment returns, after all fees and taxes, matter most for members' retirement incomes. Even a small difference in annual returns can leave a member substantially worse or better off at retirement — the power of compound interest.

We constructed a series of 'benchmark portfolios' to assess investment performance across the super system. These portfolios are measures of investment returns across a set of asset classes, with the mix of assets adjusted to match the investment strategy (asset allocation) of the funds, products (investment options) or segments of the system we are benchmarking (box 2). By being agnostic of asset allocation, the benchmarks allow investment performance to be compared right across the system. This approach has not been previously used to gauge the super system's performance.

Box 2 Our two benchmark portfolios

The Commission constructed benchmark portfolios (BPs) to assess the system's relative and absolute investment performance. This follows two technical workshops during our stage 1 study, input by way of submissions, and much consultation with industry experts.

The BPs allow comparable performance assessment across funds and products by tailoring for — and thus being agnostic of — asset allocation. They capture the investment performance (net of fees and taxes) of a set of investment strategies across a range of asset classes.

- **BP1** is a listed benchmark portfolio constructed using listed financial market indexes.
- **BP2** is a blended benchmark portfolio constructed using both listed and unlisted indexes.

BP2 is more representative of super funds' exposure to unlisted asset classes, and thus more closely represents how funds actually invest (in terms of implementing their asset allocations). It is used throughout this overview.

Data limitations mean this exercise is challenging and cannot be an exact science — indeed, our benchmarks are sensitive to assumptions (about tax, fees and the composition of some asset categories) and adjustments made to reflect funds' asset allocations in earlier years (chapter 2). The methods were further refined following our draft report, informed by further feedback and consultation. We have erred on the side of generosity to the funds in constructing the benchmarks, and we identify 'underperformance' only where performance falls short of the relevant benchmark by at least 0.25 percentage points (25 basis points) over the relevant time period.

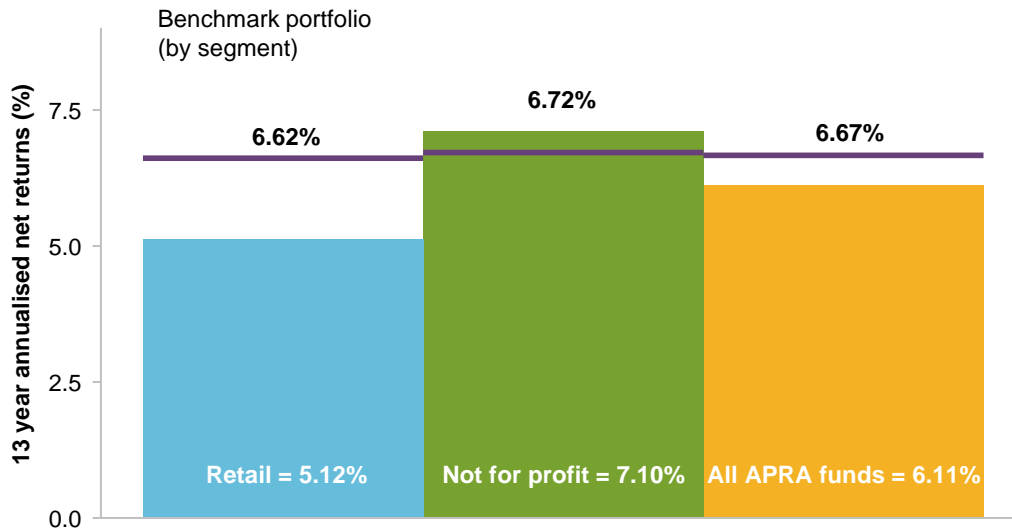
To take account of risk, we have benchmarked investment performance over the longest time period permitted by the data (in most cases, 13 years). The exact time horizon has a modest effect on the results but in general does not change the conclusions.

Over the past 21 years (to 2017), many super funds regulated by the Australian Prudential Regulation Authority (APRA) have delivered solid returns to their members — averaging about 5.9 per cent a year in nominal terms, or about 3.5 percentage points above inflation (after fees and taxes). Over the past 13 years (to 2017) — the period over which we could undertake more detailed analysis — the system delivered average annual net returns of

6.1 per cent (after investment and administration expenses, and taxes). This falls below the system-level benchmark (figure 2).

Figure 2 Funds by segment: not-for-profit funds outperform retail funds on average

Benchmark adjusted for asset allocation, 2005–2017



Sources	PC analysis of unpublished APRA data and financial market index data (various providers).
Benchmark	BP2.
Coverage	All APRA-regulated funds in each year (100% of assets and member accounts). Excludes SMSFs and exempt public sector funds. Over the whole super system, the figure represents 181 funds, 83% of member accounts and 64% of assets in 2017.
Survivor bias	No.
Selection bias	No.

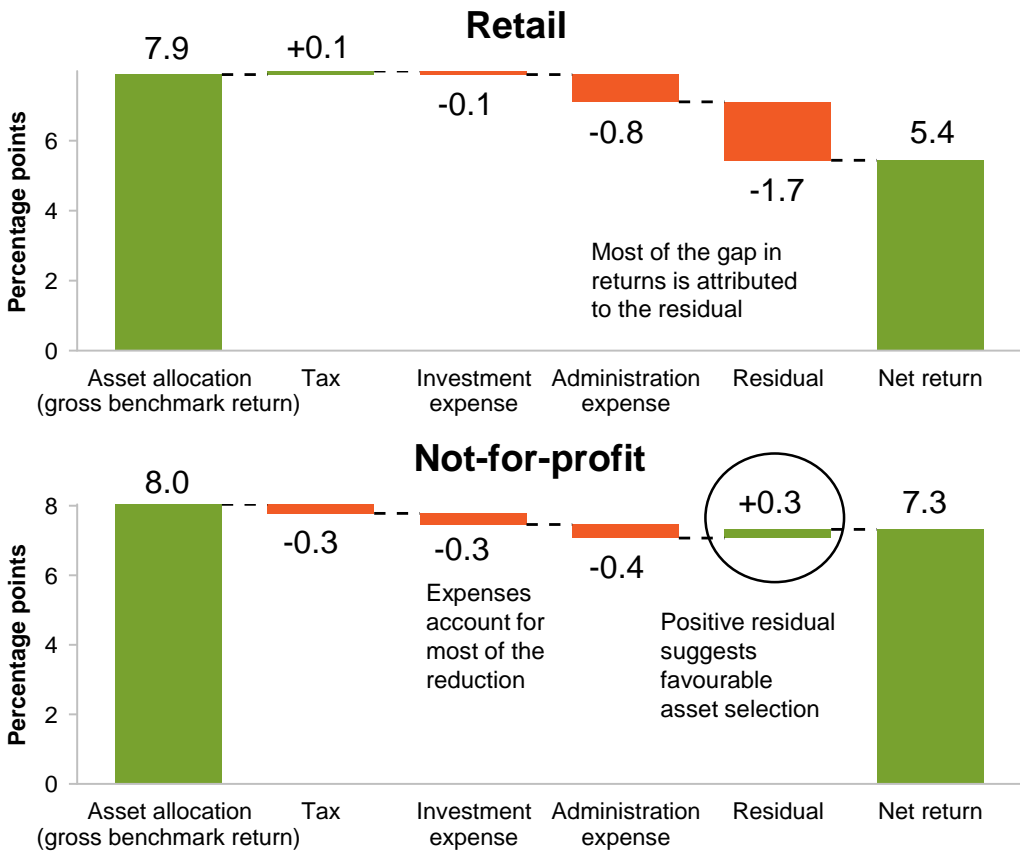
But investment performance varies considerably across the system. As a group, not-for-profit funds delivered returns above a benchmark tailored to their average asset allocation, but retail funds as a group fell below theirs. These results suggest that while many products have been delivering solid returns for members, there are also many that underperform, particularly in retail funds. (The tailored benchmarks take into account that retail funds have typically had more conservative asset allocations compared with not-for-profit funds; the benchmarks are similar across the segments over this period because of relatively strong returns to fixed income assets, though this will not always be the case.)

We undertook further analysis to decompose this systemic difference in returns between the not-for-profit and retail segments into various drivers (figure 3). For retail funds as a whole, some of the gap between actual returns and the pre-expenses benchmark is due to tax and expenses. But most of the gap is a residual — a component we cannot directly measure. In this case it is negative, meaning actual returns were lower than can be explained by asset allocation, tax or expenses. Because the benchmark largely controls for asset allocation, the

residual is likely to mainly capture how well (or poorly) funds select assets within individual asset classes. It could also, to a lesser extent, reflect unreported (indirect) investment expenses.

By contrast, the not-for-profit segment had a smaller gap between actual returns and its pre-expenses benchmark. After accounting for tax and expenses, there is a positive residual — which suggests favourable asset selection within the individual asset classes.

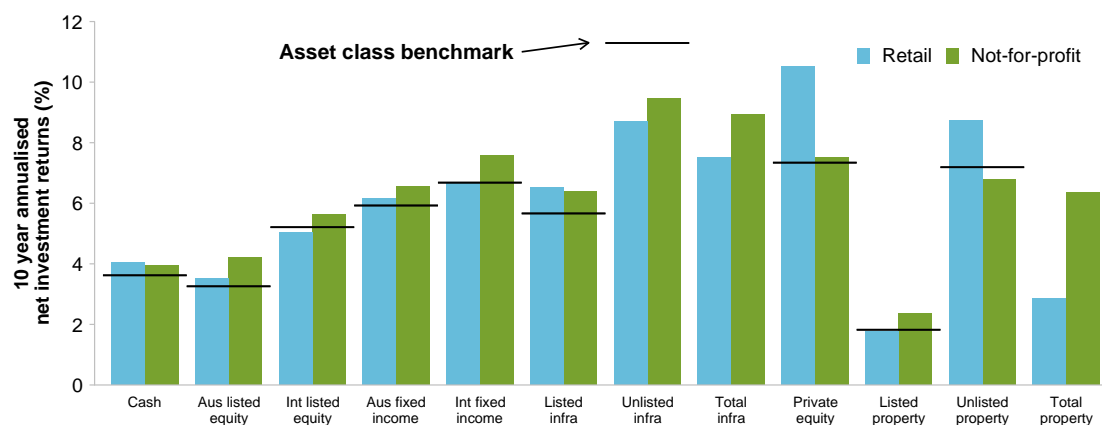
Figure 3 Funds by segment: components of different returns
2005–2017



Sources	PC analysis of unpublished APRA data and financial market index data (various providers).
Benchmark	BP2.
Coverage	All APRA-regulated funds in each year (100% of assets and member accounts). Excludes SMSFs and exempt public sector funds. Over the whole super system, the figure represents 181 funds, 83% of member accounts and 64% of assets in 2017.
Survivor bias	No.
Selection bias	No.

We then looked at how the system is performing within each asset class — something that has not been done comprehensively before. Consistent with our other analysis, not-for-profit funds outperformed retail funds in most asset classes, including for the largest asset classes in the system, listed equities and fixed income (figure 4).

Figure 4 Funds by segment: Not-for-profit returns exceed retail returns in most asset classes
 Net returns weighted by assets in the corresponding asset class, 2008–2017



Sources	Supplementary funds survey and financial market index data (various providers).
Benchmark	Asset-class benchmarks as per BP2.
Coverage	In 2008, the funds in this figure represent up to 66% of total assets and 69% of member accounts in APRA-regulated funds. In 2017, they represent up to 86% of total assets and 87% of member accounts in APRA-regulated funds.
Survivor bias	Yes.
Selection bias	Yes.

Across the system as a whole, funds outperformed their benchmark in most asset classes. This may appear contrary to the earlier benchmark results. But our asset-class level analysis relied on our supplementary survey results that were positively biased due to missing data for funds that have exited the system (survivor bias) and that did not provide the requested data (selection bias).

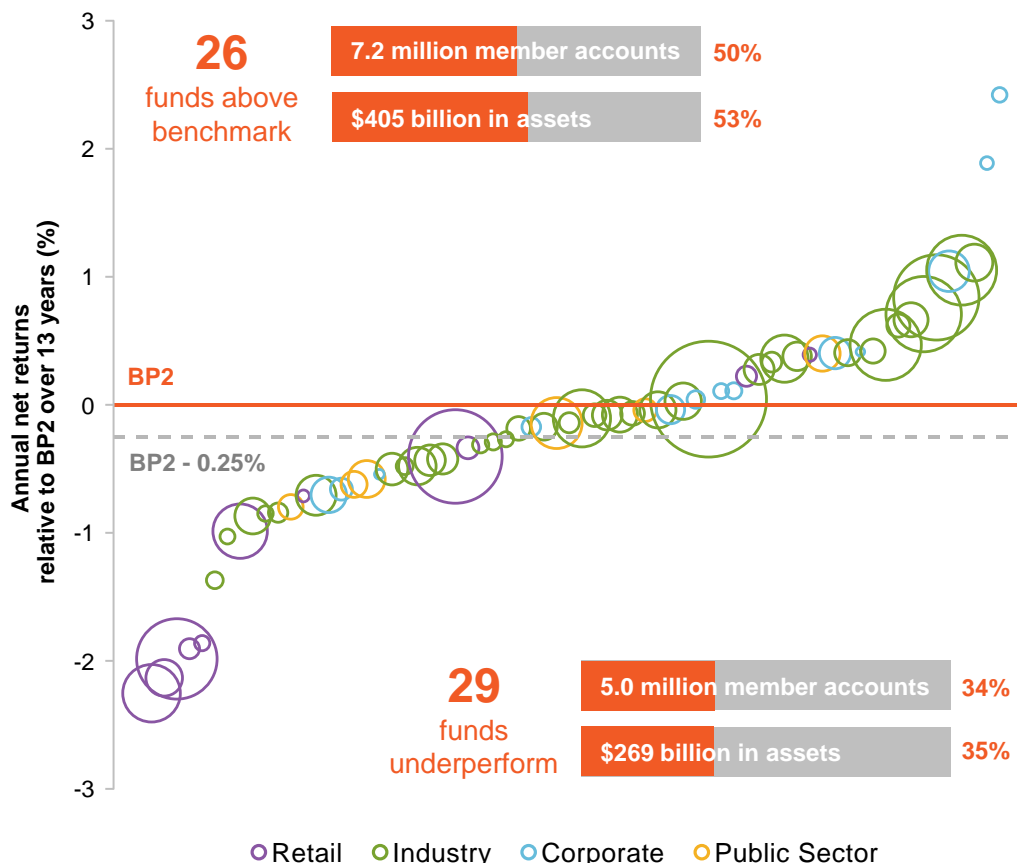
Australian funds in our survey also performed comparably, on average, to large pension funds in other developed countries across most asset classes.

Averages can conceal a lot of variation, especially across individual funds and products. After adjusting for differences in the asset allocation of each fund, we found a wide range of performance (figure 5).

- Over the 13 years to 2017, 26 funds performed above their benchmark. Over 7 million member accounts (about half the accounts in the dataset) and over \$400 billion in assets were in these funds.
- Over the same period, 42 funds performed below their own benchmark portfolio, of which 29 underperformed by more than 0.25 percentage points. These 29 underperforming funds contain 5 million member accounts and about \$270 billion in assets. About half are industry funds and almost a third are retail funds. Notably, the retail funds were larger on average, collectively accounting for 77 per cent of member accounts in underperforming funds (some 3.8 million accounts).

Figure 5 Individual funds (with MySuper products): 5 million accounts are in underperforming funds

Performance relative to individual funds' benchmark portfolios, 2005–2017
Size of circles indicates the size of each fund's assets under management



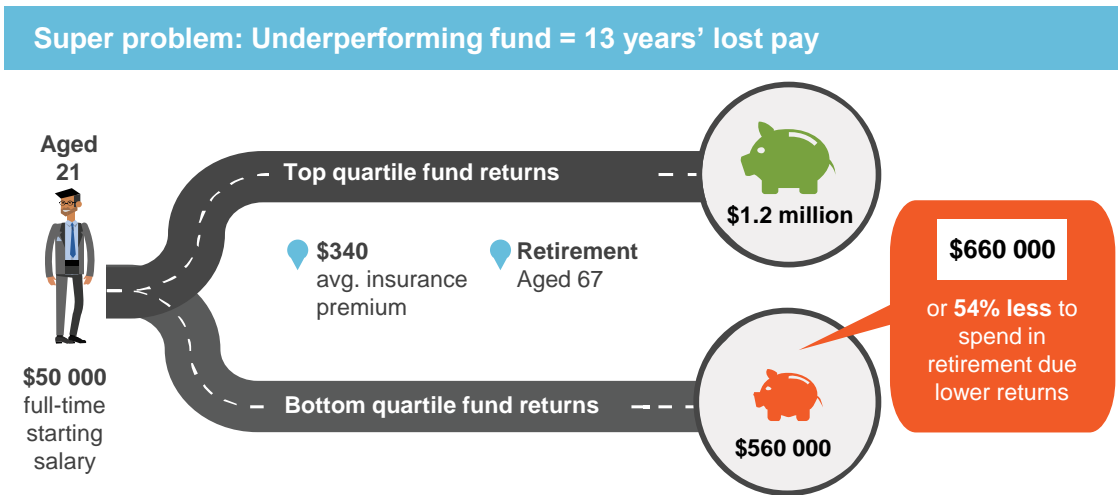
Source	PC analysis of unpublished APRA data and financial market index data (various providers).
Benchmark	Fund-tailored BP2.
Coverage	All APRA-regulated funds with a MySuper product in the dataset over the full period (60% of assets and 66% of member accounts in all APRA-regulated funds with a MySuper product in 2017). Over the entire super system, the figure represents 68 funds, 30% of assets and 51% of member accounts in 2017.
Survivor bias	Yes.
Selection bias	Yes.
Further results	13 funds performed between BP2 and 0.25 percentage points below BP2 (2.4 million member accounts and \$85.5 billion in assets).

These results have been updated since our draft report — by adding another year of data and refining our methods. But data limitations still confine the analysis to funds that currently offer a MySuper product — and thus only about half the member accounts in the system.

It is nigh impossible to overstate the significant implications for members' retirement incomes from this wide dispersion in fund performance over the long term. For example, a typical full-time worker experiencing the investment performance of a bottom-quartile fund

over their lifetime would retire with a balance 54 per cent (or \$660 000) lower than if they experienced returns commensurate with the top quartile (based on the median fund's return in each quartile) (cameo 1).

Cameo 1 Underperformance compounds to substantially lower retirement balances



Asset allocation is the largest driver of total returns at the fund level, but most of the variation across funds is captured by the residual, likely reflecting how well funds invest within asset classes.

Outcomes vary by product too. To look at outcomes in the default segment — where MySuper products collectively hold over 15 million (over half of all) member accounts — we tracked products over the past decade by matching current MySuper products to their default precursors. This revealed significant dispersion in the performance of MySuper products. Many member accounts are in products that perform well above the average, but a material portion significantly underperform a benchmark portfolio tailored to their own asset allocation.

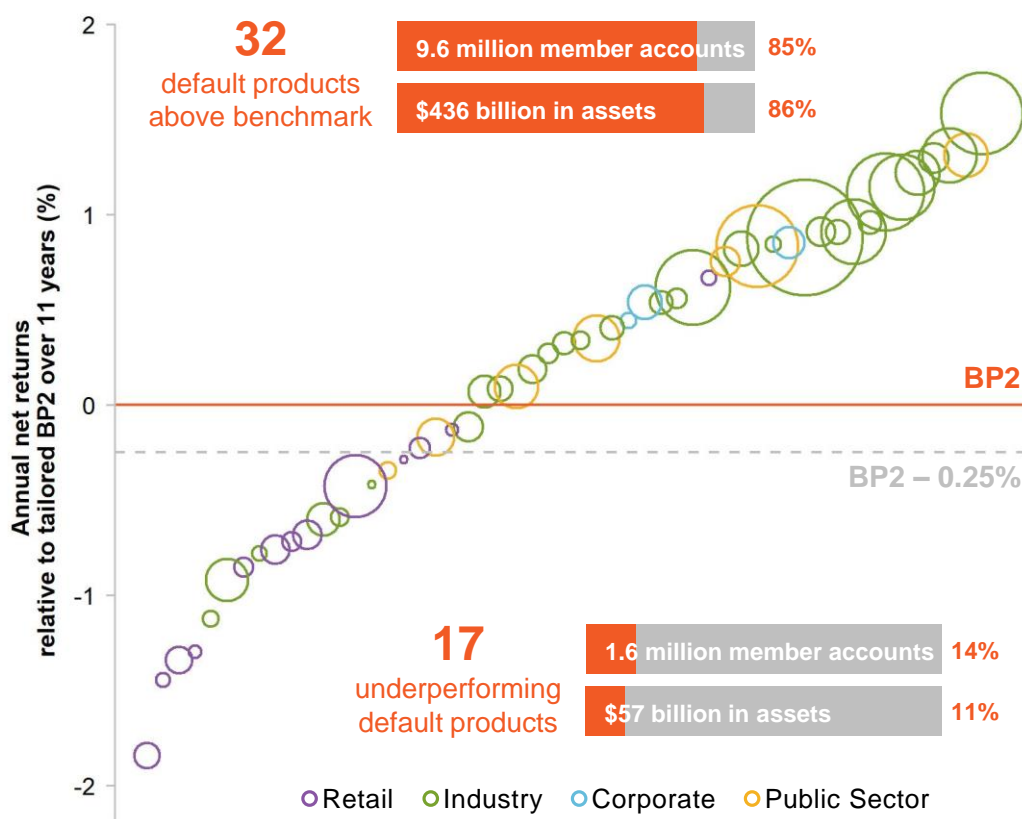
The analysis suggests that some members have ended up in funds with very good performing MySuper products (after controlling for asset allocation), whereas many others are experiencing considerably poor performance (figure 6).

- In the 11 years to 2018, 32 MySuper products (of 53 in the sample) performed above their tailored benchmark, and generated a median net return of 5.5 per cent a year. Nearly 10 million member accounts and \$440 billion in assets were in these products, almost all of which were associated with not-for-profit funds (of varying sizes).
- Over the same period, 21 products performed below their tailored benchmark, of which 17 underperformed by more than 0.25 percentage points and generated a median net return of 3.8 per cent a year for their members. These 17 underperforming products

contain about 1.6 million member accounts and \$57 billion in assets. They comprise 10 products from retail funds, 6 from industry funds, and 1 from a public sector fund. And over a third (7) are life-cycle products — where members are automatically moved into less risky and lower-return asset allocations as they age.

Figure 6 Default products: vastly different net returns, with 1.6 million member accounts in underperforming default products

Performance relative to individual products' benchmark portfolios, 2008–2018
Size of circles indicates the size of each product's assets under management

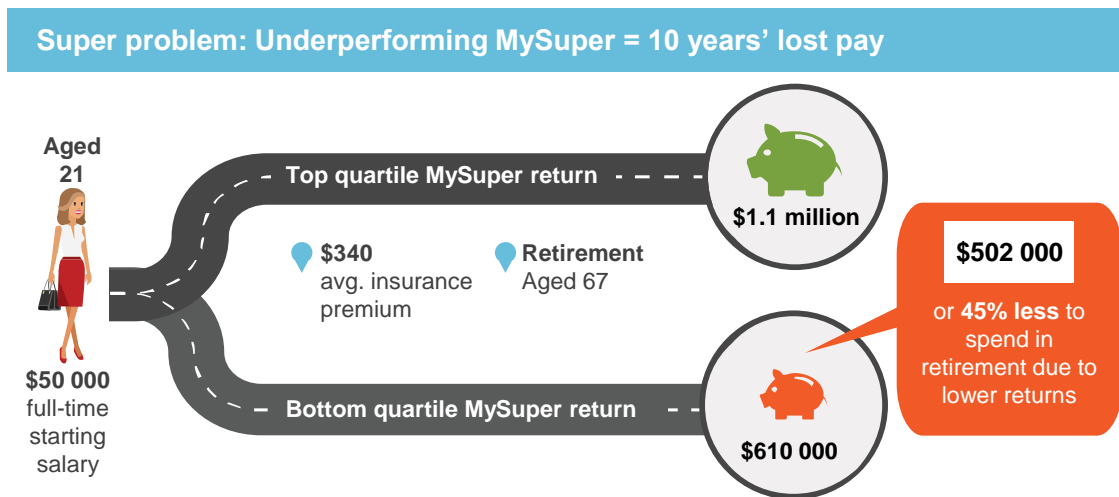


Sources	PC analysis of APRA (2018a, 2018k), financial market index data (various providers), and SuperRatings data.
Benchmark	Product-tailored BP2.
Coverage	53 of 105 current MySuper products covering 76% of member accounts and 75% of assets in all MySuper products as at June 2018.
Survivor bias	Yes.
Selection bias	Yes.
Further results	4 products performed less than 0.25 percentage points below BP2 (150 000 member accounts and \$12.6 billion in assets).

These conclusions do not change materially when MySuper products are benchmarked using the average asset allocation across MySuper products (as we did in our draft report). And APRA data on a near complete set of MySuper products — over the four years since MySuper was introduced — show a similarly large dispersion in investment performance. This suggests that the observed dispersion in net returns is not an historical artefact of the pre-MySuper era.

The large differences in investment performance for MySuper products have enormous implications for members. For example, a typical full-time worker who ends up in the median bottom-quartile MySuper product would retire with a balance 45 per cent (or \$502 000) lower than if they were in the median top-quartile product (cameo 2).

Cameo 2 MySuper returns can be a lottery for default members



Some choice members in APRA-regulated funds are also earning poor returns (across both the accumulation and retirement phases). Part of this may be due to their investment strategy, or a preference for more costly services that detract from net returns. But after we controlled for asset allocation, we found that about 36 per cent of choice products in our sample, with about 15 per cent of assets, underperformed benchmarks tailored to their own asset allocation (in the 13 years to 2017). Almost all were offered by retail funds. This is likely to be a conservative estimate of underperformance in the whole choice segment, as our data disappointingly only cover about 16 per cent of assets in the segment — a chasm of selection bias.

More than one million members have chosen to self-manage their super in a self-managed super fund (SMSF). Large SMSFs earn broadly similar net returns to APRA-regulated funds, but smaller ones (with less than \$500 000 in assets) perform significantly worse on average. This is mainly due to the materially higher average costs they incur (relative to assets) due to being small. While some SMSFs expand quickly and perform better, others appear to start small and stay small — and an estimated 380 000 members are in smaller SMSFs that have

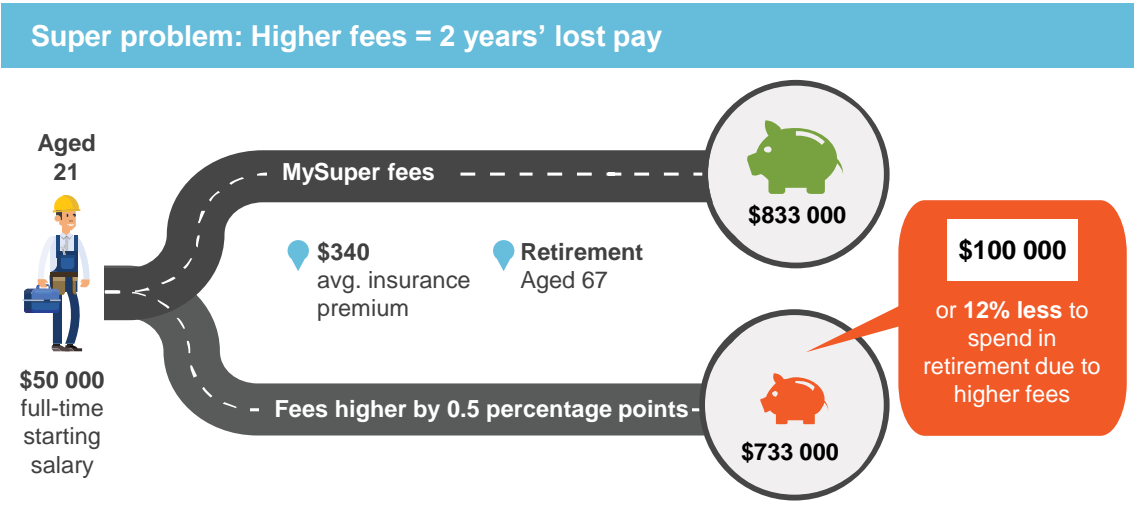
been established for more than two years (about 200 000 SMSFs, comprising 42 per cent of all SMSFs). Some of these members may be benefiting from high returns or tax advantages, but on average they are paying relatively high costs and facing low net returns.

Clearly, some members — in choice as well as default — do well, but many could be doing a lot better.

Fees have come down but remain a drain on net returns

Australians pay over \$30 billion a year in fees on their super (excluding insurance premiums). Fees can have a substantial impact on members — for example, an increase in fees of just 0.5 percentage points can cost a typical full-time worker about 12 per cent of their balance (or \$100 000) by the time they reach retirement (cameo 3).

Cameo 3 Higher fees materially erode balances at retirement



Reported fees in Australia are higher than in many other OECD countries. While some of the difference may reflect regulatory or other factors beyond funds' control, we obtained data on investment costs by asset class, which are much more comparable across countries. The data reveal that Australian super funds pay higher costs for the biggest asset classes (equities and fixed income) compared with their peers in other developed countries.

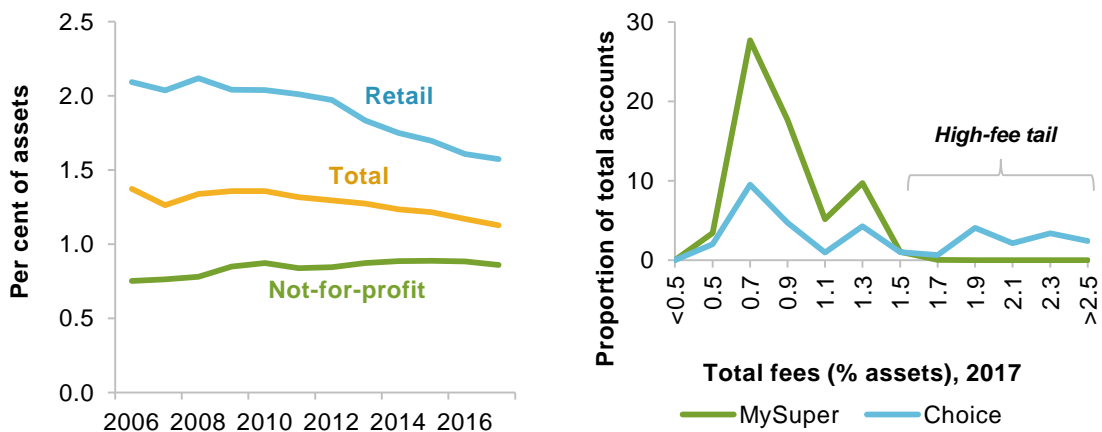
Our analysis reveals that significant economies of scale have been realised in the super system over the past 13 years, particularly for administration expenses. Holding constant other cost drivers, increases in scale are estimated to have generated cost savings of about \$340 million each year (on average), amounting to \$4.5 billion in incremental gains since 2004. But there is little evidence that these cost savings have been systematically passed through to members in the form of lower fees, and only tentative evidence (and only for

not-for-profit funds) that scale benefits have manifested as higher net returns. Data limitations mean it is difficult to tell precisely how members have benefited from greater scale.

As a percentage of balances, the reported fees members pay have fallen since the global financial crisis — from 1.3 per cent in 2008 to 1.1 per cent in 2017 (figure 7). This downward trend is apparent across most of the system, but is most pronounced in the retail segment, where average administration fees have fallen materially. By contrast, average fees charged by not-for-profit funds have been largely flat over time, but remain well below the fees charged in the retail segment.

The decline in retail segment fees may partly be due to the MySuper reforms, which led to many retail funds moving their default members to lower-fee MySuper products. It could also be a competitive response to members leaving retail choice products to open SMSFs.

Figure 7 Products by segment: retail and choice products have materially higher fees



Source	PC analysis of SuperRatings data.		
Coverage	362 products covering 78% of total assets and 76% of member accounts across all APRA-regulated funds in 2017.		
Survivor bias	Yes.	Selection bias	Yes.

Nevertheless, a tail of high-fee products remains entrenched. Annual fees exceed 1.5 per cent of balances for an estimated 4 million member accounts (holding about \$275 billion). Almost all of these accounts are in choice products offered by retail funds. While some may be receiving exceptional investment returns or member services, the evidence indicates that funds that charge higher fees tend to deliver lower returns, once both investment and administration fees have been netted off. High fees also persist over time.

Other types of fees can also harm members. High exit fees in some choice products can create a barrier to member switching, across both the accumulation and retirement phases. Fees for financial advice appear excessive in parts of the choice segment. In 2017, 10 retail

funds collected about \$1.4 billion of advice fee revenue, charging their members about \$341 per account in that year alone.

Further, at least 2 per cent of member accounts are still subject to trailing adviser commissions — despite such commissions being banned since 2013 for new accounts by the Future of Financial Advice laws. Eleven retail funds identified in data published by the Royal Commission are estimated to have collected in excess of \$400 million in such trailing commissions in 2017 alone. While largely a legacy problem, these commissions can materially erode member balances.

Analysing fees is bedevilled by significant gaps and inconsistencies in how funds report data on fees and costs, despite regulator endeavour to fix this. This lack of transparency harms members by making fee comparability difficult at best, and renders cost-based competition largely elusive.

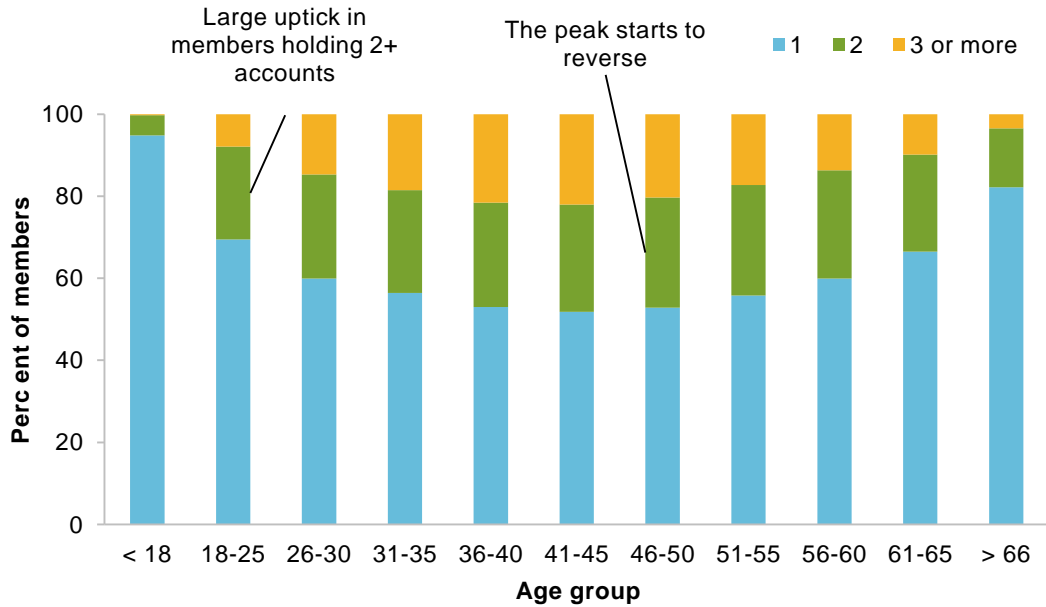
There are too many unintended multiple accounts

Over a third of all super accounts are ‘unintended multiples’ — created when a new default account is opened for a member when they change jobs or industries, and the member does not close their old account or roll over their existing balance. Much of this account proliferation appears early in adulthood and persists well into middle age (figure 8).

These unintended multiples collectively cost the members who hold them \$1.9 billion a year in excess insurance premiums and \$690 million in excess administration fees. Over time, the foregone returns compound to unnecessarily erode their retirement balances, and can leave a typical full-time worker 6 per cent (or \$51 000) worse off at retirement (cameo 4). Even worse, the effects are regressive, affecting younger and lower-income members the most.

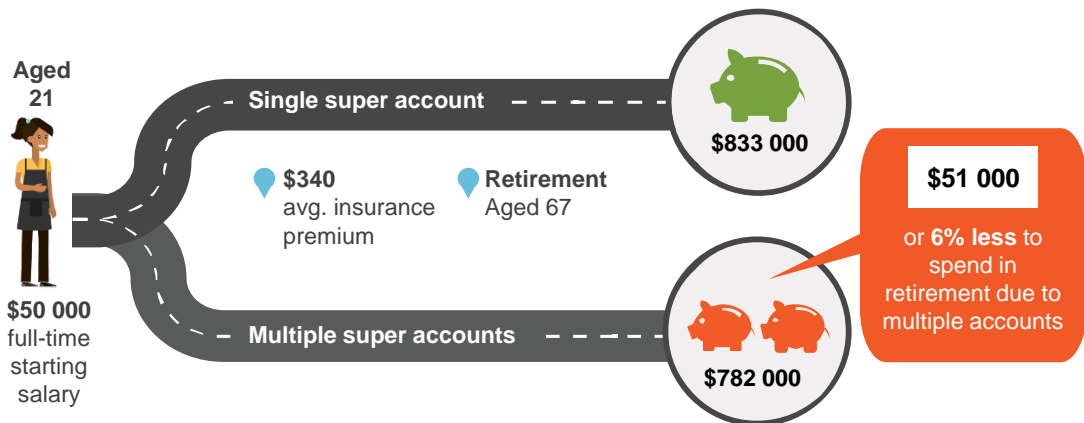
This absurdity of unintended multiple accounts has arisen because defaults are anchored to the job or the employer, not the member (discussed below). It is an avoidable system failure that has hurt members since the inception of compulsory super. Recent initiatives have made it easier to find and consolidate accounts in the system, but progress has been slow and a large stock of unintended multiple accounts remains — about 10 million. These initiatives will never amount to more than ‘mopping up spilt milk’ while unintended multiple accounts continue to be created. The problem is unlikely to abate given ongoing changes in the workforce (including multiple job holding and more job mobility across occupations and industries). Government and the regulators could and should have acted earlier to identify this costly systemic problem and taken decisive policy action.

Figure 8 **Account proliferation happens early, and persists**



Cameo 4 **Multiple accounts reduce retirement balances**

Super problem: Multiple accounts = 1 years' lost pay



Members face a bewildering number of products to choose from

An efficient super system would offer members a range of products and services suited to their needs and make sure they can readily access good quality (salient and simple) information to make decisions. It would also direct those who do not make a choice to good

defaults. While a large diversity of products exist, many members struggle to find the right product for them.

In the accumulation phase, most members have fundamentally simple needs: high net returns, low fees, well-managed risks and transparent product features. ‘No-frills’ products can meet their needs well, and many default (MySuper) products fall into this category (though their insurance offerings are often too complicated, as discussed below).

But most MySuper products fail to strike the right balance between high net returns and protecting members from the risk that asset prices will fall as they near retirement (crunching their retirement balance). Well-designed life-cycle products can address this sequencing risk by moving members into more defensive (but lower-growth) assets as they approach retirement. In practice, however, many life-cycle products have simply ended up leaving members with lower retirement balances than they would otherwise have got in a fixed-strategy product. This is a combination of failing to adequately take account of members’ personal characteristics — as not all members will need to de-risk ahead of retirement — and of dialling down risk too early in the life cycle (in some cases as early as 30 years of age). Almost a third of MySuper member accounts and assets are in such life-cycle products.

In the choice segment, a proliferation of little used and complex products — some tens of thousands — increases fees without boosting net returns, and makes effective decision making elusive for most members. There is evidence that some members who use these products are unwittingly buying a degree of control over their super at the price of materially lower retirement incomes.

In retirement, members’ needs are no longer as straightforward. The large diversity of household preferences, incomes and other assets means that no single product can meet everyone’s needs. Pre-retirees need to navigate an increasingly complex maze. The range of retirement products on offer — including account-based pensions, annuities and new hybrid annuities — does not appear to be deficient. The bigger issue is whether people are choosing the product that is best for them. The Government has announced a new Retirement Income Covenant that will require funds to offer a risk-pooled product to members when they retire, but the exercise has been beset by design challenges and implementation has been (sensibly) delayed to 2022.

A broader underlying problem is that members at all stages find the super system too hard to navigate, and do not know where to turn for help. While there is no shortage of information, many members find it complex, overwhelming and inconsistent with their needs. Product disclosure statements seem more focused on protecting the fund than helping the member. Members get excessive choice at the expense of less comparability, and even highly engaged and financially literate members struggle. Many would like more relevant and simpler information to help them find and compare products and, if necessary, switch.

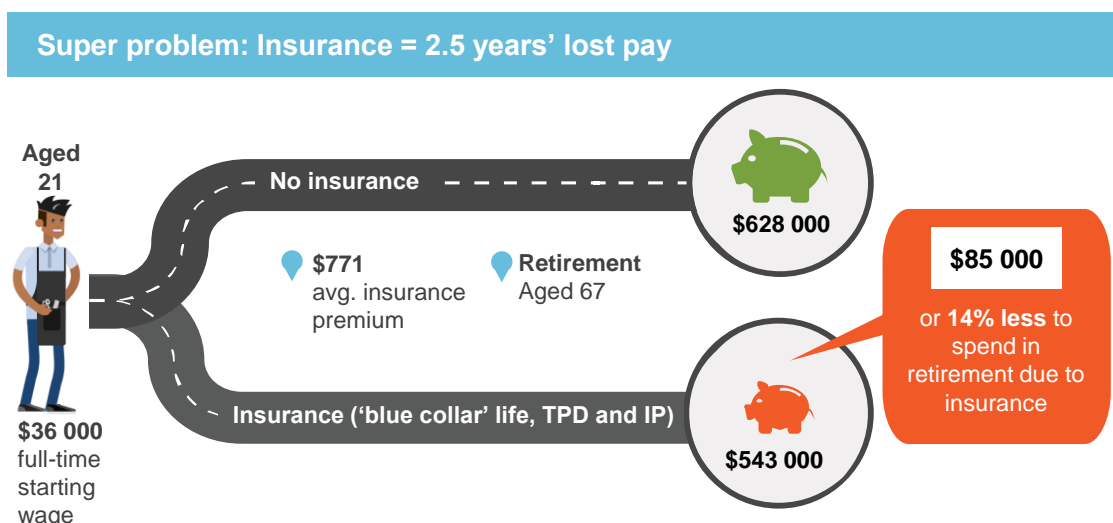
Access to information and affordable, credible and impartial financial advice is crucial — especially in the retirement phase — and its importance will only grow as the system matures. Some members seek out financial advice, but few know where to look for impartial and affordable advice, or how to judge the quality of the advice received. Despite the Future of Financial Advice reforms, conflicted financial advice remains an egregious problem (especially within vertically integrated organisations).

Insurance is not delivering value for all members

About 12 million Australians have insurance (life, total and permanent disability and/or income protection cover) through their super. Group insurance arrangements deliver many of them much more affordable insurance than they would be able to get through individually written cover outside of super. Because most of these group policies are provided on an opt-out basis, the large share of low-risk members in the pool acts to keep premiums down for everyone. Some have argued that insurance in super has been a key factor in addressing an underinsurance gap in Australia, though we have not assessed this issue as part of this inquiry.

But not all members receive good value from the insurance in their super. The premiums that come out of members' accounts erode their retirement balances. The effects are worse for members on low incomes and those with intermittent labour force attachment, who continue to have premiums deducted from their accounts while not contributing to their super (while, at the same time, often facing more onerous criteria for an insurance claim to be accepted). The retirement balance erosion for these members could reach 14 per cent (\$85 000) (cameo 5), and as much as 28 per cent (\$125 000) for some disadvantaged members with duplicate insurance policies.

Cameo 5 Insurance policies erode balances for low-income workers



More fundamentally, wide variation in the types and levels of default cover (as well as premiums) across funds does not seem warranted based on inherent differences in each fund's membership cohort. In many cases, member circumstances and needs vary more within than across funds — but funds typically collect little data to tailor default insurance to their members. Which insurance policy members end up in is often determined by which default product their employer has chosen — the luck of the draw.

Even worse, some members end up with insurance policies that are simply unnecessary. About 17 per cent have duplicate policies across multiple super accounts — eroding their retirement balances by over \$50 000. And some members are being defaulted into insurance products they are ineligible to claim on, with income protection cover being the chief and costly culprit for such 'zombie policies'. Typically, a member can only claim against one income protection policy and only when they are working (although only a small share of members are likely to be affected). A typical full-time worker can expect insurance to erode their retirement balance by 7 per cent (\$60 000) if they have income protection cover, compared with just 4 per cent (\$35 000) if they only have life and disability cover.

Other questionable practices include:

- extremely complex and incomparable policies, which impede member decision making and act as barriers to account switching and consolidation, and can derail fund mergers
- member difficulties in interacting with funds, particularly to opt out of insurance and to make a complaint
- the bundling of life and disability insurance, meaning that some members without dependants are unable to opt out of life cover while retaining their disability cover
- poor application of risk premiums in default insurance, for example, for occupation or smoking status.

These outcomes are hard to reconcile with the legal obligations on super fund trustees to act in their members' best interests and to ensure that insurance does not inappropriately erode their members' balances.

In response to some of these outcomes — and after much Government prompting — the industry developed a voluntary code of practice. This is a small first step at addressing some of the most egregious problems, such as excessively high premiums for some members. Many funds have committed to adopting the code, but how rigorously they will comply with the rules in practice remains unclear. The code is unenforceable, falls well short of what is needed, and does not reflect best practice for an industry code of conduct. Its effectiveness will depend on the extent of voluntary take up and the strength of its provisions (which are yet to include standard definitions and a short-form annual insurance statement for members). In its current state, it will only herald modest improvements in member outcomes.

What drives poor member outcomes from super?

Beyond the performance of financial markets, the outcomes that members get from their super are shaped by the behaviour of system participants, the degree of competition, and the effectiveness of regulation and regulators. Many members do reasonably well, as evidenced by the number of funds and products with strong long-term investment performance. Yet structural flaws in the form of inadequate competition, governance and regulation have created problems that drag down the system's performance and lead to very mixed performance across the system — with members footing the bill.

Members are not always going to make good decisions

Some members are highly engaged with the super system — actively comparing products or opening SMSFs. But most are not. Many members simply default, and rely on their fund to manage their super for them (whether out of trust, a lack of interest or an inability to compare products themselves). Levels of engagement are especially low among the young and members with low balances. Engagement is higher for members approaching retirement or with larger balances, suggesting that attention and engagement varies over the life cycle.

In general, rates of switching between funds and products are modest — historically, fewer than 10 per cent of members switch funds each year and only a third have ever changed their investment option. (Recent data suggest an uptick in switching to industry funds associated with the Royal Commission, but this is likely to be a temporary phenomenon absent system reform.) Close to 60 per cent of members do not understand their fees and charges, and about 40 per cent lack an understanding of basic investment options (such as growth, balanced and conservative). This reflects broader trends: about 30 per cent of Australians have low financial literacy, and a quarter do not understand basic financial concepts.

Low member engagement is not necessarily a problem. For many members, it is rational. Engaging takes time and effort, and trustees are charged with acting on members' behalf and in their best interests. Indeed, low engagement is to be expected in a compulsory and complex system that covers the bulk of the population. In some cases, disengagement can also be a consequence of cognitive constraints and behavioural biases, such as myopia, loss aversion, and a tendency to procrastinate.

But in many respects the system — and government — has made engagement harder than it ought to be for members. Complexity of products (and oft-changing rules), a lack of easy to understand information, and challenges in finding where to go to get help have made it hard for members to engage. These factors also make it harder for members who do engage to get the best outcomes, with evidence of poor decision making by some. This has implications for competition.

There is some competition in the system, but it's not always healthy

Competition matters, not for its own sake, but because it is an impetus for improving member outcomes — by maximising net returns, minimising costs and delivering the products and services members need. Robust rivalry between funds is essential for delivering these outcomes, and for stimulating ongoing innovation in the super system.

On some indicators, the system looks competitive. The retail level is characterised by many funds, low concentration, a contestable choice segment and competitive tension from SMSFs. Structural features of the system create challenges for new funds but do not constitute high barriers to entry. While some wholesale markets appear relatively concentrated (such as for administration services), those few providers are likely realising economies of scale.

But a closer look reveals problems. Muted competitive pressure from the demand side — members and their advisers — means that competition is not playing the corrective role that it does in other, less complex markets. In the choice segment, poor comparability of products (due to poor data and product proliferation), the charging of fees for no service, the entrenched tail of high-fee products and persistent underperformance by some funds all point to an absence of healthy competition. Evidence suggests that funds are competing to provide increasingly tailored products and administrative services (such as smartphone apps), but are putting less effort into delivering the highest net returns to members.

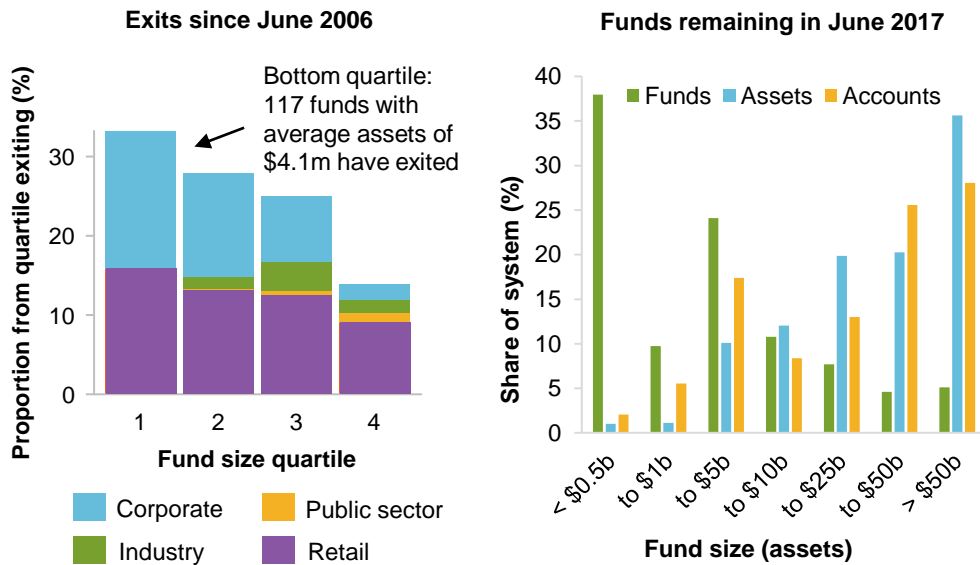
In the default segment, competition is at best superficial. Members who default are typically disengaged and exert no competitive pressure — there is limited or no competition *in* the market. As a result, competitive pressure has to come from competition among the funds authorised to provide default products — competition *for* the market. But this is not happening either. Default policy settings mean that competition is muted. In particular, those funds that have gained access to the default market face no systematic pressure to compete strongly. The stalled process for listing default funds in modern awards has acted to keep new entrants out of the default segment, and there is currently no process in place to remove from awards funds that are not performing well (discussed below).

At the wholesale level, evidence suggests that investment managers have some market power, even though market concentration is low. As a consequence, smaller funds, in particular, pay higher fees than would be the case if competition was more robust. Some larger funds have responded by bringing some of their investment management in-house, thereby putting competitive pressure on external investment managers.

Further, our analysis of economies of scale reveals that substantial cost savings from greater scale remain to be made, especially from further consolidation in the super system. Many small funds (with high average expenses) have exited the system, but a large tail remain (figure 9). About half (some 93) of all APRA-regulated funds have less than \$1 billion in assets, and many underperform. We have (conservatively) estimated that cost savings of at least \$1.8 billion a year could be realised if the 50 highest-cost funds merged with 10 of the

lowest-cost funds — benefitting an average member in the system by \$22 000 at retirement. That this potential exists reflects a lack of effective competition.

Figure 9 **Small funds have been exiting but many remain**



Default allocation is not putting members first

Default arrangements are a necessity in a compulsory super system to protect members who do not make their own investment decisions. The design of the system results in up to two-thirds of members defaulting when starting a new job. About half of all member accounts are in MySuper (default) products, representing 24 per cent (\$595 billion) of total system assets. Current arrangements — comprising workplace determination of default funds and a requirement for the funds that provide them to hold MySuper authorisation — have worked well for many funds and industrial parties (such as employer groups and unions). And many members have ended up in default funds that have demonstrated good investment performance.

But current arrangements are clearly not putting members first. Member outcomes are too variable. Policy settings have created an ‘unlucky lottery’ for members by failing to ensure they are placed in the very best funds — over 5 million member accounts are in funds experiencing serial underperformance. This has significant consequences for members’ balances and ultimately their wellbeing in retirement.

As noted above, a lack of healthy competition *for* the market means poor-performing funds are not being weeded out. Tying defaults to the employer rather than the member has led to the absurdity of members accumulating unintended multiple accounts (and paying multiple sets of fees and insurance premiums). And policy settings have enabled restrictive clauses

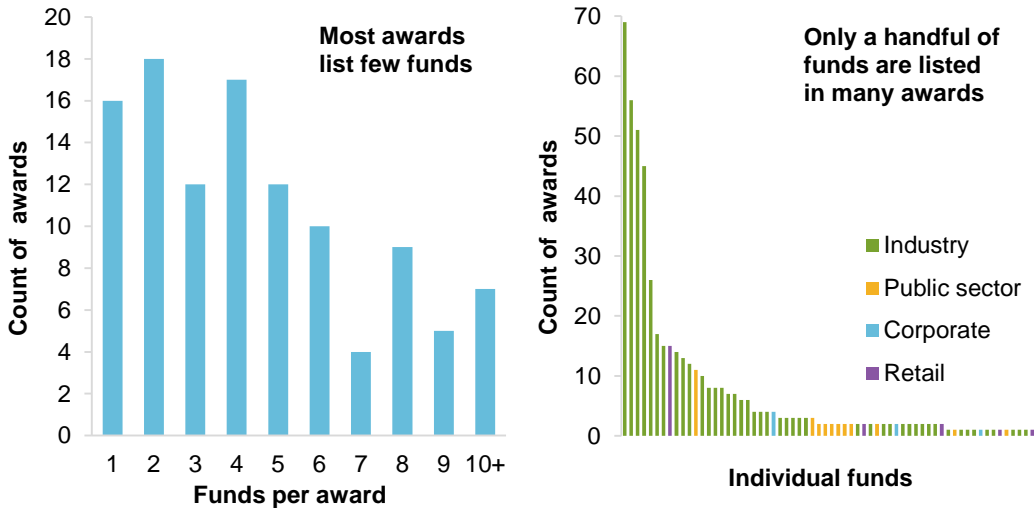
in workplace agreements that prevent an estimated 1 million members from exercising choice should they want to.

One of the main drivers of subpar outcomes is the way default funds are tied to employers and the workplace relations system, with employer choice constrained by lists of funds in modern awards and enterprise bargaining agreements.

Employers are not always well placed to navigate this maze and make decisions on behalf of their workers. Any system in which employers play such a central role in choosing defaults will always be hostage to constraints on employers' time, expertise and even goodwill to find the best super product for their workers. While some employers are highly capable and make much effort (sometimes using corporate tenders), many others (especially smaller businesses) put in limited effort or struggle to compare products. And there is evidence that some funds offer benefits to influence employers' choices — a problem that is both hard to observe and to regulate.

The listing of funds in modern awards is designed to mitigate some of the risks with employer choice, but is beset by a structure that restricts contestability between funds to obtain default members. Where bound by an award (and not all employers are), employers could face a choice of anywhere between 1 to 15 funds, depending on which of the 122 awards is relevant (figure 10). Only a handful of funds are listed in more than 10 awards.

Figure 10 Award listing is concentrated



In making listing decisions, the Fair Work Commission (FWC) (until it was rendered unable to do so) has historically drawn heavily on precedent, and viewed itself as a dispute solving body — not as an arbiter of the quality or merit of funds put up for inclusion. Members’ interests are a secondary consideration to questions of standing and history. Only funds backed by employer or employee representatives have generally been able to have themselves considered by the FWC — but these industrial parties have themselves sponsored the joint development of funds, and so have not been unhindered by conflicts of interest when reviewing other funds’ requests to be registered.

The process for listing funds in modern awards was revamped in 2012 following a Productivity Commission inquiry (which was limited by its terms of reference to look only at how funds are listed in awards). Legislation now provides for an expert panel within the FWC that all funds may apply to, and be considered by, on merit. But a legal challenge derailed the first attempt to appoint an expert panel, and the Government has since failed to appoint a replacement. Default allocation is effectively dormant, with no process in place for new funds to be listed in awards, or for underperforming funds to be removed (albeit APRA is now pressuring some poorly performing funds to justify their MySuper authorisation). Even if a new panel was to be appointed, the panel’s decisions could be overridden by the full bench of the FWC, to which many funds do not have legal standing.

The introduction of MySuper (also in 2012) was intended to reduce some of the variation in member outcomes in the default segment by requiring all funds to obtain MySuper authorisation to be allowed to offer a default product (and thus be chosen by employers). However, the original MySuper hurdle was set too low and significant variation across default products remains, especially in terms of investment strategy, performance and fees.

In the context of ongoing changes in the workforce (including multiple job holding and more job mobility across occupations and industries) and the broad terms of reference for this inquiry, the need for fundamental modernisation has become clear. The good member results seen in some default products appear to be mainly owed to trustee and employer goodwill. Yet wide variation in performance is inevitable, given the large number of funds and the current way of allocating defaults. Sustaining a high level of performance, and spreading it to more members, is only achievable by providing incentives to innovate and meet new needs.

Governance falls short of best practice

High-quality governance is integral to a super system where members rely on others to make decisions on their behalf, especially in an environment of compulsory savings and muted competition. Unlike shareholders in listed companies, super fund members have no voting rights and little if any influence over board appointments. In this context, governance (and its regulation) matters.

Over the past 30 years the governance of super funds has improved, yet governance practices lag contemporary best practice. Some trustee boards are either not complying with all of their regulatory obligations, or are complying in a ‘tick and flick’ sense without striving to protect and promote members’ best interests. The Royal Commission has revealed evidence of conflicts of interest directly resulting in member harm, including many instances where trustees in vertically integrated retail groups have preferred the financial interests of related-party shareholders over those of their members.

Best practice governance would require the trustee boards of *all* super funds to avoid conflicts of interest wherever possible, and then manage any unavoidable conflicts that remain. Trustee boards should also have a good mix of knowledge, skills and experience. Evidence from our governance survey suggests that not all funds employ satisfactory practices for appointing adequately skilled and qualified directors and for assessing board performance. Little more than half of CEOs firmly believed that their board has the right mix of capabilities, and only three in five firmly believed that their board has effective recruitment practices or seeks to improve its effectiveness on a regular basis.

Further, some retail fund directors, although considered ‘independent’, are on a number of related-party boards, which raises questions about their independence and fuels perceptions of (and sometimes actual) conflicts of interest. Indeed, one recent study estimated that nearly 80 per cent of directors on retail fund trustee boards are affiliated with related parties.

Vertical integration is not a problem per se, and can deliver benefits when competition and regulators are both fully effective — but neither are in the current super system.

Moreover, disclosure and trustee diligence are often lacking when it comes to outsourcing to related-party providers (a key source of conflicts of interest). APRA has voiced concerns that some funds may not be achieving value for money in their outsourcing arrangements. Our survey data and research by others suggest that funds that outsource administration to related parties pay more, but the poor quality of the data (especially on investment) makes it challenging to robustly analyse outsourcing practices.

Evidence of unrealised economies of scale, persistent underperformance and a large number of small funds — all imposing large costs on members — raises the question of why more funds have not merged. Little is known about mergers that have been broached but not completed. Some impediments to mergers are still evident, despite recent changes in regulatory guidance to funds (on successor fund transfers). Self-interest of board members is one, with the Royal Commission revealing clear evidence that board composition decisions have scuppered some merger discussions. The temporary nature of capital gains tax relief for funds that merge could also be a factor.

Conduct regulation appears to be missing in action

Regulation is essential for a compulsory and complex system holding large amounts of money and characterised by many disengaged members and potential conflicts of interest.

Regulation has evolved and improved over many years, and there is already a cornucopia of regulation aimed at trying to ensure members' best interests are met. Recently proposed reforms to boost the regulators' powers and regulatory levers will increase this further. Legislating an outcomes test for MySuper products will give APRA greater scope to lift standards and remove authorisation from funds that are failing to act in the best interests of members (especially on mergers). And the new product intervention powers put forward for the Australian Securities and Investments Commission (ASIC) will strengthen its ability to guard against upselling.

But steadfast and confident enforcement of the existing rules seems lacking. In particular, strategic conduct regulation appears to be largely missing in action — especially when it comes to public deterrence. Ideally, a regulator would proactively identify actual or potential instances of material member harm, investigate the underlying conduct and take strategic enforcement action in a way that provides a valuable public deterrent to future poor conduct. But the requisite data analytics (akin to those in this report) and consequential strategic surveillance have fallen short.

The Royal Commission's hearings have highlighted the deficit, to date, of public exposure of poor conduct (and associated penalties) to demonstrably discourage similar behaviour by others — now and in the future. The hearings have also revealed failures in both the detection and deterrence of poor conduct, by both APRA and ASIC.

In part, this is attributable to confusing and opaque arrangements for regulating trustee conduct, with significant overlap and no clear delineation between the roles of APRA and ASIC. There is a very real and ongoing risk that regulatory breaches 'fall through the cracks' as a result of divided responsibilities — with each regulator believing the other should be dealing with a matter, and neither being held accountable for not doing so. It has also led to heavy reliance on cooperation between the regulators.

Regulator culture and practice also matter. APRA steadfastly regulates through a prudential lens — focused primarily on 'accounting for the money' — when super is not a market characterised by prudential risk (most members and taxpayers underwrite the risks) nor one of 'caveat emptor' (buyer beware). The regulators appear focused on funds and their interests, and not on whether members' needs are being met and their interests unharmed.

There are yawning gaps in data

Super has been a large and compulsory public policy endeavour, yet there is remarkably little publicly available data on the outcomes that individual members are actually experiencing — in terms of the returns they earn, the fees they pay, the insurance they hold and the outcomes they receive over time.

The regulators' data collections are largely focused on funds and (only recently) on MySuper products, with a deficiency of member-based data. Despite regulator awareness, there are also major gaps and inconsistencies in these data collections, including in key drivers of

member outcomes and in areas prone to potential conflicts of interest. Among other things, APRA fails to collect reliable data on funds' true investment expenses, with pervasive non reporting and under reporting by funds. It also fails to collect robust data on funds' outsourcing arrangements with related parties. Poor-quality disclosure by funds appears to go unchecked and unpunished. Regulators have done much to improve the breadth and depth of their data holdings in recent years, but this has been off a low base. Progress has been glacial in some areas. Regulators appear to be hamstrung by industry opposition (on the misplaced basis of short-term compliance costs). And the absence of a strong member voice to give impetus to change means there has been no countervailing influence.

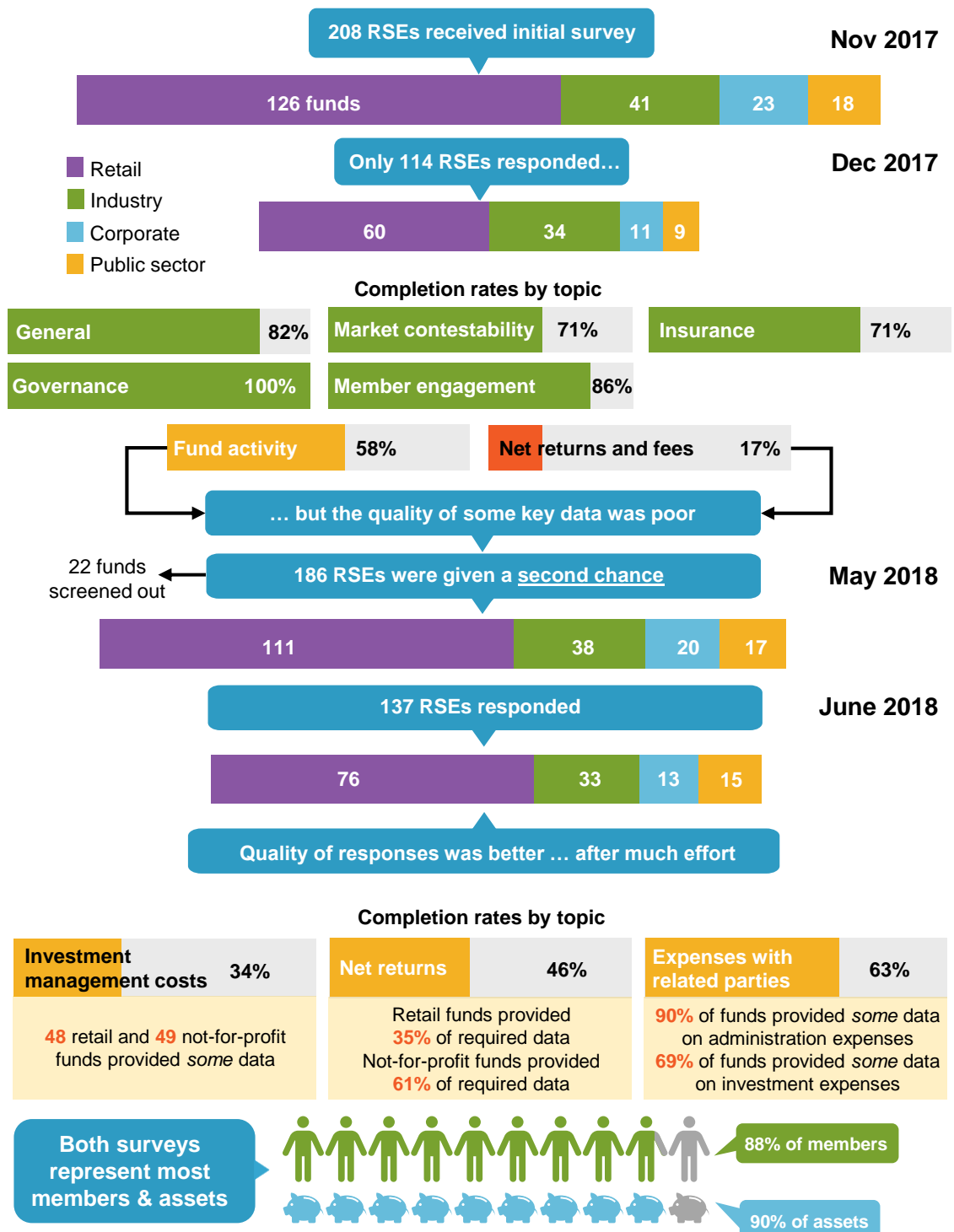
While our surveys were designed to fill some of the data gaps we faced in this inquiry, the overall quality of responses was symptomatic of a concerning disregard (on the part of many, but not all, funds) for transparency and members' best interests (figure 11). Only about half of super funds chose to participate (although notably they represented the overwhelming majority of member accounts and system assets). And of those that did participate, many skipped questions or provided incomplete data, especially on outcomes that matter most to members.

This prompted a supplementary survey of funds on a subset of topics, which had better response rates (after much follow up by us). Even then, this revealed that some funds do not comprehensively undertake performance attribution analysis or due diligence on their underlying products — must-haves for a trustee board to satisfy themselves that they are acting in members' best interests.

Poor data result in poor transparency, which leaves regulators and ultimately members in the dark as to what they are really paying for, and makes it harder for engaged members to compare products and identify the best-performing funds. This suppresses competitive pressure on the demand side, and gives rise to the perverse risk of worse outcomes for members who do get engaged. Poor data also suppress competitive pressure on the supply side, as any fund seeking to assiduously benchmark against its peers would struggle to do so.

The continued absence of regulators confidently collecting and analysing data also precludes their effective supervision, enforcement and ultimate protection against member harm. The analysis in this inquiry highlights the value of data analytics in identifying member harm, which should have always been core business for a regulator.

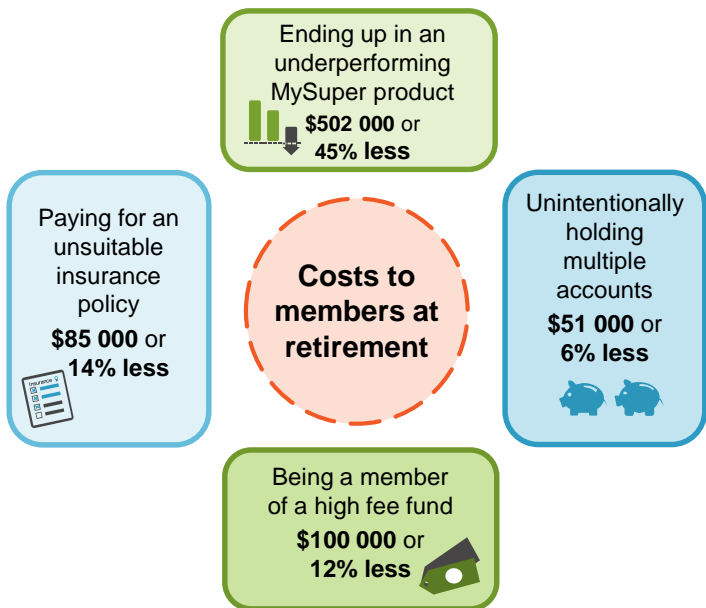
Figure 11 Responses to our super funds survey: not so super



A package of improvements to benefit members

Even though the super system has performed reasonably well for most members, policy settings need to change to make it work better for *all* members. Subpar system performance can compound to do considerable harm to members’ balances at retirement. For example, holding multiple accounts can reduce a typical worker’s balance by about 6 per cent (\$51 000) and an underperforming MySuper product can reduce a typical member’s balance by 45 per cent (\$502 000) by the time they retire (figure 12).

Figure 12 The character of member harm



The payoffs from fixing some of the worst problems in the super system would be significant. We have estimated that members would have collectively been in the order of \$2.6 billion better off each year if there were no unintended multiple accounts. And members would have collectively gained a further \$1.2 billion each year had all bottom-quartile MySuper products delivered returns in line with the median product in the top quartile. While these figures may appear immaterial across a \$2.7 trillion system, being defaulted into a single top-quartile MySuper product would lift the retirement balance of the median 55 year old by up to \$79 000 when they retire, compared with being defaulted into two bottom-quartile products. For a new workforce entrant today, the gain would amount to \$533 000 by the time they retire in 2064. This unlucky lottery needs to end — and the first line of defence is and should always be the policy settings.

The remainder of this overview sets out our recommendations to modernise the super system and make it work better for all members. These recommendations span the whole system: default and choice, accumulation and retirement, institutional funds and SMSFs. Collectively, they will harness healthy competition to make the super system work better

for all members, bringing it into line with the needs of the modern workforce and diverse retirees.

There is a rare and welcome alignment of inquiry endeavour whereby the Government's superannuation policy deliberations can be informed by both the recommendations of this inquiry and those of the Royal Commission.

A modern approach for default super

In a world of compulsion the onus is on government to ensure that default super is the system exemplar, mitigating the costly (and highly regressive) twin risks for a default member: defaulting more than once or defaulting into an underperforming product. In the course of this inquiry and the stage 2 inquiry that preceded it, we have developed a modern approach for default super.

As a starting point, members should no longer be defaulted into a new super fund whenever they change jobs or industries. Members should only be defaulted once, if they do not have an existing super account and fail to make a choice of their own. Members who change jobs or re-enter the workforce should have an opportunity to switch to a better super product, but if they do nothing they should stay with their existing (most recently active) account. In other words, once members are in the super system, they — not someone else — should choose when they switch funds or open a new account.

A 'best in show' shortlist

Our approach is one of employee (rather than employer) choice. At its centre is a safer and simpler choice architecture to help all members choose their own super product — regardless of whether they are default members. This consists of a single shortlist of 'best in show' products for all members. Members should be empowered to choose their own product from the shortlist or to switch, and this should be safe and easy to do. The shortlist is thus an essential accompaniment to employee choice in a world of complexity and compulsion.

This new approach will support member engagement by 'nudging' members towards good products without forcing them to pick one. Members will retain the option to choose from the wider set of MySuper and choice products (or establish their own SMSF), and elevated 'outcomes tests' will help to weed out persistently underperforming products from the system (described below). In this way, choosing a super product will become much safer and simpler than it is today. Members will also still be able to join corporate or job-specific products, as long as they actively consent.

The small number of members who do not do anything — likely to be fewer than 5 per cent, by our survey evidence — should simply be allocated on a sequential basis to a product from the shortlist. Employers would no longer be tasked with selecting default products for their workers. Most do not feel equipped to do so and do not wish to continue to do so. Further,

evidence reveals that some employers fall to the temptation of inducements offered by super funds (at the expense of their employees).

The design of this model is inspired and informed by evidence from behavioural economics on how people actually behave, not how they ‘should’ behave. This evidence strongly suggests that the shortlist should be short — with no more than 10 products — and accompanied by simple and comparable metrics on each product’s features in a way that captures members’ attention. Our model is also informed by the substantial body of work of several international pension experts that supports a simple choice environment, where members who do not choose end up in good defaults, and those who do exercise choice are able to do so simply and safely.

Who compiles the list?

The shortlist should be developed by an independent expert panel in a way that makes funds vigorously compete *for* the default market. Every four years, this panel should assess applications from funds (including those already on the shortlist) on the basis of clear criteria that are focused on the fund’s likelihood of delivering strong long-term outcomes for members. Only MySuper products would be eligible for shortlisting. A high weight would be placed on investment strategy and performance, though the panel would also consider the fund’s track record on fees, governance and innovation, as well as how well its default insurance arrangements can cater to new members of all occupations.

This task would be broad in scope and the expert panel could draw on similar types of analysis to that of this inquiry (albeit with access to better data). But the specific analysis in this inquiry, and in particular the investment performance assessment, was undertaken to inform our system-level assessment of how the super system has been performing — it is distinct from the selection criteria we are proposing for the expert panel, and should not be conflated.

Each fund selected for the shortlist would be required to extend any benefits offered to new default members in the course of competing for and securing the right to act as a default fund to all its existing MySuper members. And all members who join the fund should also receive the same benefits as existing members.

Following feedback on our draft report, we have further advanced and prescriptively articulated the shortlisting criteria and principles. While some inquiry participants were concerned funds may be able to ‘game’ the process by taking excessive short-term investment risks, the panel would be able to detect this by requiring funds to share data on their investments. Other participants argued that the process could harm competition if the benefits of being on the shortlist lead to the same funds becoming entrenched on the list. This overstates the importance of default flows in the system: all funds would remain free to compete for members and build scale. The expert panel should also be explicitly required to create a competitive dynamic each time it selects funds for the shortlist.

The age-old adage that past performance is no guarantee of future performance is only true of investment markets in a narrow sense. The expert panel would have a remit to consider a much wider range of criteria than historical investment returns. The adage is also incongruent with the evidence in this inquiry that good long-term performance is associated with low fees, good governance, and sufficient scale. That is not to say that judgment will not be required — and thus an expert panel is much better placed to identify *likely* future outperformers than employers (as under current arrangements) or individual members themselves (particularly default ones).

But good judgments can only be made if free of bias. The best in show panel should be comprised of experts and be independent of — but accountable to — government. Appointed panellists should be free of direct conflicts of interest, and be seen to be so by the public. Panellists should be appointed through a robust selection process, and chosen by a selection committee comprising the heads of respected, independent government agencies (such as the Reserve Bank) and a consumer representative. To further ensure independence, the panel appointment procedures should follow those used to appoint the Parliamentary Budget Officer, whereby appointments are made by the presiding officers of the Parliament and a Parliamentary committee must approve the appointment. The panel's decisions would be subject to judicial but not merits review.

Based on our three years of endeavour, consultation and analysis on the super system, we are confident there are many suitable, expert candidates who are free of conflict and well placed to assess and determine relatively superior funds for listing.

Although the current legislated (but not implemented) default model includes a panel within the FWC, the best in show expert panel proposed here should not sit within that body. This is because widespread acceptance by the community (including members and industry) of the legitimacy of the body housing the expert panel would be desirable. Such acceptance is problematic when the FWC process has become mired in controversy. Further, the FWC is not a technocratic decision-making body — and that is what is required for a member-focused panel with widespread public credibility. In any case, the selection of best in show products should give no weight to workplace relations and industrial precedent, the FWC's core areas of expertise.

How should the shortlist be implemented?

The Australian Taxation Office (ATO) should be the lead agency in implementing the new default model. An online service should be set up so that members can easily pick from the shortlist or nominate a new super fund, whether they are new to the workforce, changing jobs, or simply wishing to engage with their super. This could build on work already underway to provide super 'standard choice' forms through myGov. The system should facilitate simple choice, easy account consolidation and universal participation by employers and employees. It should be configured in a way that gives a clear nudge to support and encourage member decision making and engagement.

In parallel, the legacy stock of existing multiple accounts in the system needs to be cleaned up. The Government has legislation before Parliament that would empower the ATO to do this by automatically consolidating inactive accounts with low balances (under \$6000) where a member already has another super account (with the balance staying with the ATO, and incurring no fees, where no other account exists). This should be enacted without delay, with the threshold for such auto-consolidation increased over time to allow more accounts to be captured.

These improvements to default arrangements would result in a small pool of members being defaulted each year — only new workforce entrants who do not make a choice. This would be much less than the number of members being defaulted each year under the current arrangements. It would represent a large reduction in ‘churn’ in the system, as members would not be re-defaulted whenever they change jobs. But funds would be competing for more than just defaulters: many more members would voluntarily choose from the shortlist (figure 13). Funds will need to compete for members, not employers — and the best funds will do well.

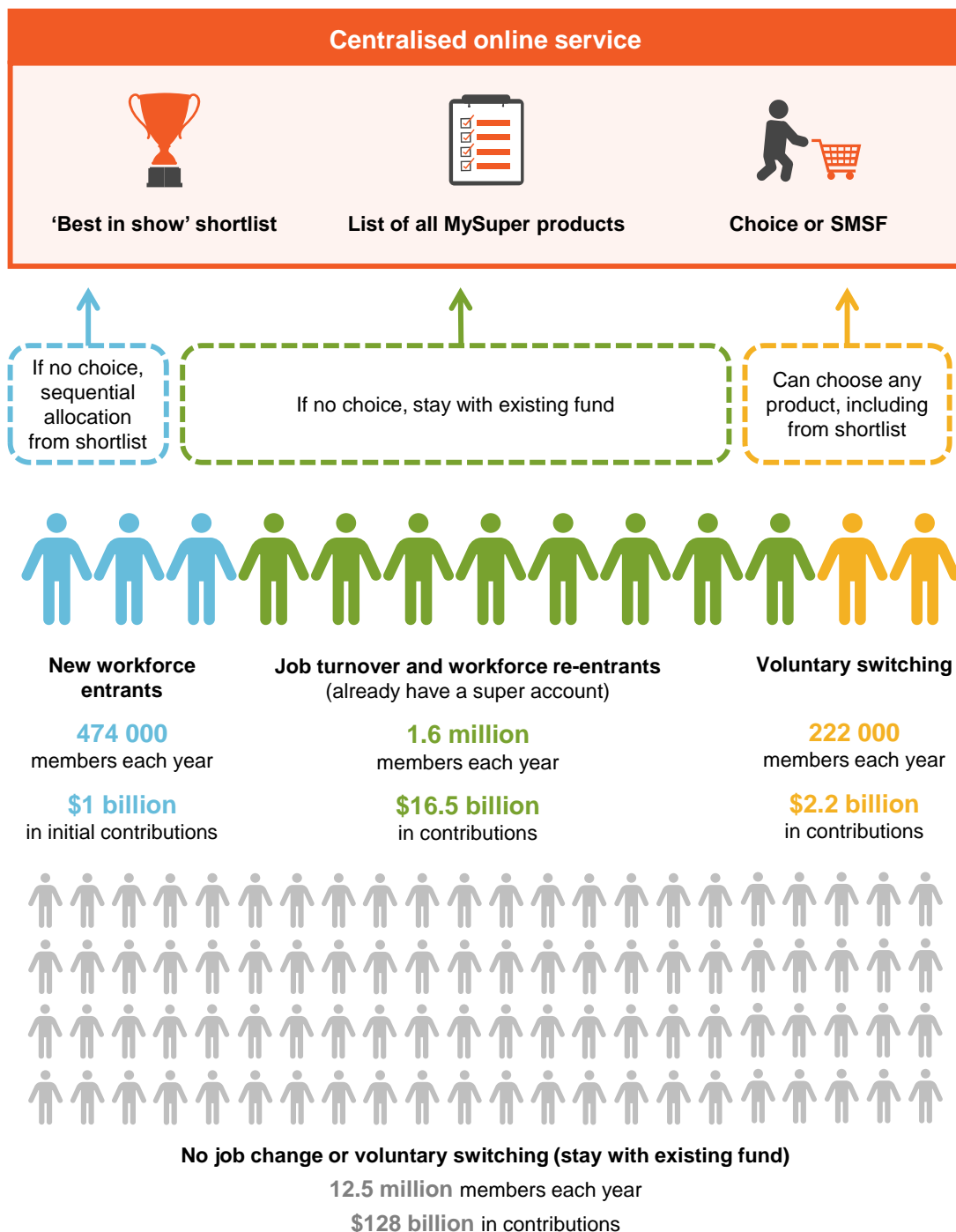
Modelling we undertook, and that was reviewed by APRA, suggests that even if many existing members chose to switch to a best in show fund, and other funds needed to exit or merge in the first few years, this should be manageable for APRA. It would induce much-needed consolidation and thus advance (not compromise) members’ interests.

How will members benefit?

A best in show process will be more than a step change from today’s system of confusing product comparisons and workplace-specific defaults. It is a ‘must have’ for making the super system work better for all members. In particular, it would bring five unique benefits that are over and above the gains that would arise from simply cleaning up the long tail of underperformers in the system, or from introducing ‘default once’ in isolation. It would:

1. support simple member choice, as well as safe choice, by making it easy for members to compare and select from a set of good products
2. stimulate competition between funds to get on the shortlist, and thus drive healthier competition to deliver for members
3. present clear ‘role models’ for other funds to emulate
4. accelerate desirable industry consolidation
5. serve as a discernible point of reference for financial advisers and their customers, and thereby strengthen the application and enforcement of financial advice laws by ASIC.

Figure 13 **Where will members go?**



New workforce entrants would be the immediate beneficiaries, as most would end up in a fund on the shortlist — one that is likely to deliver the best outcomes, with a potentially large impact on their balances at retirement. Existing members would benefit by being able to simply and safely choose a new super product, and from not being re-defaulted (and accumulating unintended multiple accounts) when they change jobs.

To illustrate this distinct benefit of best in show, conservative estimates suggest that the best in show process in and of itself could deliver a new workforce entrant an extra \$165 000 by the time they retire — nearly doubling the gain for millions of members compared to only removing persistent underperformers from the system (through the proposed elevated outcomes test discussed below).

All members would benefit from healthier competition. The new model will harness competition (and the innovation that flows from it) to deliver for members, rather than funds and providers — in other words, competition *for* the market. The competitive dynamics generated by wanting to get onto, or remain on, the shortlist will drive funds to deliver strong investment performance for their members, pass through the benefits of greater scale, and innovate to better meet their needs. The shortlisted funds will effectively serve as ‘role models’ for other funds that miss out, who will have a clear incentive to beat their competitors the next time around. In the course of doing so, existing default members in these funds will benefit just as much as prospective new members. And those funds that are not well placed to serve a broad cohort will be encouraged to better define and serve their niche cohort (or, if they cannot, to wind-up and merge).

Over time, the member-centric nature of the process would also see greater competition *in* the market, and this would be reinforced by the effects on financial advisers (discussed below). Funds will have a stronger incentive to lift their performance to retain members, including in the choice segment. While this may see some uptick in switching rates, any costs of switching would be considerably outweighed by improvements to member engagement and ultimately member outcomes. Indeed, greater member engagement does not always take the form of switching. It can simply be better member awareness — knowing which fund they are with, what their balance is, what long-term returns they are getting and whether they have insurance.

Further benefits will arise from moving to ‘default once’, in conjunction with the best in show shortlist. It will halt the generation of unintended multiple accounts that are currently causing much member harm. It will also avoid members being automatically shifted in and out of multiple funds over their working lives as they change occupations or industries, which members are increasingly likely to do in the modern workforce. And default once will avoid the additional costs to members (at least \$45 million a year) and disengagement an ‘auto-rollover’ approach would bring — a proposal put forward by some industry participants that would see members’ existing balances being automatically transferred to a new default super fund when they start a new job.

Linking defaults to the member and not the job — and thereby removing employers from the process — will also sidestep the potential conflicts of interest that go hand in hand with the current system. And it will extricate default selection from workplace relations and likely see a long-overdue increase in average scale, to the benefit of millions of members. Employers can still play a role, such as by negotiating with super funds to secure group discounts or tailored insurance for their employees, and corporate funds will remain in the

system. Members will need to actively choose these products themselves, and employers and unions would be well placed to guide them to relevant information.

Elevated outcomes tests

MySuper authorisation was intended to play an essential safety role in the super system by setting strong protections for MySuper members and requiring funds to meet a high standard of disclosure. It was meant to make products more comparable, and thus to help members to make decisions about their super and to exert competitive pressure on funds to meet their needs. At the same time, MySuper authorisation acts to reduce some of the material risks to members who want to become engaged and choose their own product.

The Government has already presented legislation to Parliament to strengthen MySuper. This entails the introduction of an annual outcomes test whereby trustees must determine whether their MySuper product is meeting the best interests of their members, and must compare their MySuper product against others in the market based on fees, returns, risk and other metrics. APRA would have increased powers to revoke the MySuper authorisation of funds that do not comply, and to require underperforming funds to transfer their MySuper members to another fund. These reforms are a clear step in the right direction and should be legislated.

But the MySuper outcomes test needs to be further elevated. Funds should be required to obtain independent verification — to an audit-level standard — of their outcomes test assessment at least every three years. They should also be required to compare their MySuper performance to a benchmark portfolio tailored to their asset allocation — as we have done to examine the super system’s performance in this inquiry. The results should be published.

Elevated outcomes testing should also be extended to the choice segment. APRA has already taken steps in this direction by setting regulatory standards for a fund-wide outcomes assessment to apply from January 2020 (which would sit above the MySuper outcomes test). These assessments should also be subject to independent verification, and supplemented by more prescriptive requirements for comparing each of a fund’s choice investment options to a tailored benchmark portfolio and publishing the results (as per the elevated MySuper outcomes test).

The investment benchmarks should serve as a clear test for the right to remain in the super system. MySuper products and choice options that persistently underperform the benchmark would fail this ‘right to remain’ test. This should be assessed over a rolling eight-year period, with a margin of 0.5 percentage points. The fund would then have 12 months to remediate (such as by cutting fees) or to withdraw the investment option and move the affected members somewhere more suitable. Where neither of these occurs, APRA should direct the fund to withdraw the investment option, or revoke the fund’s MySuper authorisation. APRA would then need to oversee the transfer of members to a superior fund, such that those members are likely to be better off in the long term (even if their exact ‘bundle of rights’ differs).

The elevated outcomes tests would also require funds to rigorously assess their fees and the member services, insurance and financial advice they provide. Trustees would need to justify to APRA that their MySuper product has an appropriate investment strategy for the member cohort, and be able to justify to ASIC that their choice investment options are appropriate for the relevant target market.

It can be expected that elevated outcomes tests would result in many funds seeking to lift their game, rationalise their products or merge with another fund. Many underperforming and grossly inappropriate products should disappear, and the benchmarking will give APRA a clear lever to make this happen. This would weed out the underperformance that infiltrates all corners of the super system (including among legacy products — which hold an estimated 3 million member accounts), thereby affording a much more targeted approach than blanket prohibitions on particular types of funds or service providers. It would also see much-needed consolidation in the super system and better outcomes for millions of members.

Elevated outcomes tests will also promote clearer accountability. As funds are vessels for members' assets, the onus should be on funds to justify why they should remain in the system. Basing this 'right to remain' on a clear and objective benchmark will make it harder for trustees to game or work around by selectively choosing their own methods of performance comparison. It would also act to both counter and deter poor conduct (that results in poor performance) and make the enforcement task easier for regulators by providing greater clarity and certainty about when regulator action can be expected — and thus will also help to hold the regulators to account.

Products and information that meet member needs

Simpler and more comparable disclosure

Making it easier for members to get engaged, compare products and make decisions is an essential prerequisite (alongside our other policy improvements) for driving healthier and safer competition in the super system, and ultimately making competition work for members rather than against them.

The spirit of product disclosure needs to be re-oriented from risk aversion to helpfulness, with regulators taking the lead to make disclosure meaningful and digestible. Clearer, simpler and more widely applied product dashboards are needed to help members compare the returns, fees and risks associated with all super products. Dashboards already exist for MySuper products and have been slated for choice products, but the process of developing these has been beset by industry resistance, missed deadlines and an attempt by the Government to exempt some products from the rules.

Perfection should not be a barrier to the possible, nor an excuse for perpetual delay. Legislation to narrow the scope of dashboards should not be pursued, and ASIC should prioritise full compliance for *all* super products by the end of 2019 — with exceptions only granted on a truly exceptional basis. ASIC should seek to revise the content and format of

dashboards to simplify them and provide more easily comprehensible metrics. In doing so, it should consult with independent experts and consumer organisations. Behavioural economics research points to the importance of ‘less is more’ in funds competing for the meaningful attention of members.

To make dashboards even more useful, ASIC should make them available on a single website. They should also be accessible via the new centralised online service for the best in show shortlist. Members should be prompted to compare their current product with those on the shortlist to see how their product is performing and, if desired, to easily switch.

Better advice

Not all members will need financial advice. But more can be done to help those who do to access advice that is impartial, affordable and meets their needs. A significant body of evidence has emerged through the Royal Commission and work by ASIC that conflicted and unsuitable advice pervades the super system. This must be fixed.

The best in show shortlist will help by serving as a discernible (and unavoidable) point of reference. It will help advisers (in recommending products), their customers (in putting pressure on advisers to explain why any product advice diverges from the list), and also the regulators (in enforcing financial advice laws).

Stronger regulatory oversight of financial advice is overdue. Advisers should be required to disclose which products are on their approved product lists, as we recommended in our parallel inquiry on *Competition in the Australian Financial System*. Steps are in train to lift the qualification requirements of financial advisers, and this should be extended to require specialist training for those advising on SMSFs. And when a member is being advised to set up an SMSF, the adviser should be required to give them a document that clearly explains key issues they need to consider (‘red flags’) in deciding whether an SMSF is right for them. A minimum balance is too blunt an instrument, but advisers should be prepared to justify to ASIC why they are recommending any SMSF be established with a balance remaining under \$500 000 beyond the initial establishment years.

Conflicts of interest in the provision of financial advice would also be reduced by banning trailing commissions and lifting the quality of products across the board via elevated outcomes tests, which would remove the risk of members switching to persistently underperforming products.

More broadly, a clearer distinction is needed between financial advice (that takes account of a member’s individual circumstances) and information (that can help them to make their own decisions). All advice in relation to super is arguably personal, and the term ‘advice’ should not be used where members are only being provided with product information or marketing material (which we also recommended in our parallel inquiry).

Impartial advice will be especially important for many members in the retirement phase, where diverse needs, preferences and non-super assets mean one size can never fit all. There are real risks in nudging many members into risk-pooled products that may not suit their needs and are costly to get out of. Trustees do not always want to offer these products, and forcing them to do so may conflict with their obligations to act in members' best interests. The Government should thus reassess the benefits and costs of its proposed Retirement Income Covenant, and abandon it if the flaws cannot be sufficiently remediated (by the now deferred date of 1 July 2022).

In conjunction with this reassessment, the Government should also consider extending the existing Financial Information Service (provided by the Department of Human Services) to offer members at or near retirement impartial information to help them navigate complex retirement income decisions and, where relevant, seek out impartial financial advice. In time, digital ('robo') technology could potentially be incorporated. In the meantime, the Government should prompt pre-retirees (when they reach age 55) to online information to help them make decisions about their retirement.

Smarter use of data

There is much scope for super funds to better harness data and technology to provide advice (including digital advice) and to design super and insurance products. This includes collecting and analysing more data about their members, as well as drawing on cost-effective imputed data that are not fund specific. In particular, there are good prospects for further personalising life-cycle and retirement products to better match them to diverse member needs. To accelerate progress, the Government should roll out the new Consumer Data Right to super, and automatically accredit super funds to be eligible to receive information that banks hold on members (with their consent).

Fees charged on a cost-recovery basis

Evidence abounds of excessive and unwarranted fees in the super system — a particular focus of evidence to the Royal Commission. Because super funds are legally obliged to act in members' best interests, the fees they charge should not exceed cost recovery levels. The Government should enforce this across all MySuper and choice products, and prohibit funds from cross-subsidising between members — which would see an end to excessive fees (such as some percentage-based administration fees) while also ruling out scope for some members to bear the cost of other members' decisions.

The Government should also, as soon as practicable, ban trailing commissions. These commissions remain in the system despite being grandfathered over five years ago as a transitional arrangement. The time for transition is over.

Insurance that works for members

Much can be done to improve the value that members get from insurance in super. For young members in particular, stopping the creation of unintended super accounts will avoid excessive erosion of balances due to multiple insurance policies. But this is not enough. Insurance should be made opt in for members aged under 25 (rather than opt out, as is currently the case). Many young members work in casual or part-time jobs, and have relatively low financial commitments and/or no dependants to support, meaning life insurance is simply not of value to them. While a small minority of under-25s might benefit from opt-out insurance, exemptions should only be granted to funds that can convincingly demonstrate to APRA that this exception should apply for specific cohorts of their members.

Another area for improvement is making sure that insurance cover ceases on accounts that have had no contributions for the past 13 months, unless the member explicitly informs the fund that they wish to retain their cover. This would help to remove some unintended multiple policies and thus also reduce the risk of members holding ‘zombie’ insurance policies they are unable to claim on.

The Government is in the process of legislating changes along these lines, together with making insurance opt in for accounts with balances less than \$6000. This legislation should be passed without delay.

More broadly, super fund trustees need to more clearly explain the trade-offs they are making when entering and designing group insurance arrangements. Trustees should immediately be required to articulate and quantify the balance erosion trade-off they have made for their members and make it available on their website, along with a simple calculator that members can use to estimate how insurance premiums would affect their balances at retirement. In addition, funds seeking inclusion on the best in show shortlist should articulate this trade-off for prospective members, and demonstrate how their default cover could cater to new members of all occupations.

Finally, the voluntary code of practice for insurance in super needs to be bolstered and turned into a binding and enforceable set of rules with broad industry adoption. ASIC and APRA should work together to monitor and report on adoption and implementation of the code, and to direct the industry to strengthen the code’s provisions such that it meets ASIC’s definition of an enforceable code of conduct. Standardising key definitions and provisions is a priority, but this cannot be left to the industry alone. The industry should be given a hard two-year deadline to make the bolstered code binding and enforceable on all signatories, at which point adoption of the code should become a licence condition for all funds that offer insurance.

This inquiry has not asked the broader question of whether insurance *should* be funded through super. That question should be answered by an independent public inquiry into insurance in super, which should commence within four years from the completion of this current inquiry report. This inquiry should also evaluate the effectiveness of policy initiatives to date, examine the intersection of insurance in super with other schemes (such as worker’s

compensation), and consider whether opt-out insurance through super is the most efficient and equitable way to provide assistance to people in the event of illness and injury.

Best practice fund governance

Members' outcomes — more than process or intent — must be the key focus of governance arrangements and trustee endeavour. The interests of the fund and the member are not interchangeable concepts. Super funds exist solely as a vessel for members' assets. What is in the best interests of the fund need not automatically be in the best interests of the member.

We are recommending a set of amendments to governance rules to lift the performance of boards and make trustees more accountable to their members. Trustees of all super funds should be required to have, use and disclose a process to assess their board's performance relative to its objectives and to assess the performance of individual directors (at least annually). Boards should be required to maintain a skills matrix that identifies the skills and experience of each trustee director (and publish a consolidated summary each year), such that new appointments can be selected on the basis of filling identified gaps in expertise. At least every three years, an external third party should be engaged to evaluate the board's performance and capability against the skills matrix, with a copy to be provided to APRA. This would better align super funds' governance with best practice for companies listed on the stock exchange.

Best practice also means that all new board appointees have a professional understanding of the super system and investment decision making, gained either through industry experience or formal training. This should be a regulatory requirement.

A focus on skills would likely lead to more independent directors as boards recruit from a wider 'gene pool'. Tightening the definition of 'independence', as the Government has proposed, will help by putting a stronger focus on recruiting genuinely independent directors. But the debate over mandating independent directors has become highly polarised. Arguing only about the number of independent directors on a board loses sight of what matters: getting the right mix of knowledge, skills and experience, and managing conflicts of interest.

Stronger disclosure is needed to shine a light on conflicts of interest and put pressure on trustees to first avoid conflicts and then better manage (unavoidable) residual conflicts. APRA should require funds to conduct formal due diligence of their outsourcing arrangements at least every three years, with a copy of the assessment to be provided to APRA. Funds should also publicly disclose to current and prospective members the proportion of their costs paid to related-party service providers.

Further rigour is also needed in the contracts that trustees sign with outsourced providers. APRA should require trustees to include in all material service contracts a clause that obliges the service provider not to do or take any action that adversely affects members' interests. Good trustees should already be doing this, along with monitoring contract performance. But

the Royal Commission has revealed evidence that some have taken a very lax approach towards oversight of their outsourcing arrangements.

The regulators can do more to facilitate mergers between underperforming or subscale funds. Trustees on both sides of a merger attempt should be required to disclose all attempts that reach the memorandum of understanding stage to APRA, as well as the reasons why a failed merger did not proceed and the assessment of members' best interests that informed the decision. This would assist APRA in facilitating or compelling mergers as it applies the elevated outcomes tests (discussed above). APRA should also be empowered to prevent mergers that are not in members' best interests. At the same time, ASIC should proactively investigate questionable cases where mergers between super funds stalled or did not proceed, and the Government should ensure ASIC has the powers it needs to pursue action against directors in the event of failed mergers that should have proceeded. This would dovetail with a greater focus on strategic conduct regulation (discussed below).

More generally, it has become evident that funds do not always act in the best interests of their members. It would appear that this reflects not only trustee misconduct but a lack of clarity around what is expected of trustees under the best interests duty in legislation — as has become apparent in the evidence emerging through the Royal Commission. The best interests duty should really be about achieving what an informed member might reasonably expect. More clarity could be achieved by re-articulating the definition in legislation, by providing clearer guidance in regulation, and/or by regulators confidently pursuing 'test cases' through the courts. The Government should consider these options in light of the outcomes of the Royal Commission.

Regulators that are member champions

Confident regulators that champion the member are essential in a compulsory super system. Regulatory arrangements need to support this. A clearer articulation of the roles of APRA and ASIC is needed to more closely align these roles with each agency's 'regulatory DNA'.

APRA is best placed to focus on licensing and authorisation to promote high standards of system and fund performance. The elevated outcomes tests should be central to its regulatory approach, by helping to detect poor performance — whether caused by a failing of competence, conduct or a combination of both — and thus informing how APRA prioritises its supervisory effort. The Government should provide APRA with a more explicit 'member outcomes' mandate to replace its traditional (and here misplaced) prudential mandate, and clarify that 'outcomes' should be synonymous with actual member outcomes, not adherence with processes. APRA will also need an exponential uptick in dedicated expertise and resources to deliver on what is expected of it. An independent and expert capability review of APRA is now overdue. Recently announced and completed reviews are no substitute.

ASIC is best placed to regulate the (mis)conduct of trustees and advisers, and to oversee the appropriateness of products (including to particular target markets) and disclosure. In principle, it should be the primary strategic conduct regulator for the super system. This

entails both the detection and deterrence of misconduct. ASIC will need to work closely with APRA to share data and identify areas for closer scrutiny (with the elevated outcomes tests thus also assisting ASIC). They will also need to coordinate enforcement action. ASIC is well suited to undertaking *public* enforcement activities that provide a strong deterrent effect to all trustees.

We are mindful that these matters are subject to consideration by the Royal Commission. Ultimately, and with the benefit of this report and that of the Royal Commission, the Government should clarify the precise allocation of roles between APRA and ASIC. At the same time, it should comprehensively examine whether APRA and ASIC need stronger powers and whether penalty provisions should be strengthened, especially in relation to trustee misconduct.

In any case, it is clear that many of the accountability mechanisms for regulators that already exist — such as ministerial and Parliamentary oversight, performance reporting, and Statements of Expectation and Intent — have been left largely dormant or at best underutilised by Government. The Government needs to set much clearer expectations of APRA and ASIC and proactively hold them to account for the outcomes they deliver. This should include requiring them to jointly publish a *State of Superannuation* report every two years to report on member outcomes in the super system and progress in identifying, stemming and remediating member harm.

The regulators also need to confidently and systematically collect more data relevant to assessing member outcomes, make these data public, and analyse the data to inform and prioritise their regulatory activities. There should be a prioritised and ongoing endeavour by APRA, ASIC, the ATO, the Australian Bureau of Statistics and the Commonwealth Treasury to improve data collection and analysis across the whole super system, with a strong focus on collecting and publishing consistent data. As part of this, APRA should collect more data on actual member outcomes on an ongoing basis (including product-level reporting), tackle inconsistencies and misreporting by funds head on, and work more closely with ASIC to advance data analytics. It cannot be overstated how fundamental data analytics are to strategic and effective conduct regulation of the super system. The data gathered (and the analysis) in this inquiry are a good starting point. Better data would also make it easier for the Government to hold the regulators to account (including through their *State of Superannuation* report), and to fulsomely evaluate policy interventions over the long term.

Regulators should not be left to champion member interests on their own. They will always struggle in a system where debate is dominated by the interests of funds and their service providers rather than the interests of members. To balance this, the Government should provide ongoing funding for a new organisation to understand, promote and give voice to member interests — and to provide assistance to members themselves.

Implementation

Implementing the package of recommendations in this report will modernise the super system, harness healthy competition and make the system work better for all Australians into the future (table 1). These recommendations also offer enduring policy solutions to the sorts of poor conduct that have occurred under current policy settings. But the industry and its structure will need to change.

We have designed a transition timetable that will allow for a considered implementation that reduces disruption to members, and is manageable for the regulators to oversee and for industry to digest (figure 14). The transition should be achievable within three years following the passage of legislation. The first stage is to remove underperforming funds and products from the system (by phasing in the elevated outcomes tests). Once the risk of new members being defaulted into underperforming funds has been removed, employee choice (guided by the best in show list) and default once can be introduced. This will also allow time for an expert panel to be appointed, a shortlist to be developed and the requisite online systems to be set up and tested.

These policy changes are of significant import to future national wellbeing. Their timely and effective implementation should be overseen by a Steering Group comprising the Secretary of the Department of the Prime Minister and Cabinet, Secretary to the Treasury, Chairs of APRA and ASIC, and the Commissioner of Taxation.

Beyond the specific recommendations in this inquiry, further changes in enforcement practices or new regulation in some areas may also prove to be warranted, pending the final findings and recommendations of the Royal Commission. Any such changes will need to be incorporated into the implementation strategy.

This is not the first inquiry on the super system, and will not be the last. Nor should it be. In a compulsory system, it is incumbent on the Government and regulators to ensure ongoing accountability and review. This is essential for the super system to remain fit for the future and deliver the best possible outcomes for members in retirement.

Table 1 Modernising the super system to work better for all members

<i>Causes</i>	<i>Recommendation(s) (numbers)</i>	<i>How members will benefit</i>
Problem: Balances are eroded by fees and insurance		
Default allocation directly results in unintended multiple accounts	Members default once and retain existing account for new jobs (1) ATO to clean up stock of low-balance inactive accounts (5)	In time, all members will pay a single set of fees and insurance premiums (unless they choose otherwise)
Excessive fees and trailing commissions	Require all fees (including exit fees) to be cost recovery and ban trailing commissions (14)	Less undue balance erosion Greater member switching to better products
Problem: Persistently underperforming funds and products		
Poor performing funds and products remain in the system	Elevated outcomes tests (4) Remove impediments to mergers (20, 21)	Members get better returns as funds lift their performance, transfer members to a better fund, or merge
Problem: Poor investment performance for some default members		
Lack of simple and safe choice	A single best in show shortlist of products (2, 3) Centralised online service (1)	Easier for members to engage by choosing their own product, and to compare products and switch
Default allocation means some members are not defaulted into high-performing funds	A competitive and independent process to select 'best in show' products (3) Replace employer selection of defaults with sequential allocation from best in show shortlist (2)	Better net returns for members of funds that currently underperform Members only default once and to a high-performing product designed to meet the needs of default members Employers no longer pick defaults
Poor performing funds are retaining their MySuper authorisation	Elevated outcomes tests (4)	Members get better returns as funds lift their performance, transfer members to a better fund, or merge Safer choice for members
Economies of scale are not fully realised	Elevated outcomes tests (4) Remove impediments to mergers (20, 21)	Better net returns for members of currently underperforming funds
Problem: Poor outcomes in the choice segment		
Lack of quality, accessible and comparable information on products	Simple and comparable dashboards for all products (6), with comparisons to a member's current product and best in show shortlist (7) More meaningful product disclosure (24) Consumer data right for super (13)	Easier for members to compare options and switch products, and to benchmark the quality of financial advice Safer choice for members
Proliferation of complex and high-fee products in the choice segment	Elevated outcomes tests (4) Require all fees (including exit fees) to be cost recovery (14) APRA review of legacy products (23) Best in show shortlist (2, 3)	Closure of poor performing products (including legacy products) Easier for members and their advisers to evaluate available products and compare to current product
Limited data on products and member outcomes	Dashboards for all products (6) Publish product-level data (23) Improve data collection and release, with focus on member outcomes (27)	High and low performing funds are clearly identifiable to members Accountability to members that the system is performing in their interests

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Table 1 (continued)

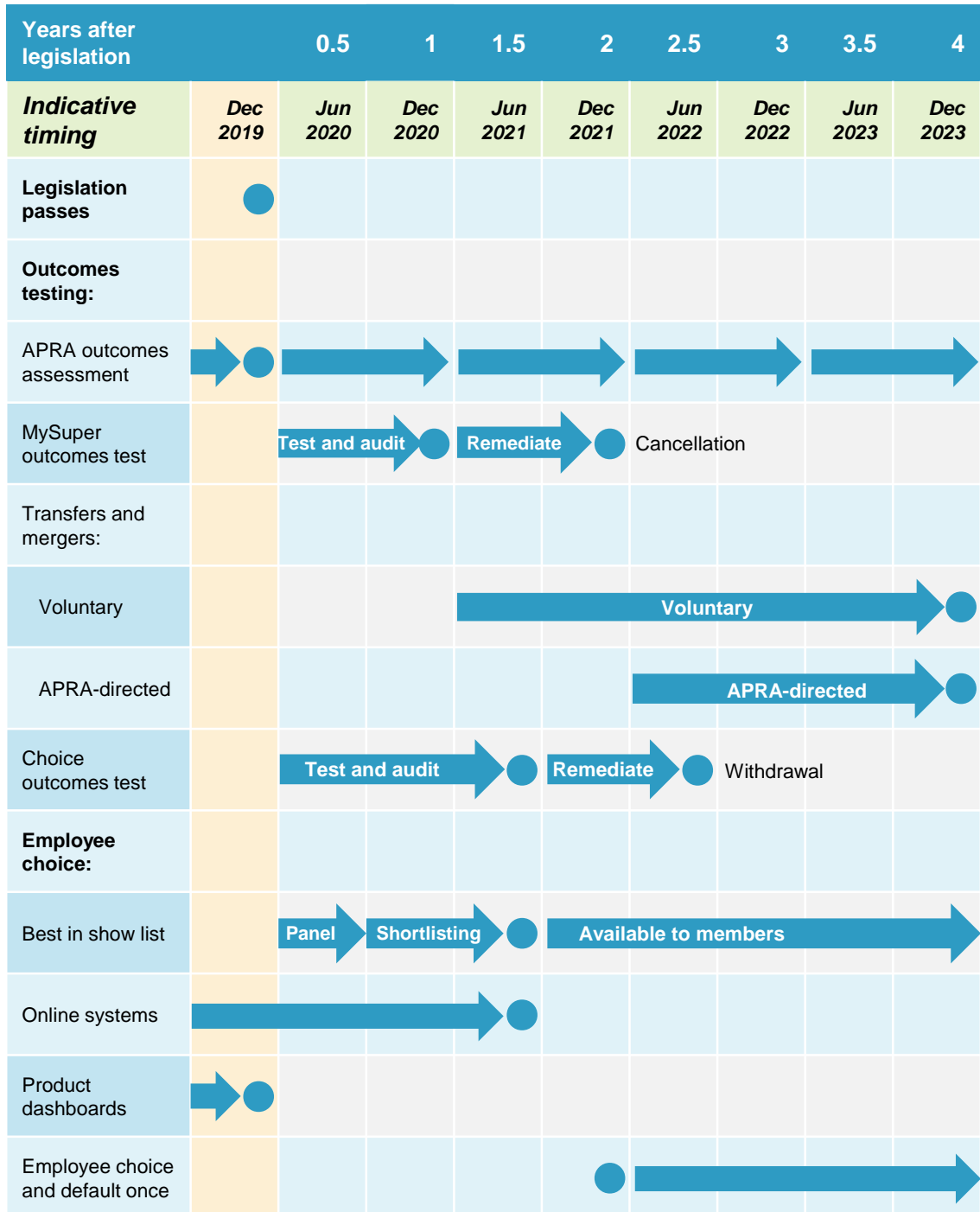
<i>Causes</i>	<i>Recommendation(s) (numbers)</i>	<i>How members will benefit</i>
Problem: Members do not always end up in the right products		
Funds do not make full use of data in designing products (including life-cycle products and insurance)	Improve data collection and release (27) Consumer data right for super (13) Elevated outcomes tests (4)	Stronger competitive dynamic to push funds to design better products Investment strategies and product features are better tailored to member needs
Members struggle to find the right retirement products	Guide pre-retirees to online information (11) Consider funding information sessions for retirees (10) Delay Retirement Income Covenant (10) Independent member advocacy body (28)	Easier to access impartial information to make decisions Members approaching retirement are more aware of their options
Problem: Member engagement is often low		
Products are complex and hard to compare	Simple and comparable dashboards for all products (6), with comparisons to a member's current product and best in show shortlist (7)	Easier for members to compare options and switch products, and to benchmark the quality of financial advice
Low levels of financial literacy	Evaluate financial literacy programs to target funding to those that work (9)	Greater levels of financial literacy
Many members do not know where to get help	Independent member advocacy body (28) Guide pre-retirees to online information (11) Consider funding information sessions for retirees (10)	Independent information and assistance easier to access Members approaching retirement are more aware of their options
Problem: Financial advice is expensive or conflicted		
Members struggle to gauge the quality of advice they receive	Best in show shortlist (2, 3) A 'red flags' document for members advised to establish an SMSF (12)	Easier for members to question the advice they receive and benchmark its quality
Weak enforcement of financial advice laws	Disclosure of approved product lists (8) Stronger safeguards on SMSF advice (12) Best in show shortlist (2, 3) Greater conduct regulation role for ASIC (24, 25)	Greater transparency of adviser behaviour to members and regulators, allowing for stronger enforcement of advice laws Less scope for conflicted advice
Confusion of what constitutes advice	Ensure the term 'advice' can only be used where personal advice is given (8)	Less scope for members to be misled or for entities to circumvent advice laws
Problem: Insurance is not delivering value for money for all members		
Unsuitable insurance, including default insurance members cannot claim on	Opt-in insurance for young and inactive members (15) Clearer articulation of balance erosion trade-offs (16)	Removal of unsuitable insurance policies and, over time, greater value for members
Inconsistent standards and poor practices across industry	Strengthen and enforce insurance code (17) Inquiry into insurance in super (18)	Removal of unsuitable insurance policies and, over time, greater value for members

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Table 1 (continued)

<i>Causes</i>	<i>Recommendation(s) (numbers)</i>	<i>How members will benefit</i>
Problem: Poor conduct by fund trustees		
Poorly managed conflicts of interest	Stronger contract terms with outsourced providers, formal due diligence by funds (23), and greater disclosure of outsourcing costs to members (24) Stronger definition of independent director (19) Elevated outcomes tests (4)	Lower fees and/or higher net returns Conflicts of interest are more transparent Products with poor performance due to related party conflicts are improved or withdrawn
Some trustee boards lack sufficient skills, expertise or independence	Lift standards for boards, including independent skills assessments (19)	More capable boards that ultimately deliver higher net returns and products that better meet member needs
Self-interest appears to stymie mergers	Elevated outcomes tests (4) Greater disclosure of merger activity (20) APRA reporting on merger activity (23) ASIC investigation of stalled mergers (24)	Underperforming funds exit the system or merge Trustees are deterred from stymieing beneficial mergers
Varying interpretations of best interests duty	Clarify definition of best interests duty (22)	Stronger trustee focus on delivering outcomes that benefit members
Lack of strategic conduct regulation	See below	
Problem: Absence of strategic conduct regulation		
Unclear regulator roles and powers, especially for conduct regulation	Clarify regulator roles and powers (25) Capability review of APRA (26)	Confident regulators actively deter misconduct and promote member outcomes
Inadequate data	Publish product-level data (23) and develop more consistent, member-relevant data across system (27)	Accountability to members that the system is performing in their interests Regulators better able to monitor conduct and outcomes
Strong member voice is lacking	Independent member advocacy body (28)	Greater championing of member interests in policy debates and regulation development
Insufficient regulator accountability	Regulator reporting on activities and outcomes to government and the public (29) Clarify regulator roles and powers (25) Elevated outcomes tests (4)	Accountability to members that the system is performing in their interests Easier to hold regulators to account for delivering what is expected of them

Figure 14 Implementation: a transition road map



Findings and recommendations

Investment performance

FINDING 2.1

The Commission's funds survey suggests that superannuation funds on average outperformed a market index benchmark in most individual asset classes over the 10 years to 2017. Not-for-profit funds outperformed retail funds on average within most major asset classes over this period.

However, these survey results are positively biased due to missing data for funds that have exited the system (survivor bias) and that did not provide the requested data (selection bias).

While international comparisons add further data issues, compared with large pension funds in other developed countries, Australian superannuation funds appear to have achieved comparable returns on individual asset classes.

FINDING 2.2

APRA-regulated funds have delivered investment returns to members over the past 21 years (net of all fees and taxes) of 5.9 per cent a year, on average. The majority of members and assets in the system are in products that have performed reasonably well. But there is significant variation in performance within and across segments of the system that is not fully explained by differences in asset allocation.

Not-for-profit funds, as a group, have systematically outperformed retail funds. This outperformance cannot be fully explained by asset allocation, tax or expenses. Much of it is likely due to differences in asset selection (within asset classes) between the segments.

FINDING 2.3

There is wide variation in performance at the fund level. About 5 million member accounts and \$270 billion in assets are in 29 funds that underperformed conservative benchmarks tailored to each fund's own asset allocation over the 13 years to 2017. About 77 per cent of member accounts and 72 per cent of assets in underperforming funds were in retail funds, even though retail funds represented just 9 of the underperforming funds. Of the other underperforming funds, 14 are industry funds, 3 are corporate funds and 3 are public sector funds.

While asset allocation is the largest determinant of returns at the fund level, most of the variation across funds cannot be explained by asset allocation, tax or expenses. Rather, it is most likely primarily due to differences in asset selection (within asset classes) between funds.

FINDING 2.4

There is wide variation in performance in the default segment. About 1.6 million member accounts and \$57 billion in assets are in MySuper products that underperformed conservative benchmarks tailored to each product's own asset allocation over the 11 years to 2018. This suggests that many members are currently being defaulted into underperforming products and could be doing better.

If all members in bottom-quartile MySuper products received the median return from a top-quartile MySuper product, they would collectively be \$1.2 billion a year better off. Being in the median bottom-quartile product means that, on retirement, a typical worker (starting work today) is projected to have a balance 45 per cent lower (or \$502 000 less to retire with).

FINDING 2.5

There is wide variation in performance in the choice segment that is not fully explained by differences in asset allocation. Almost \$25 billion in assets are in investment options that underperformed conservative benchmarks over the 13 years to 2017. Many choice members could be doing a lot better.

FINDING 2.6

The SMSF segment has delivered broadly comparable investment performance to the APRA-regulated segment, but many smaller SMSFs (those with balances under \$500 000) have delivered materially lower returns on average than larger SMSFs.

Fees and costs

FINDING 3.1

Superannuation fees in Australia are higher than those observed in other OECD countries. This may be partly because Australian funds face higher expenses. While international comparisons are not straightforward, there is evidence (by asset class) that Australian investment management costs are generally high by international standards, including for significant asset classes (such as equities and international fixed income).

FINDING 3.2

In aggregate, total fees in APRA-regulated funds (for administration and investment management services) have been trending down as a proportion of assets over the past decade, from 1.3 per cent in 2008 to 1.1 per cent in 2017.

FINDING 3.3

Fees have fallen for retail funds, albeit remaining higher (for choice products) than the (largely unchanged) fees for industry funds.

Among APRA-regulated funds, the MySuper and SuperStream reforms have likely acted to reduce fees (including some possible competitive spillover to choice products), although this is difficult to attribute directly given the impact of other fee drivers.

FINDING 3.4

While financial advice can benefit members, excessive advice fees in choice products and all trailing commissions erode member balances. Ten retail funds collected about \$1.4 billion of advice fee revenue in 2017, charging their members about \$341 per account in that year alone. Separately, members of 11 retail funds identified in data from the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* are estimated to have paid in excess of \$400 million in (grandfathered) trailing adviser commissions in 2017.

In contrast, advice fees are closely regulated in MySuper products (with funds only permitted to recoup the cost of intrafund advice from fee revenue), thereby protecting members from undue balance erosion. The disparate regulation of fees and costs in the choice and MySuper segments is in part contributing to poor member outcomes in the choice segment.

FINDING 3.5

There is a 'tail' of choice products with high fees (exceeding 1.5 per cent of balances), offered by retail funds. This tail accounted for about 17 per cent of assets and 15 per cent of member accounts in APRA-regulated funds in 2017. Retail legacy products account for almost half of all products in the high-fee tail.

The share of member accounts in the high-fee tail has been declining over time, particularly since 2013 and the introduction of MySuper, but today still accounts for an estimated 4 million member accounts holding \$275 billion in assets. Further declines are likely to hinge on the effectiveness of regulator efforts to shift members out of retail legacy products.

FINDING 3.6

Despite regulator awareness, there remain significant gaps and inconsistencies in how funds report data on fees and costs. Funds that misreport or underreport fees and costs appear, at times, to have gone unpunished. This harms members by making fee comparability and decision making difficult at best, and thus renders fee-based competition largely elusive.

FINDING 3.7

Higher fees are clearly associated with lower net returns over the long term. The material amount of member assets in high-fee funds, coupled with persistence in fee levels through time, suggests there is significant potential to lift retirement balances overall by members moving, or being allocated, to a lower-fee and better-performing fund.

Fees have a significant impact on retirement balances. For example, an increase of just 0.5 per cent a year in fees would reduce the retirement balance of a typical worker (starting work today) by a projected 12 per cent (or \$100 000).

FINDING 3.8

Reported costs for SMSFs (relative to assets) have increased over recent years and, for those with over \$1 million in assets, are broadly comparable with APRA-regulated funds. By contrast, costs for SMSFs under \$500 000 in size are particularly high, on average, and significantly more so than for APRA-regulated funds.

About 42 per cent of all SMSFs (some 200 000 in 2016, with an estimated 380 000 members) have been under \$500 000 in size for at least two years, and appear to persist with high average cost ratios and low average returns. Nevertheless, the proportion of new SMSFs with very low balances (under \$100 000) has fallen from 35 per cent of new establishments in 2010 to 23 per cent in 2016.

Members' needs

FINDING 4.1

Qualitative judgments by members of superannuation funds suggest that a small share are dissatisfied with the overall performance of their fund. Members who have a poor understanding of the system and less capacity for accurately gauging the performance of their funds tend to report being much less satisfied. Many more members indicate that the performance of funds, including their service quality, has improved over time than those who feel that performance has flagged.

A sizable minority of members selecting a retirement product express equivocal or negative views about the degree to which funds meet their specific product needs.

FINDING 4.2

Many members find it hard to make comparisons between the large numbers of superannuation products available. The proliferation of tens of thousands of investment options in the choice segment complicates decision making and increases member fees, without boosting net returns.

A low-fee product that, over a person's working life, exposes them to a mix of defensive and growth assets is likely to meet the needs of most Australians during the accumulation phase. A better-designed and modernised default allocation mechanism could act as a trusted benchmark for better member decision making across the entire system.

FINDING 4.3

Well-designed life-cycle products can produce benefits greater than or equivalent to single-strategy balanced products, while better addressing sequencing risk for members. There are also good prospects for further personalisation of life-cycle products that will better match them to diverse member needs, which would require funds to collect and use more information on their members.

Some current MySuper life-cycle products shift members into lower-risk assets too early in their working lives, which will not be in the interests of most members.

FINDING 4.4

In the retirement phase, risk-pooled lifetime income products may meet some members' preferences for a predictable income stream and for managing longevity risk. However, the proposed Retirement Income Covenant may nudge many others into products ill-suited to their long-term needs, may not achieve its desired goal of increasing retirement consumption, and fails to take sufficient account of the diversity in household preferences, incomes and other assets.

The requirement that all funds must offer a 'flagship' risk-pooled product would oblige any fund without a capacity to create such a product to purchase it from a third party — where there are few choices currently on the market. The requirement for a standardised risk-pooled product may conflict with trustees' obligations to act in members' best interests, and many funds do not want to offer them. Their complexity, limited scope for reversibility and major deficiencies in the credibility, independence and affordability of financial advice for retirement products leaves significant scope for member detriment arising from the requirement to supply risk-pooled products.

FINDING 4.5

Superannuation funds make insufficient use of their own (or imputed) data to develop and price products (including insurance). This is particularly problematic for designing products for the retirement and transition to retirement stages, because this is when different strategies can have the biggest payoffs for members.

Member engagement

FINDING 5.1

Across a range of indicators, member engagement remains low on average, though it is not realistic or desirable for members to be engaged all the time. Engagement tends to be higher among those approaching retirement, those with higher balances and owners of SMSFs. Engagement is lowest for the young and those with relatively low balances.

While many Australians have good broad knowledge of the superannuation system, many lack the detailed understanding necessary for effective decision making. Low financial literacy is observed among a sizable minority (about 30 per cent) of members.

FINDING 5.2

Demand-side pressure in the superannuation system is weak.

- Most members in the accumulation phase let the default segment make decisions for them, at least when they enter the workforce.
- A significant minority of members (an estimated 1 million) are barred from exercising choice even if they wanted to.
- Fund and investment switching rates are modest, suggesting that active members (or their intermediaries) have not exerted material competitive pressure on funds.

Proposed legislative changes to prohibit restrictive clauses in workplace agreements on members' choice of fund are much needed.

FINDING 5.3

While there is no shortage of information available to members, it is often overwhelming and complex. Dashboards should be a prime mechanism to allow for product comparison and need to be salient, simple and accessible to be effective — but most are not, and regulators have left this unresolved.

FINDING 5.4

The quality of financial advice provided to some members — including those with SMSFs — is questionable, and often conflicted.

The need for information and affordable, credible and impartial financial advice for retirees will increase as retirement balances grow with a maturing system, and given the rising diversity and complexity of retirement products.

Erosion of member balances

FINDING 6.1

Several proposed policy changes will promote Superannuation Guarantee payment compliance.

- Single Touch Payroll being extended to small employers (with less than 20 employees) from 1 July 2019.
 - Funds being required to report contributions to the ATO at least monthly.
 - The ATO having stronger powers to penalise non-compliant employers and recover unpaid contributions.
-

FINDING 6.2

The superannuation system, primarily due to its policy settings, does not minimise the unnecessary and undesirable erosion of member balances. This erosion is substantial in size and regressive in impact.

- Structural flaws have led to the absurdity of unintended multiple accounts in a system anchored to the job or the employer, not the member. These unintended multiple accounts (one in three of all accounts) are directly costing members nearly \$1.9 billion a year in excess insurance premiums and \$690 million in excess administration fees. For an individual member holding just one unintended multiple account throughout their working life, the projected reduction in their balance at retirement is 6 per cent (or \$51 000).
- Superannuation Guarantee non compliance is hard to estimate, but may be costing members about \$2.8 billion a year.

Recent policy initiatives have improved the situation, but current policy settings are inevitably making slow progress by treating the symptoms and not the structural cause.

Market structure, contestability and behaviour

FINDING 7.1

The market structure of the superannuation system (as distinct from its policy and regulatory settings) is conducive to rivalry. At the retail level, there are many funds and products. At the wholesale level, there is concentration in some service provider markets for outsourcing (like administration). However, a growing ability for larger funds in particular to insource all, or parts, of their service requirements adds to competitive pressure.

While concentration is low in the investment management market, evidence suggests that managers have some market power. As a consequence, smaller funds, in particular, pay higher fees than would be the case if competition was more robust.

FINDING 7.2

Fund-level regulation creates a significant cost of entry and some structural features of the system are likely to create challenges for new entrants (including gaining scale by attracting members). However, these are not prohibitive or even high barriers to entry. Nor does the strategic use of integrated business models to gain members stifle contestability in the choice segment.

In the default segment, regulatory settings limit access to the market (including difficulty being listed in a modern award), competition *for* the market is absent, and competition *in* the market is muted.

FINDING 7.3

There is a high propensity for funds in the system (particularly retail funds) to report using associated (or related) service providers — a form of vertical integration. Use of related parties is associated with higher costs, and weaknesses in contract review processes suggest some funds are outsourcing to related parties ahead of more efficient (but unrelated) service providers — constraining contestability and likely at the expense of member outcomes.

FINDING 7.4

Evidence of economies of scale is compelling — larger fund size is strongly associated with lower average costs in the Australian superannuation system.

Significant economies of scale have been realised over the past 13 years, particularly on the administration side. Holding constant other cost drivers, ‘marginal’ (or incremental) gains in system savings (accruing from increases in scale in any year) totalled an estimated \$4.5 billion between 2004 and 2017. Data limitations rule out estimation of realised ‘cumulative’ savings (scale benefits that persist beyond the year in which gains are first realised), but no doubt they have also been material.

Significant unrealised economies of scale remain. For example, annual cost savings of at least \$1.8 billion could be realised if the 50 highest-cost funds merged with the 10 lowest-cost funds. And a 0.01 percentage point reduction in administration expense ratios for funds with more than \$10 billion in assets could result in annual savings of about \$130 million. The presence of these potential gains, particularly from further consolidation, reflects a lack of effective competition in the system.

Scale benefits also manifest through increasing returns to scale. Net returns are positively related to size for not-for-profit funds. (No corresponding correlation was found for retail funds.) Stronger net returns among larger not-for-profit funds might be due to higher exposure to unlisted asset classes, but data limitations rule out strong conclusions. Larger funds do appear, however, to make better investment decisions within asset classes.

There is little evidence that realised economies of scale have systematically been passed through to members in the form of lower fees. Scale benefits may have been passed through in the form of member services or increases in reserves, or offset by the costs of meeting new regulatory requirements. And not-for-profit funds, on average, might have passed through some scale economies by investing more heavily in (higher-cost) unlisted assets and obtaining higher returns. Data limitations preclude firm conclusions about the form of pass through of economies of scale, and thus how members are actually benefitting and whether they are benefitting in a form they value.

Insurance

FINDING 8.1

The deduction of insurance premiums can have a material impact on member balances at retirement. This balance erosion is more costly to members with low incomes. It also has a larger impact on members with intermittent attachment to the labour force, and those with multiple superannuation accounts with insurance (the latter comprise about 17 per cent of members).

Balance erosion for low-income members due to insurance could reach a projected 14 per cent of retirement balances in many cases, and in extreme cases (for low-income members with intermittent work patterns and with multiple income protection policies) could be well over a quarter of a member's retirement balance.

FINDING 8.2

In terms of premiums paid, default insurance in superannuation offers good value for many, but not for all, members. For some members, insurance in superannuation is of little or no value — either because it is ill-suited to their needs or because they are not able to claim against the policy. Income protection insurance and unintended multiple insurance policies are the main culprits for policies of low or no value to members.

Younger members and those with intermittent labour force attachment — groups which commonly have lower incomes — are more likely to have policies of low or no value to them.

FINDING 8.3

The fiscal impact of insurance in superannuation is complex and multifaceted. The effect on Age Pension outlays of the erosion of superannuation balances by insurance premiums is not trivial, and could materially offset any savings to government in social security outlays (that would otherwise have been paid to members that become insurance payout recipients).

Fund governance

FINDING 9.1

Board processes to recruit highly skilled and experienced directors, and to effectively evaluate board performance and capability, are an essential prerequisite for best practice governance. Although there have been improvements to trustee board processes to better ensure boards have the necessary skills and experience, there is still much room to do better. Many boards are not employing effective assessment processes.

Use of a skills matrix (informed by external evaluation of board performance, skills, experience and knowledge) to guide the appointment process should be considered best practice by superannuation trustee boards. A focus on skills would likely lead to more independent directors as boards recruit from a wider 'gene pool'.

FINDING 9.2

Contract management processes, along with disclosure and reporting, need much improvement. While vertical integration is not a problem per se, conflicts of interest raised by the use of related parties need to be better managed by trustees and, where left poorly managed, redressed decisively by confident regulators.

A better definition of the term independent director is needed. Trustee directors are not independent if they are affiliated with parties related to a fund.

FINDING 9.3

Many funds mimic (at least to some degree) the investment strategy of rival funds for fear they will otherwise exhibit poor short-term performance relative to their peers ('peer risk'). This short-termism is likely to be at the expense of long-term returns to members.

FINDING 9.4

Robust and independently assessed performance attribution is needed for a trustee board to satisfy itself that it has acted in members' best interests. But trustees have considerable room for improvement in the use of performance attribution. Indeed, some even appear to have 'outsourced' their best interests duty for members using platforms and wrap accounts to financial advisers and product providers.

FINDING 9.5

Benefits provided to employers by some funds unduly influence some employers' choice of default fund.

FINDING 9.6

Considerable evidence of trustees acting in ways that are inconsistent with members' best interests suggests that trustees and regulators adopt a broad and at times inappropriate interpretation of members' best interests.

System governance

FINDING 10.1

The package of reforms contained in the Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill 2017 would improve member outcomes if legislated.

In particular, the proposed MySuper outcomes test (a good first step) should better enable APRA to de-authorise poorly performing products and better promote fund consolidation. But the test needs to be strengthened, extended to choice investment options and then fully and transparently enforced by APRA.

Introducing civil and criminal penalties for trustee directors, and giving APRA more power to deal with ownership changes of superannuation funds, are policy 'must haves' to better protect members.

FINDING 10.2

Conduct regulation arrangements for the superannuation system are confusing and opaque, with significant overlap between the roles of APRA and ASIC. These arrangements inevitably lead to poor accountability and contribute to the lack of strategic conduct regulation, especially public deterrence through enforcement action, with poor outcomes for members.

FINDING 10.3

The formation of the new Australian Financial Complaints Authority should be a positive reform for members, provided it is adequately resourced to deal with the level of complaints received.

FINDING 10.4

The relatively small number of SMSFs with some form of limited-recourse borrowing arrangement (about 7 per cent of SMSFs representing 5 per cent of SMSF assets) means such borrowing does not currently pose a material systemic risk. However, active monitoring (along with public reporting and discussion by the Council of Financial Regulators) is warranted to ensure that SMSF borrowing does not have the potential to generate systemic risks in the future.

Concerns about SMSF borrowing arrangements being utilised by members that lack the requisite financial literacy to properly understand the risks associated with them (or for whom such arrangements are unsuitable for other reasons) are best dealt with through measures to improve the quality of SMSF-related advice.

FINDING 10.5

The frequency and pace of policy change undoubtedly create real pressures for participants in the superannuation system. However, most of the recent major reforms (such as MySuper and SuperStream) have been overwhelmingly beneficial from a public interest perspective.

Overall assessment

FINDING 11.1

Fixing some of the worst problems in the current superannuation system would bring substantial benefits. If there were no unintended multiple accounts (and the duplicate insurance that goes with them), members would have been collectively better off by about \$2.6 billion a year. If members in bottom-quartile MySuper products had instead been in the median of the top-quartile performing MySuper products they would collectively have gained an additional \$1.2 billion a year.

Competing for default members

FINDING 12.1

While the default segment has *on average* provided better outcomes for members than the system as a whole, it fails to ensure members are placed in the very best funds and places a sizeable minority in funds delivering poor outcomes. For example, focusing on investment performance (an important aspect of member outcomes), products that performed above their benchmark generated a median return of 5.5 per cent a year in the 11 years to 2018, whereas the 17 underperformers generated a median return of 3.8 per cent a year (and represented about 1.6 million member accounts and \$57 billion in assets).

Current arrangements also lead to unnecessary account proliferation, rely heavily on third-party decision making and deny some members any ability to choose their own funds. Default arrangements need to be modernised and recrafted to harness the benefits of competition *for* default members. The interests of members (not funds) should be paramount.

FINDING 12.2

Current default arrangements do not promote member engagement. Survey evidence reveals that when members are provided with a simple and accessible list of superannuation funds, only a small minority would not choose their own fund. This evidence aligns with the lessons of behavioural economics.

Modernising the super system

RECOMMENDATION 1 **DEFAULT ONCE: ONLY DEFAULT MEMBERS WITHOUT AN ACCOUNT**

Default superannuation accounts should only be created for members who are new to the workforce or do not already have a superannuation account (and who do not nominate a fund of their own).

To facilitate this, the Australian Government and the ATO should continue work towards establishing a centralised online service for members, employers and the Government that builds on the existing functionality of myGov and Single Touch Payroll. The service should:

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

There should be universal participation in this process by employees and employers. It should be fully in place by no later than the end of December 2021.

RECOMMENDATION 2 **A 'BEST IN SHOW' SHORTLIST**

A single 'best in show' shortlist of up to 10 superannuation products should be presented to all members who are new to the workforce (or do not have a superannuation account), from which they can choose a product. Clear and comparable information on the key features of each shortlisted product should also be presented. The shortlist should also be easily accessible to all members at any time, including when starting a new job.

Members should not be prevented from choosing any other fund (including an SMSF). Terms in enterprise and workplace agreements that restrict member choice should be invalidated.

Any member who does not have an existing account and who fails to make a choice of fund within 60 days should be defaulted to one of the products on the shortlist, selected via sequential allocation.

The ATO should embed the shortlist and accompanying information into the centralised online service.

The first 'best in show' shortlist should be in place by no later than the end of June 2021.

RECOMMENDATION 3 INDEPENDENT EXPERT PANEL FOR 'BEST IN SHOW' SELECTION

The Australian Government should establish an independent expert panel to run a competitive process to develop the 'best in show' shortlist. This panel should select from products submitted by funds that meet a clear set of criteria (established and published beforehand by the panel) and that are judged as likely to deliver the best outcomes for members over the long term, with high weight placed on investment strategy and performance. All APRA-regulated superannuation funds should be free to participate in the 'best in show' selection process, regardless of ownership or sponsor (including government-owned funds).

In setting the criteria and selecting products, the expert panel should be guided by three legislated guiding principles.

- Products should be chosen based on the fund's likelihood of providing the best outcomes for members in the accumulation phase, taking account of risk.
- Products chosen should be particularly suitable for members who have typically defaulted but should also be highly suitable products for all members.
- The panel should always seek to ensure a competitive dynamic exists between funds, without compromising the integrity of the 'best in show' list.

The panel should have flexibility to select up to 10 products, with the exact number at the discretion of the panel based on the merit of each product and what is most tractable for members, while maintaining a strong competitive dynamic between funds for inclusion on the shortlist.

The panel should be comprised of independent experts who are appointed through a robust and independent selection process and held accountable to the Government through adequate reporting and oversight.

The process should be repeated, and the panel reconstituted, every four years. No more than half of expert panel members should carry over from one selection period to the next, and no individual member should remain on the panel for more than two terms.

RECOMMENDATION 4 ELEVATED MYSUPER AND CHOICE OUTCOMES TESTS

The Australian Government should legislate to require all APRA-regulated superannuation funds to undertake annual outcomes tests for their MySuper and choice offerings. These outcomes tests should include:

- a requirement for funds to obtain independent verification, to an audit-level standard, of their outcomes test determination, at least every three years (starting with the first test)
- clear benchmarking requirements for all MySuper and choice investment options.

This benchmarking should include a requirement for all investment options to be compared with a listed investment benchmark portfolio tailored to their asset allocation (with exceptions only to be granted on an 'if not, why not' basis). APRA should issue clear and specific guidance on the construction of these benchmark portfolios (drawing on the methodology established by this inquiry). Options that fall short of this benchmark portfolio by more than 0.5 percentage points a year, on average, over a rolling eight-year period should be subjected to a 12-month period of remediation or, if remediation is not possible, withdrawn from the market, with members transferred by funds to a better performing option. Any remediation or transfer activity should be subject to close oversight by APRA.

The Government should provide APRA with the power to stop a fund from launching new investment options or accepting new members into existing options subject to remediation until that remediation is complete.

APRA should also be given the power to revoke the fund's MySuper authorisation or direct the fund to withdraw the choice option where remediation is not successful in the required timeframe or a voluntary withdrawal of the product from the market does not occur. In these circumstances, APRA should oversee a process of transferring the affected members to another suitable fund, including on a temporary sub-fund basis where necessary, provided that APRA has determined that the transfer is, on balance, likely to be in the best long-term interests of the members of both funds. Should no fund be willing to accept the members, APRA should appoint an independent acting trustee with a remit to wind-up the fund.

The outcomes tests should form part of the new APRA standard to require fund-wide assessments of member outcomes.

Funds should be required to complete their first (annual) elevated outcomes tests by no later than the end of December 2020 for MySuper products, and no later than the end of June 2021 for choice investment options.

RECOMMENDATION 5 **CLEANING UP THE STOCK OF UNINTENDED MULTIPLE ACCOUNTS**

The Australian Government should seek the passage of legislation to require the auto-consolidation of superannuation accounts with balances under \$6000 and 13 months or more of inactivity. Trustees should be required to transfer these accounts to the ATO for auto-consolidation with a member's matched active account.

The Government should make explicit that this process should capture accounts held in Eligible Rollover Funds. These funds should be wound up within three years, with APRA oversight.

The Australian Government should increase the balance threshold for auto-consolidation over time, unless there are compelling reasons not to. The Government should also review the policy framework for lost and unclaimed superannuation accounts with the aim of streamlining the framework and ensuring it works in harmony with the auto-consolidation mechanism.

RECOMMENDATION 6 **A MEMBER-FRIENDLY DASHBOARD FOR ALL PRODUCTS**

The Australian Government should require funds to publish simple, single-page product dashboards for all superannuation investment options.

ASIC should:

- prioritise the implementation of these dashboards for choice investment options to achieve full compliance by the end of 2019
- only grant an exemption for an option or set of options from the dashboard requirement on the basis of evidence under the principle of 'if not, why not'
- revise the dashboards to simplify the content and provide more easily comprehensible metrics (drawing on robust consumer testing) by the end of 2019
- immediately publish all available MySuper and choice dashboards on its MoneySmart website, with the information clearly and readily accessible from the area of myGov that allows for consolidation of accounts.

The Australian Government should also require all superannuation funds to provide their members with the corresponding dashboards when a member requests to switch from a MySuper product to a choice option within the fund.

RECOMMENDATION 7 **DELIVERING DASHBOARDS TO MEMBERS**

The Australian Government should require the ATO to provide a link to the relevant (single page) product dashboard(s) on a member's existing account(s) via its centralised online service. Links to each single-page product dashboards for the 'best in show' products should also be presented on the centralised online service.

RECOMMENDATION 8 A CLEARER DEFINITION OF ‘ADVICE’ AND DISCLOSURE OF APPROVED PRODUCT LISTS

The Australian Government should immediately amend the *Corporations Act 2001* (Cth) to ensure that the term ‘advice’ can only be used in association with ‘personal advice’ — that is, advice that takes into consideration personal circumstances.

The Government should also immediately require Australian Financial Service Licensees to disclose to ASIC, in relation to superannuation products:

- the number of products on their approved product list (APL)
- the proportion of in-house products on their APL
- the proportion of products recommended that are in-house
- the proportion of products recommended that are off-APL.

ASIC should publish this information annually.

ASIC should also conduct selected audits of the information received to facilitate assessment of the effectiveness of advisers in meeting clients’ best interests.

RECOMMENDATION 9 EVALUATION OF FINANCIAL LITERACY PROGRAMS

The Australian Government should comprehensively and systematically evaluate the programs it funds that aim to improve the financial literacy of Australians. Such a review would help to better target funding to those programs evaluated as effective and to defund those that are not. This could be done through a review of the National Financial Capability Strategy, which could also include State and Territory Governments evaluating such programs in their own jurisdictions.

RECOMMENDATION 10 REASSESS THE NEED FOR A RETIREMENT INCOME COVENANT

The Australian Government should reassess the benefits, costs and detailed design of the Retirement Income Covenant — including the roles of information, guidance and financial advice — and only introduce the Covenant if design imperfections (including equity impacts) can be sufficiently remediated.

In conjunction with this reassessment, the Australian Government should also:

- consider cost-effective options, including possibly extending the Financial Information Service to provide retirees with access to a one-off, impartial information session to help them navigate complex retirement income decisions
- explore the business case for investing in digital technology that assists people’s financial decision making.

RECOMMENDATION 11 MORE USEFUL INFORMATION FOR PRE-RETIREEES

The Australian Government should prompt all superannuation members when they reach 55 years of age to visit the:

- 'Retirement and Superannuation' section of ASIC's MoneySmart website
- Department of Human Services' Financial Information Service website.

RECOMMENDATION 12 STRONGER SAFEGUARDS ON SMSF ADVICE

The Australian Government should:

- require specialist training for persons providing advice to set up an SMSF
- require persons providing advice to set up an SMSF to give prospective SMSF trustees a document outlining ASIC's 'red flags' prior to establishment
- extend the proposed product design and distribution obligations to SMSF establishment.

RECOMMENDATION 13 ROLL OUT THE CONSUMER DATA RIGHT FOR SUPERANNUATION

The Australian Government should automatically accredit superannuation funds to be eligible to receive (following member consent) information held by banks under the Open Banking Initiative. The Government should also roll out the new Consumer Data Right to superannuation in parallel with implementation of the elevated outcomes tests (recommendation 4).

RECOMMENDATION 14 LIMIT ALL FEES TO COST RECOVERY AND BAN TRAILING COMMISSIONS

The Australian Government should require that all fees charged by APRA-regulated superannuation funds are levied on a cost-recovery basis. Using fees to cross-subsidise between members should be prohibited. These rules should be implemented and enforced by regulators in such a way that avoids gaming by funds and does not pose new barriers to member switching.

The Australian Government should ban trailing financial adviser commissions in superannuation, to take effect as soon as practicable.

RECOMMENDATION 15 OPT-IN INSURANCE FOR YOUNG AND INACTIVE MEMBERS

The Australian Government should seek the passage of legislation to make insurance through superannuation opt-in for members under 25 years of age, and to require trustees to cease all insurance cover on accounts where no contributions have been made for the past 13 months (unless the member provides express permission that the cover is to be retained).

In addition to these proposed legislative changes, exemptions to the under-25 opt-in restriction should only be granted if the trustee can demonstrate to APRA that opt-out disability or income protection insurance would be in the best interests of a specific cohort of younger members.

RECOMMENDATION 16 INSURANCE BALANCE EROSION TRADE-OFFS

APRA should immediately require the trustees of all APRA-regulated superannuation funds to articulate and quantify the balance erosion trade-off determination they have made for their members in relation to group insurance, and make it available on their website annually.

As part of this, trustees should clearly articulate in their annual report why the level of default insurance premiums and cover chosen are in members' best interests. Trustees should also be required to provide on their websites a simple calculator that members can use to estimate how insurance premiums affect their balances at retirement.

RECOMMENDATION 17 A BINDING AND ENFORCEABLE INSURANCE CODE OF CONDUCT

The Australian Government should immediately establish a joint regulator taskforce to advance the *Insurance in Superannuation Voluntary Code of Practice* and maximise the benefits of the code in improving member outcomes. The taskforce should:

- monitor and report on adoption and implementation of the code by funds
- direct and monitor enhancements to strengthen the code, particularly implementation of standard definitions and moving to a short-form annual insurance statement for members
- direct the industry to take further steps for the code to meet ASIC's definition of an enforceable code of conduct, and to give ASIC an enforcement role under the code.

Both ASIC and APRA should be members of the taskforce, with ASIC taking the lead. The taskforce should annually report findings on industry progress on the code.

The code owners should be given two years to strengthen the code and make it binding and enforceable on signatories. At this point, adoption of the code should become a condition of holding a Registrable Superannuation Entity Licence for all superannuation funds that offer insurance.

RECOMMENDATION 18 INDEPENDENT INQUIRY INTO INSURANCE IN SUPER

The Australian Government should commission an independent public inquiry into insurance in superannuation. This inquiry should evaluate the effectiveness of initiatives to date, examine the costs and benefits of retaining current insurance arrangements on an opt-out (as opposed to an opt-in) basis, and consider if more prescriptive regulation is required. It should also look at the intersection of insurance in super with other schemes (such as workers' compensation) and consider how best to provide assistance to people in the event of illness and injury, including whether opt-out insurance through superannuation is the most efficient and equitable way to do so.

This insurance inquiry should be initiated within four years from the completion of this inquiry report.

RECOMMENDATION 19 REGULATION OF TRUSTEE BOARD DIRECTORS

APRA should amend its prudential standards to be prescriptive in:

- requiring trustees of all superannuation funds to have and use a process to effectively assess their board's performance relative to its objectives and the performance of individual directors, and to disclose this process annually
- requiring all trustee boards to maintain a skills matrix and annually publish a consolidated summary of it, along with the collective skills of the trustee directors
- requiring trusts to have and disclose a process to seek external third-party evaluation of the performance of the board (including its committees and individual trustee directors) and capability (against the skills matrix) at least every three years. The evaluation should consider whether the matrix sufficiently captures the skills that the board needs (and will need in the future) to meet its objectives, and highlight any capability gaps. APRA should be provided with the outcomes of such evaluations as soon as they have been completed
- requiring all trustee board directors to have a professional understanding of the superannuation system and investment decision making, gained either through industry experience or formal training
- defining what constitutes an 'independent director', based on the definition currently in the Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017.

The Australian Government should ensure that there is no legislative impediment to APRA defining what constitutes an 'independent director', or to superannuation funds appointing independent directors to trustee boards (with or without explicit approval from APRA). It should also give APRA powers to interpret and enforce the definition of an independent director.

RECOMMENDATION 20 DISCLOSURE OF MERGER ACTIVITY

The Australian Government should require trustee boards of all APRA-regulated superannuation funds to disclose to APRA when they enter a memorandum of understanding with another fund in relation to a merger attempt. For mergers that ultimately do not proceed, the board should be required to disclose to APRA (at the time) the reasons why the merger did not proceed, and the members' best interests assessment that informed the decision. APRA should also be empowered to prevent mergers that are not in members' best interests.

The Australian Government should also legislate new powers and penalties to explicitly enable ASIC to pursue action against trustee directors for misconduct in relation to mergers.

RECOMMENDATION 21 CAPITAL GAINS TAX RELIEF FOR MERGERS

The Australian Government should legislate to make permanent the temporary loss relief and asset rollover provisions that provide relief from capital gains tax liabilities to superannuation funds in the event of fund mergers and transfer events.

RECOMMENDATION 22 DEFINITION OF THE BEST INTERESTS DUTY

The Australian Government should pursue a clearer articulation of what it means for a trustee to act in members' best interests under the *Superannuation Industry (Supervision) Act 1993* (Cth). The definition should reflect the twin principles that a trustee should act in a manner consistent with what an informed member might reasonably expect and that this must be manifest in member outcomes. In clarifying the definition, the Government should decide whether to pursue legislative change, greater regulatory guidance, and/or proactive testing of the law by regulators. It should be informed by the findings of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*.

RECOMMENDATION 23 AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

APRA should focus more on matters relating to licensing and authorisation, ensuring high standards of system and fund performance. It should (in addition to recommendations 4, 16 and 19):

- supervise and enforce the obligations of the licences and authorisations it grants
- require all APRA-regulated superannuation funds to conduct formal due diligence of their outsourcing arrangements, at least every three years, to ensure the arrangements provide value for money. Each fund should provide a copy of the assessment to APRA (including the fees paid and the comparator fees)
- require all APRA-regulated superannuation funds to include a clause in material service contracts with outsourced providers that obliges the provider not to do or take any action that adversely affects members' interests
- report annually to the Council of Financial Regulators on funds' progress with implementing the elevated outcomes tests and on fund merger activity
- undertake a systematic assessment of the costs to funds of the thousands of legacy products in the superannuation system. If the evidence demonstrates that they represent a significant cost in accumulation, APRA should further refine trustees' obligations for member transfers so these products can be rationalised
- embed product-level reporting within its reporting framework as soon as practicable (no later than 18 months) to enhance visibility of actual member outcomes across all APRA-regulated funds and to bring reporting for the choice segment into line with the MySuper segment. APRA should also expedite efforts to address inconsistencies in reporting practices.

The Australian Government should set an explicit 'member outcomes' mandate for APRA in its regulation of superannuation.

RECOMMENDATION 24 AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

ASIC should focus more on the conduct of superannuation trustees and financial advisers, and on the appropriateness of products (including for particular target markets) and disclosure. It should (in addition to recommendations 6 and 8):

- proactively set and enforce standards for the meaningful disclosure of information to members on superannuation products and insurance policies (in addition to product dashboards). Information should be simple, comparable and easy for members to understand
- require all superannuation funds to publicly disclose to current and prospective members the proportion of costs paid to service providers that are associated with related-party outsourcing arrangements
- proactively investigate (questionable) cases where mergers between superannuation funds stalled or did not proceed, and report to the Council of Financial Regulators on its enforcement against trustee directors who breach their duties by not pursuing a merger when it would be in their members' best interests
- undertake recurring thematic reviews on financial advice in superannuation, including advice in relation to choice platform products and SMSFs.

RECOMMENDATION 25 CLARIFY REGULATOR ROLES AND POWERS

The Australian Government — with the benefit of this inquiry report and that of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* — should clarify the roles of APRA and ASIC in relation to superannuation. In doing so, it should consider the suitability of each regulator's powers, the suitability and strength of penalty provisions for misconduct, and whether there are any undesirable constraints on either regulator engaging in strategic conduct regulation.

RECOMMENDATION 26 APRA CAPABILITY REVIEW

The Australian Government should immediately initiate the independent capability review of APRA, which it had previously agreed to do. This review should also examine how efficiently and effectively APRA operates to achieve its strategic objectives in relation to superannuation, including:

- the capability of APRA to adequately supervise and regulate the superannuation system in line with its current responsibilities and those proposed in draft legislation (as well as future responsibilities arising from the implementation of recommendations in this inquiry), including a focus on capability in enforcement
- identification and analysis of immediate and forward-looking priorities and risks
- the use of legal powers and enforcement tools, including the pursuit of test cases and effective coordination with ASIC and other regulators in this regard
- the skills, capability and culture of the organisation, including the number of staff dedicated to regulating superannuation and their capabilities
- internal governance and accountability mechanisms
- engagement and information sharing with other regulators, especially ASIC
- the use of data collection and analytics
- future resourcing needs.

The review should be completed and published during 2019.

RECOMMENDATION 27 SUPERANNUATION DATA WORKING GROUP

The Australian Government should establish a permanent superannuation data working group, comprised of APRA, ASIC, the ATO, the ABS, the Commonwealth Treasury and the new member advocacy body (with Treasury taking the lead). This group should:

- identify ways to improve the consistency and scope of data collection and release across the system, with a focus on member outcomes
- evaluate the costs and benefits of reporting changes, including strategies for implementation
- identify areas where legislative or regulatory change may be necessary to support better data collection
- report annually to the Council of Financial Regulators on its progress, and on the data analytics capabilities of each regulator.

RECOMMENDATION 28 AN INDEPENDENT MEMBER ADVOCACY BODY

The Australian Government should, as a priority, provide adequate ongoing funding to support an independent superannuation members' advocacy and assistance body.

RECOMMENDATION 29 ONGOING REVIEW OF THE SUPER SYSTEM

The Australian Government should:

- require APRA and ASIC to jointly produce a *State of Superannuation* report every two years on the performance of the superannuation system, including outcomes relating to investment performance, fees, low-balance inactive accounts, merger activity and the elevated MySuper and choice outcomes tests. This report should also detail progress by the industry and regulators to implement Government policy changes and address performance and member harm issues identified in this inquiry report
- commission an independent review, every five years, of the effectiveness of the MySuper and choice elevated outcomes tests at meeting their objectives, and whether they are being suitably applied by APRA to remove underperforming funds and options from the super system
- commission an independent public inquiry, every ten years, of the superannuation system, including a review of the criteria used to assess ‘best in show’ products.

RECOMMENDATION 30 INDEPENDENT INQUIRY INTO THE RETIREMENT INCOMES SYSTEM

The Australian Government should commission an independent public inquiry into the role of compulsory superannuation in the broader retirement incomes system, including the net impact of compulsory super on private and public savings, distributional impacts across the population and over time, interactions between superannuation and other sources of retirement income, the impact of superannuation on public finances, and the economic and distributional impacts of the non-indexed \$450 a month contributions threshold. This inquiry should be completed in advance of any increase in the Superannuation Guarantee rate.

RECOMMENDATION 31 A STEERING GROUP TO OVERSEE IMPLEMENTATION

The Australian Government should prioritise the implementation of this inquiry’s recommendations by establishing a Steering Group of Departmental and agency heads to oversee the implementation. This group should comprise the Secretary of the Department of the Prime Minister and Cabinet, Secretary to the Treasury, Chairs of APRA and ASIC, and the Commissioner of Taxation.

1 Setting the scene

Most Australians have superannuation. With very few exceptions, super is compulsory when participating in the workforce. Total balances now exceed \$2.7 trillion — a substantial portion of national wealth — and, at least by one projection, may reach \$9.5 trillion by 2035 (in nominal terms) (Deloitte 2015, p. 2). The sheer size of the super system, combined with its compulsory nature and the role it plays in funding retirement, means that the system’s performance is crucial for the wealth and wellbeing of Australians.

Overall, the super system has served Australians reasonably well, by delivering solid investment returns and providing significant flexibility and choice in how members’ balances are invested and drawn down. And yet the system has also been failing many of its members. Unintended multiple accounts, a tail of persistently underperforming funds and products, conflicts of interest, and the sheer complexity of navigating the system have eroded members’ trust in the system, as well as their balances. Regulators have not been member champions and have failed to regulate the system as effectively as they might.

Some of the problems reflect that the super system developed in a context quite foreign to current and impending social and workforce dynamics. Super has its origins in the industrial relations system, but multiple job holding and a higher tendency for people to move between industries and occupations than in the past have amplified the deficiencies that arise from unintended multiple accounts and employers’ role in selecting default funds. In the absence of policy change, these deficiencies are set to grow.

Technology has also shifted in ways that improve how funds manage superannuation and engage with their members. This is opening up opportunities for employees to be better placed to navigate their super and make decisions. And these trends are occurring as the system matures, with people living and working longer, and contributing more to their super. The super system (and member engagement) will become far more important in the years ahead as more and more Australians draw down their balances to support their retirement.

Why this inquiry?

In this inquiry, the Commission has assessed the super system’s performance by focusing on members’ best interests through the twin lenses of efficiency and competitiveness, broadly conceived. This has meant measuring how well the system as a whole is performing in terms of meeting member needs, delivering good net investment returns over time and providing Australians with income in retirement.

This is not the first inquiry on the super system, and will not be the last. Nor should it be. In a compulsory system, it is incumbent on the Government and regulators to ensure ongoing accountability and review. Indeed, this inquiry is recommending a separate and broader inquiry into the role of superannuation in funding retirement incomes and its effects on national savings and equity (chapter 13).

It is five and a half years since the MySuper reforms were introduced in July 2013, following the Cooper Review (Cooper et al. 2010a), and the MySuper reforms have been fully implemented since July 2017 (box 1.1). But concerns have been raised that MySuper has not lived up to its original intentions. In 2014, the Financial System Inquiry recommended that a Productivity Commission inquiry should determine whether further reform is needed (Murray et al. 2014, p. 101).

Box 1.1 The MySuper reforms

The MySuper reforms came into effect in July 2013, following a recommendation of the Cooper Review. The reforms put in place a set of regulatory standards for default accumulation products. The intention was to provide a low-cost, transparent and comparable set of products that achieve better outcomes for members who do not choose their own fund or investment strategy.

MySuper products have been designed to ensure members do not pay for any unnecessary features they do not need or use. Funds are required to provide a single diversified investment strategy (or a life-cycle strategy), with a single fee structure applying to all members. There are limits on the types of fees that can be charged. Funds must offer insurance but give members the ability to opt out. Funds are subject to governance standards set by the Australian Prudential Regulation Authority, and must regularly determine whether the scale of the fund is disadvantaging members.

Superannuation funds have been required to place new default members into a MySuper product since January 2014. Funds had until July 2017 to transfer the balances of existing default members into a MySuper product.

Though the MySuper reforms are now fully implemented, concerns have been aired that the original intentions of the reforms have not been fully realised. In 2014, the Financial System Inquiry questioned whether the reforms would significantly improve competitive pressure and realise the full benefits of scale for members, based on early indications that fees for MySuper products varied widely and had not fallen as much as anticipated (Murray et al. 2014, p. 107).

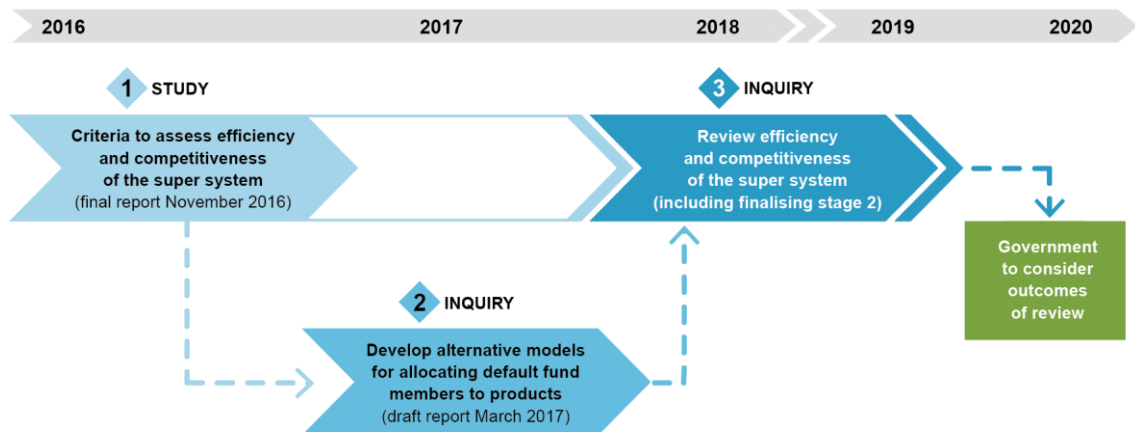
That inquiry recommended the introduction of a formal competitive process to allocate new default fund members to MySuper products unless a Productivity Commission review (the current inquiry) concluded that the MySuper and other reforms had been effective in improving competition and efficiency in the superannuation system.

Sources: ASIC (2017f); Australian Government (2011); Cooper et al. (2010a); Murray et al. (2014).

In 2016, the Government tasked the Commission with three stages of work, spanning almost three years (figure 1.1). Stage 1 involved setting the framework for assessing efficiency and competitiveness, by way of a suite of criteria and indicators (the final report was released in November 2016) (PC 2016a). Stage 2 entailed developing alternative models for allocating default members to products (with a draft report in March 2017) (PC 2017d).

This stage 3 report brings both streams of work together to provide an overall assessment of the super system and to recommend policy changes. It encompasses finalising the stage 2 inquiry. As such, the Commission has undertaken this inquiry under the twin (stage 2 and stage 3) terms of reference.

Figure 1.1 A three-stage investigation



Consistent with the Commission’s objective to maximise the wellbeing of the Australian community as a whole, it has examined how efficiently the superannuation system has delivered for its members. Much of the Commission’s consultation, through submissions, meetings and public hearings, has seen a concerning focus on the interests of the funds and their trustee boards, and less so the interests of members. The interests of the fund and the member are not interchangeable concepts. The fund is an entity structured to act as a vessel for members’ assets. What is in the best interests of the fund (for example, expanding its member base) need not automatically be in the best interests of the member, unless it ultimately translates to lower costs and better returns and products for members.

Competition is a necessary part of the assessment in this inquiry, not because it is a goal in itself, but because it is a means to an end. Competition is needed to drive better performance, keep costs low, stimulate innovation and ultimately promote members’ best interests (box 1.2). But, crucially, competition will only deliver these outcomes when it is directed to the right ends, and when regulators are effective and policy settings are in place to focus competition on the outcomes that matter to members.

This inquiry has been undertaken against an evolving backdrop. The Government is in the process of legislating or implementing new rules for account consolidation, fees and insurance. It has also been pursuing changes to regulation, the regulators and fund governance. Separately, a *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Financial Services Royal Commission) is currently underway and has run in parallel to this inquiry. These developments are discussed further below.

Box 1.2 Why does competition matter for members?

Competition can be an impetus for driving better outcomes for members. In a competitive environment, funds and other service providers in the system would have incentives to deliver the products and services that members want at prices that reflect their costs of supply, and to continually innovate over time to improve their products and attract and retain members.

Healthy competition leads to efficient outcomes, and does not necessarily require a lot of funds in the market. It would see well-performing (efficient) providers not yet in the market enter, efficient providers already in the market gain market share over time, and inefficient providers face pressure to improve or exit. Both not-for-profit and retail funds will coexist in the market. Experience suggests that no one type of fund has a monopoly over delivering good outcomes. Each kind of fund has had its share of successes and failures, both domestically and internationally.

However, it is critical to distinguish between healthy and unhealthy competition. If fund members are not well informed or engaged, or have limited influence on fund governance and direction, providers within the system could potentially compete on irrelevant product features that add little value to members. Product proliferation, high advertising expenditure and high search costs can be symptoms of unhealthy and wasteful competition. Competition is healthy only where it drives good member outcomes.

Another key distinction is between competition *in* the market and competition *for* the market. Competition in the market would involve trustees responding to member preferences and members switching funds when they can get a better deal. By contrast, competition *for* the market would involve funds competing for the right to access a particular segment of members, such as default members. This would mean funds being subjected to some kind of comparative evaluation based on merit (such as a tender or administrative filter), as assessed by experts.

Sources: PC (2016a, 2017d).

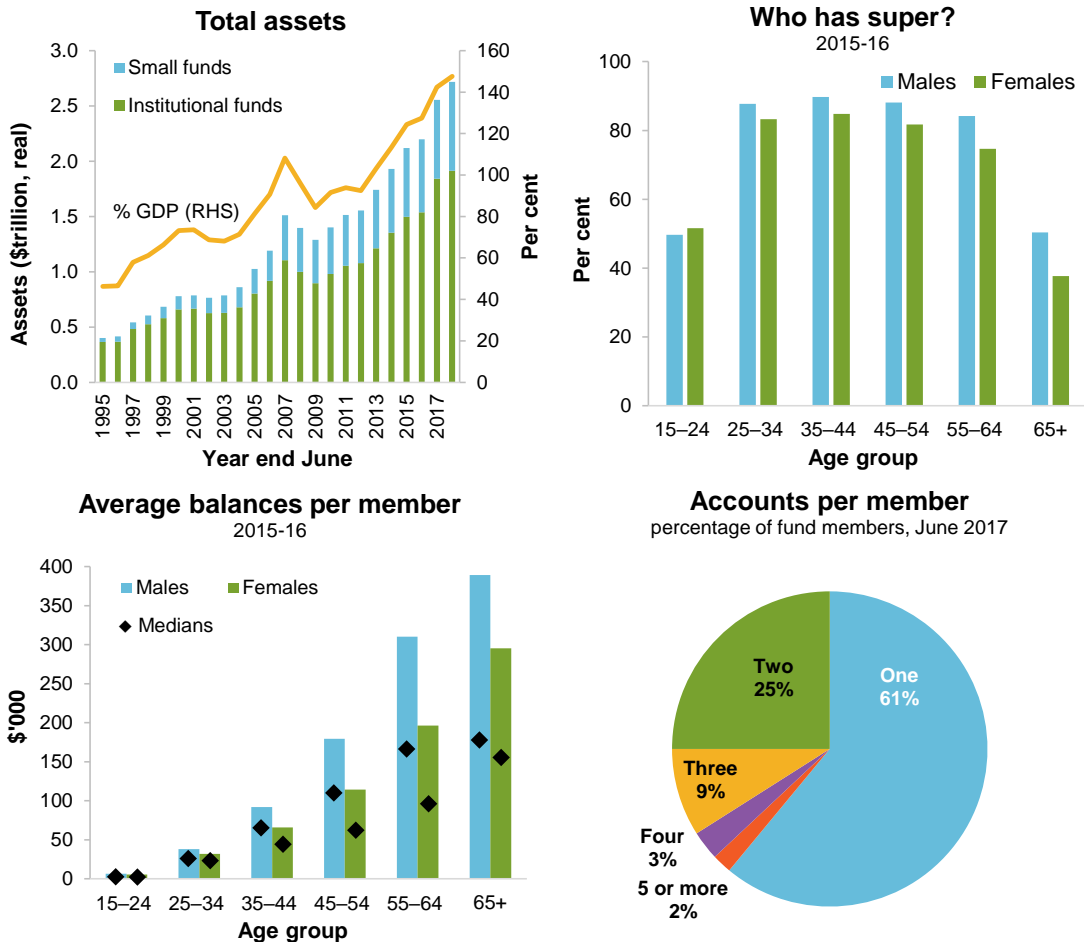
1.1 How does the super system work?

To a large extent, the super system is a product of government regulation. Employers must pay contributions equivalent to a minimum percentage of their employees' wages — currently 9.5 per cent of ordinary time earnings — into a super account. Most members cannot take this money out of the system until they retire (or are close to retirement age). In return, super receives favourable tax treatment, and members have a wide range of choice in who manages their money and where it is invested. Members who do not actively choose their own fund upon starting a new job — roughly two-thirds of members — are placed into default (MySuper) products (Colmar Brunton 2010; Delpachitra and Rafizadeh 2014; PC 2017a).

The Australian super system has grown rapidly since the introduction of the Superannuation Guarantee in 1992 — both in terms of funds under management and coverage — and in parallel to major structural shifts in the composition and form of the Australian workforce (discussed below). Collectively, Australians now have over \$2.7 trillion of assets in super funds (APRA 2018p), comprising almost 20 per cent of total household assets (ABS 2017c)

and equivalent to over 140 per cent of GDP (figure 1.2). Superannuation will continue to increase in relative importance as the system matures by the 2040s.

Figure 1.2 Member balances are rising but unevenly spread^a



^a Figures include both accumulation and retirement phases. 'Small' funds mostly comprise SMSFs, as well as some other structures, including small APRA funds (which comprised 0.3 per cent of assets in this category in 2018).

Sources: ABS (*Household Income and Wealth, Australia 2015-16*, Cat. no. 6523.0); APRA (2005, 2007, 2018b, 2018p); ATO (2018e).

Over 80 per cent of both men and women in their prime working years (ages 25 to 54) hold a super account (figure 1.2). But there are some stark disparities across age cohorts. Average balances rise significantly with age — from \$6100 among young people to \$345 000 for those of retirement age, in 2015-16 — with a large and persistent gender gap across all age cohorts (ABS 2017c). There is also a wide distribution of balances within age cohorts, with medians much lower than averages. Overall, the median balance in 2015-16 (\$48 000) was only about a third of the average (\$128 000). (More recent data on members' total balances are not available, because these data are collected only every two years by an ABS survey.)

While most members hold a single account, four in ten have multiple accounts (figure 1.2). Sometimes this will be an explicit choice made by members — survey evidence suggests just over a fifth of members with multiple accounts hold these deliberately (chapter 5) — but in other cases it will be unintended (some one in three accounts) and come at a high cost in terms of duplicate fees and forgone returns (chapter 6).

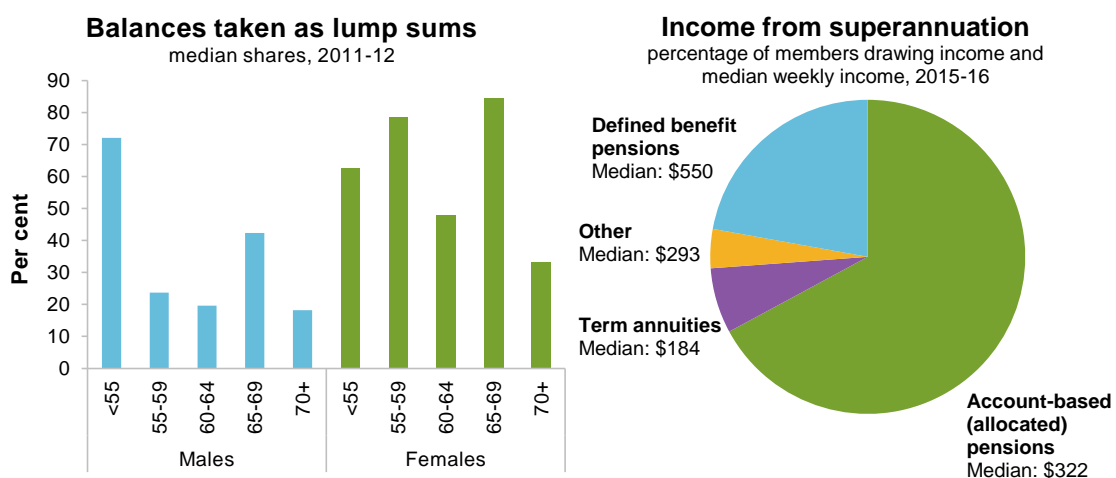
Over 90 per cent of member accounts are in the accumulation phase, with the remainder in retirement and holding over a third of the system’s assets in 2015-16 (APRA 2017a; ATO 2018h). However, some members withdraw their balances as lump sums when they reach retirement and effectively exit the super system. For example, in 2011-12, nearly 3 per cent of the population aged 55 and over withdrew more than 90 per cent of their super balances as a lump sum (PC 2015b, p. 84). These are usually members with smaller balances. In general, females withdraw a higher proportion of their balances as lump sums than males (figure 1.3).

Of the retirement age members who remain in the system and receive regular income from their super, the median income was \$391 per week in 2015-16, though the median for the typical account-based pension (which excludes members receiving defined benefit pensions) was lower, at \$322 per week (figure 1.3).

Overall, a third of Australians aged 65 years and over rely on Government pensions and allowances for over half of their total income, and only about one-fifth rely on Government payments for less than one per cent of their income (ABS 2017c).

The significance of the retirement phase will only grow as the system continues to mature. By one projection, assets in the retirement phase may grow from about \$400 billion today to over \$1.5 trillion by 2035 (Deloitte 2015, p. 6).

Figure 1.3 Balances are drawn down in diverse ways

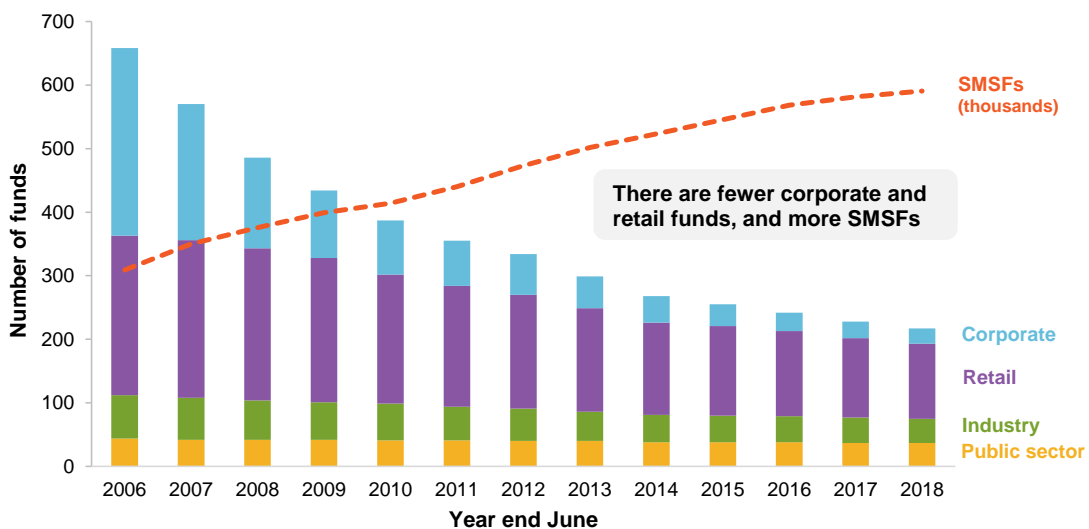


Sources: ABS (*Household Income and Wealth, Australia 2015-16*, Cat. no. 6523.0); PC (2015b, p. 85).

Who is in ‘the system’?

Super funds are key players in the system. As of June 2018, there were 217 institutional funds, which are categorised as industry, retail, corporate and public sector funds (figure 1.4). This is down from over 650 funds in 2006 due to consolidation in the industry (especially among corporate and retail funds). At the same time, the number of self-managed super funds (SMSFs) has nearly doubled, from about 309 000 to 591 000.

Figure 1.4 There are fewer institutional funds than in the past^a



^a Public sector funds include State and Territory Government funds exempt from regulation by APRA.

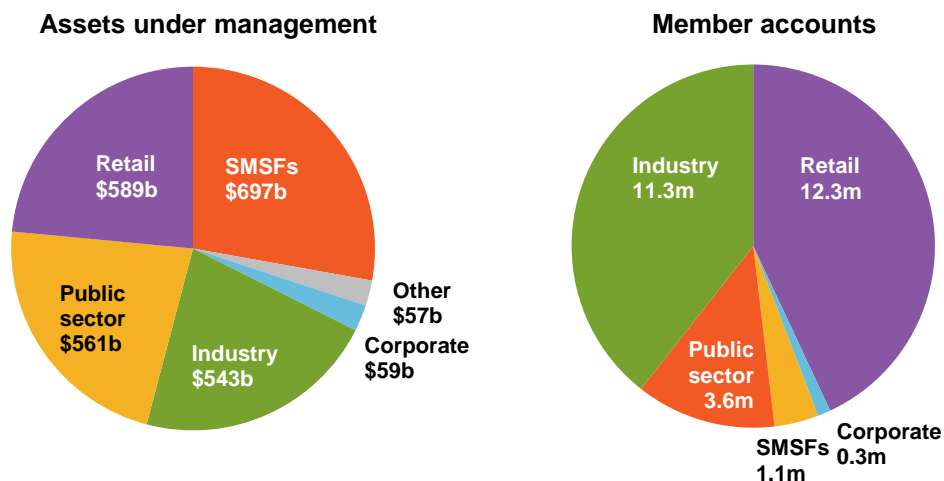
Sources: APRA (2018b, 2018n, 2018p).

Institutional funds come in two main types: defined benefit and defined contribution. Among those regulated by the Australian Prudential Regulation Authority (APRA), less than a quarter (23 per cent) of members’ benefits are defined benefits, with the remainder in defined contribution (APRA 2018b). Defined benefit funds were once common in Australia — especially for high-income workers prior to the Superannuation Guarantee — but are in long-term decline. These funds pool contributions and set retirement benefits according to a formula, with most financial risks borne by the sponsoring employer. By contrast, in defined contribution funds, most risks (in relation to investment performance, fees and retirement benefits) reside with the member.

In terms of assets under management, retail funds, industry funds, public sector funds and SMSFs each hold close to a quarter of the total, with most of the small remainder in corporate funds (figure 1.5). The number of member accounts is spread much more unevenly, with the bulk (82 per cent) residing in industry and retail funds.

Figure 1.5 **Most member accounts are in industry and retail funds^a**

June 2017

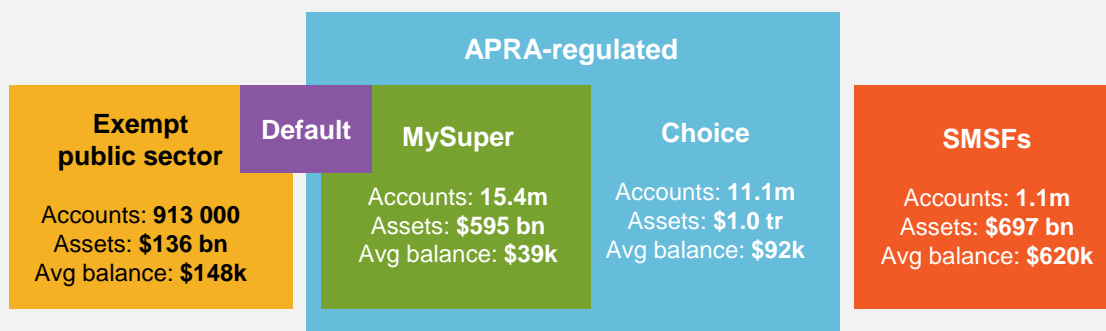


^a Public sector funds include State and Territory Government funds exempt from regulation by APRA.

Source: APRA (2018b).

There are some key differences across the main segments of the system (box 1.3 provides some definitions). Over half of all accounts are in MySuper products (mostly with not-for-profit funds), though these products only account for a quarter of assets (figure 1.6). Average balances for choice accounts are over twice those of MySuper accounts, and accounts in SMSFs are about seven times as large again (the figures for choice accounts and SMSFs include the retirement phase). Collectively, APRA-regulated funds offer tens of thousands of investment options in which members can choose to invest their super (APRA 2018s).

Box 1.3 What are the main ‘segments’ of the super system?



The superannuation system can be divided into segments in various ways, and many of these overlap (see diagram). In this report, the Commission has adopted the following definitions.

- **Institutional funds** are all funds with more than four members, comprising APRA-regulated funds and State and Territory Government funds exempt from regulation by APRA.
- **APRA-regulated funds** are institutional funds subject to regulation by the Australian Prudential Regulation Authority.
- **Default members** are those accumulation members who did not nominate an existing account to their most recent employer, and thus were placed in the employer’s choice of fund. Since 2013, most of these members have been in **MySuper products**, though some default members are in public sector funds that are exempt from APRA regulation.
- **Choice members** are those who are in a non-MySuper product in an APRA-regulated fund, and generally have chosen the specific product (or investment option) themselves, including members in the retirement phase. This definition is much narrower than the set of all members who make active choices in the system, which also includes **SMSF members** and those who choose their own investment option within exempt public-sector funds.

There are no official statistics available on the number of unique members in each segment (because one member may hold multiple accounts, including across segments). It is also unknown how many members truly ‘default’ by holding a MySuper (or exempt) default product without having chosen to go with that product. Inevitably, many members will have actively chosen to open a MySuper product, or will have deliberately let their employer place them in a specific fund.

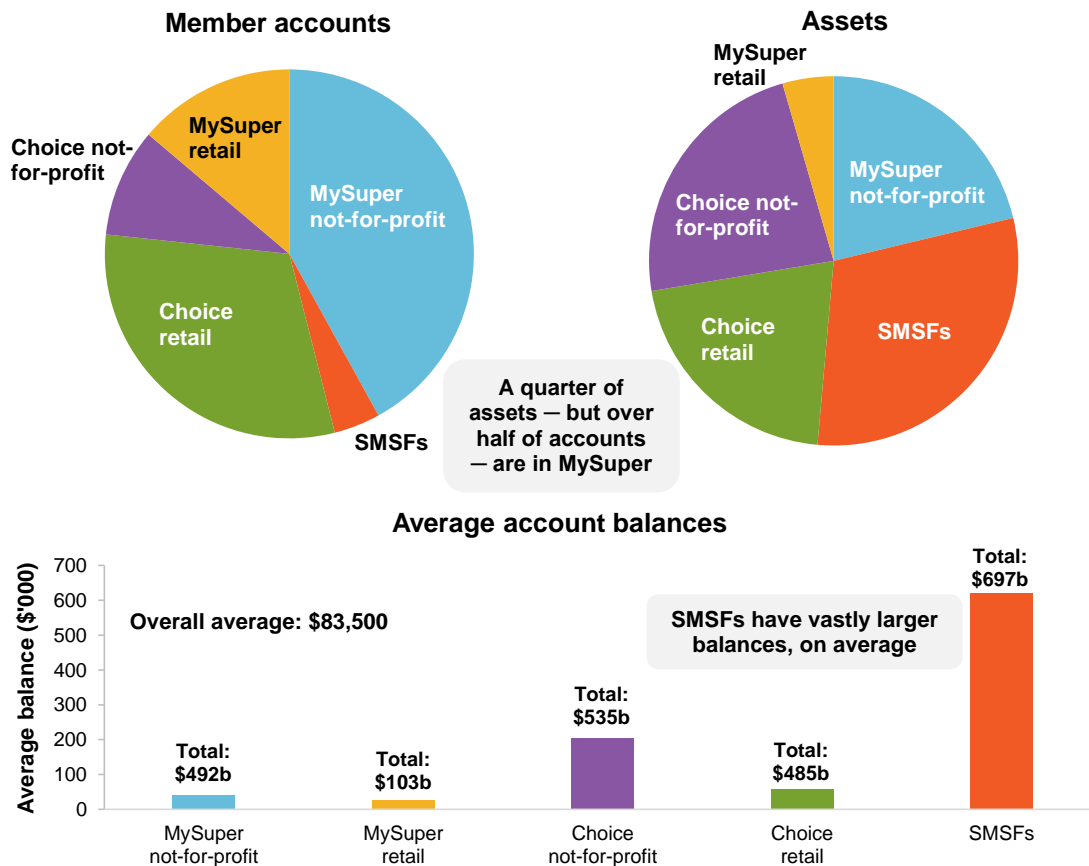
Members can also be in the accumulation segment (if they are still contributing to their balances), the retirement segment (if they have started drawing down their balance), or both.

Finally, it can sometimes be useful to analyse the system by looking at the main fund types: industry, retail, corporate, public sector, and SMSFs. In this report, the Commission has used the term ‘not-for-profit’ to denote industry, corporate and public sector funds (as distinct from retail funds). This follows industry convention. Though fund trustees generally do not extract profits directly, there is scope for trustees that are part of a vertically integrated entity to outsource some functions to related-party providers who can make a profit. This is the case for many retail funds.

Data source: APRA (2018b).

Figure 1.6 **Choice and SMSF members have higher average balances^a**

June 2017

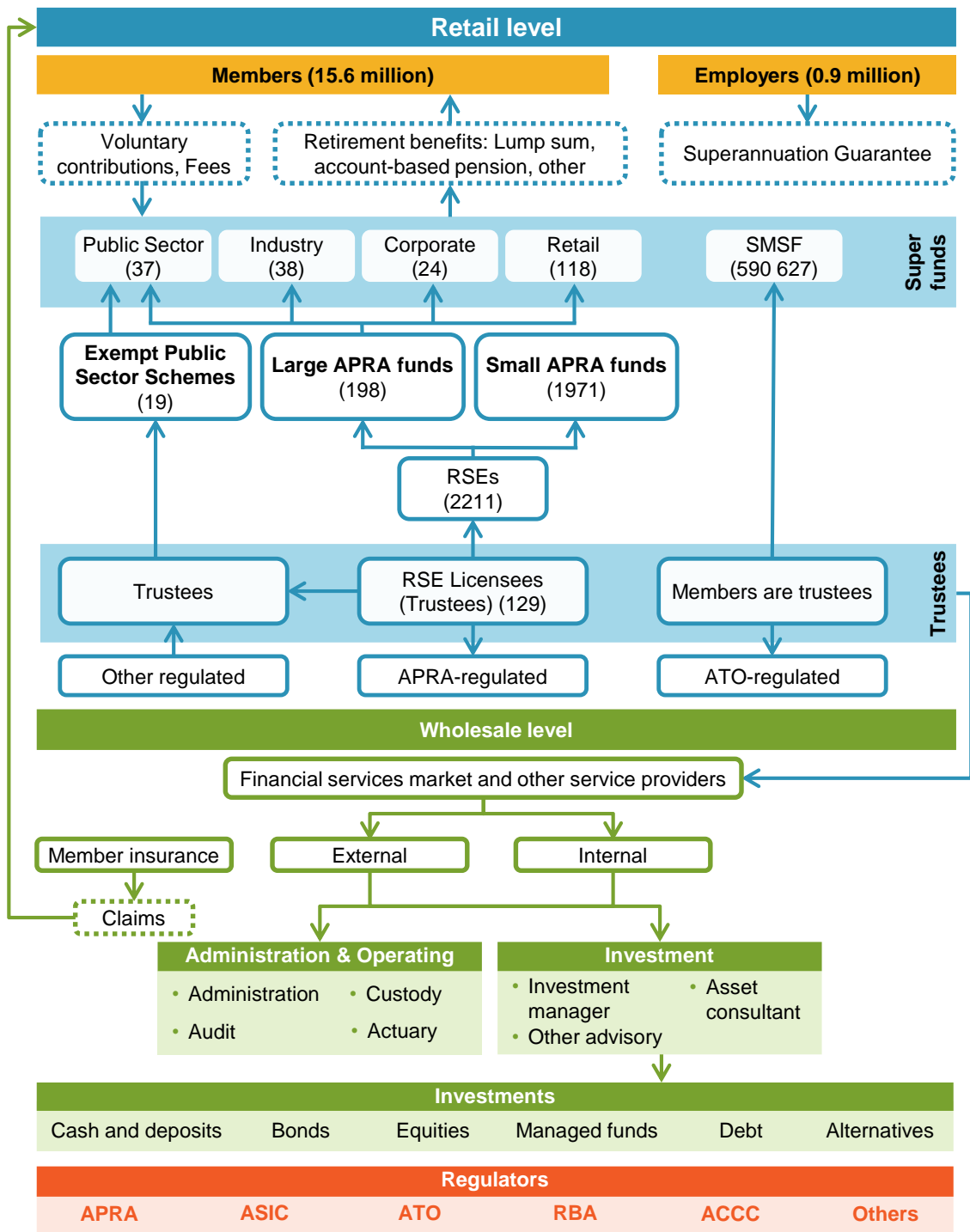


^a Figures include both accumulation and pension phases, unless otherwise indicated. Excludes State and Territory Government funds exempt from regulation by APRA.

Source: APRA (2018b).

The super system extends well beyond funds and the members it provides for (see below). It encompasses many horizontal and vertical relationships on the supply side at the wholesale and retail levels, member intermediaries on the demand side (such as employers), and the actions of regulators on both the supply and demand sides (figure 1.7). These other parts of the system are assessed in this inquiry only where materially relevant — that is, where there is evidence of potential problems that bear on the efficiency and competitiveness of the system.

Figure 1.7 An overview of the super system^a



^a Figures in parentheses indicate number of entities as at June 2018. Number of employers is at June 2017. Sources: ABS (Counts of Australian Businesses including Entries and Exits, Jun 2013 to Jun 2017, Cat. no. 8165.0); APRA (2018p); ATO (2018e).

Members in the modern workforce

Members are central to the super system — indeed, the system itself exists to meet its members' needs. Some members have large super balances; others have very little. Some are still working — or between jobs — and some have already retired. Many are passive and disengaged, and many would like to be more involved with their super but find it too complex or time consuming. Others are sophisticated investors. The system needs to accommodate all this diversity.

But the economic and social environment that gave rise to Australia's super system was quite different from that of 2018. Those differences will be accentuated over time.

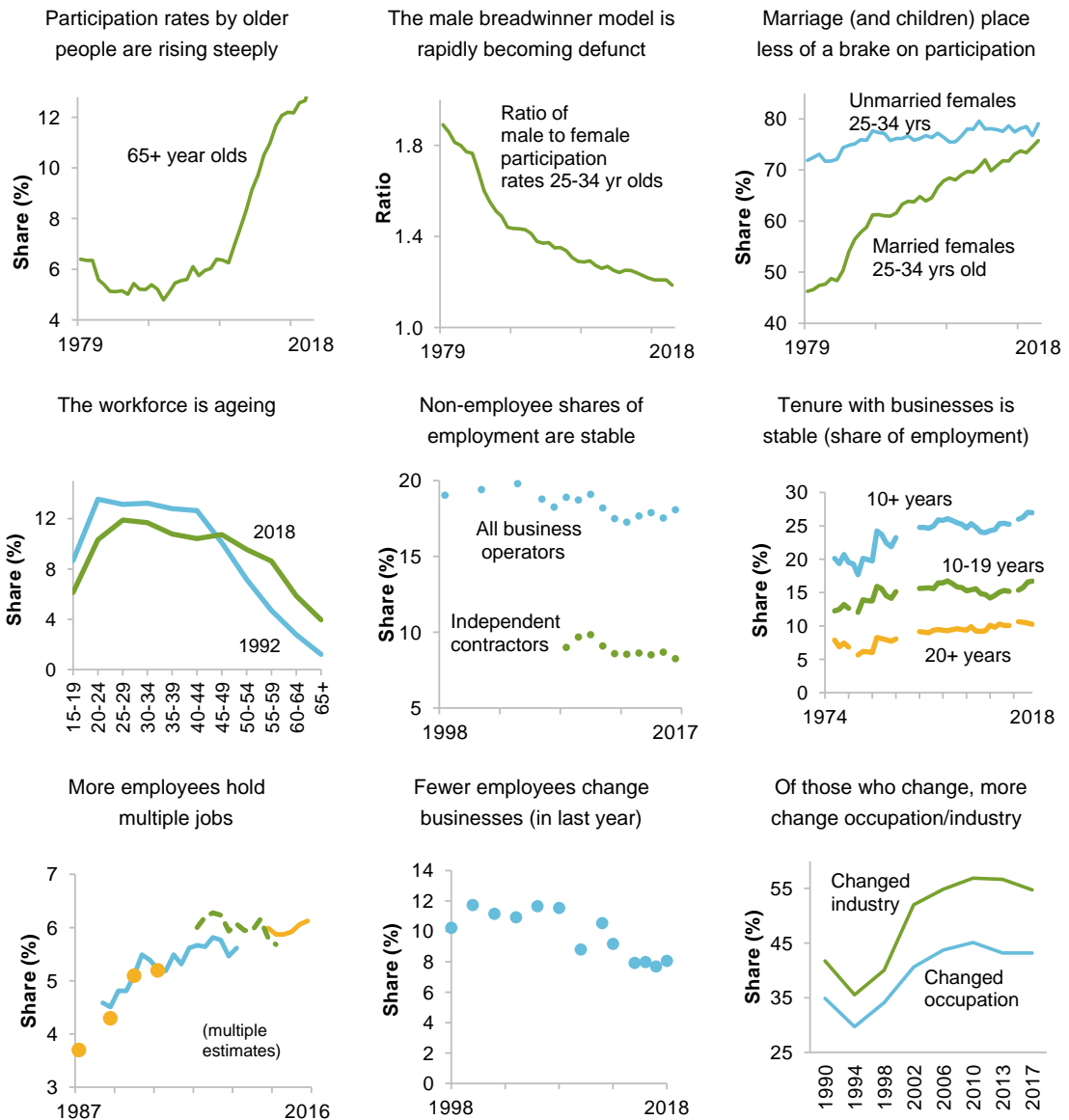
At the time of the introduction of the Superannuation Guarantee, super was not a major source of financing for the retirement of most older cohorts. This was because Age Pension eligibility ages were lower than now, contribution rates were low in the early years of compulsory super, the working age population was younger, and the remaining lifetime income before retirement for many was modest.

While it will still be some time (another 20 years or so) before the retirement of the first cohorts to have experienced their full working life under compulsory super, many members have now been in the system for several decades. Moreover, the portion of a member's lifetime spent in work is rising given a shift to later retirement ages. In 2005, about 28 per cent of males (and 17 per cent of females) aged 45–49 years expected to retire after age 65. The comparable figures in 2017 were 38 and 30 per cent respectively (ABS 2006, 2017g). Labour force participation rates of those aged over 65 have risen strongly, albeit from a low base (figure 1.8), while reductions in labour force participation for young people (aged 15–19 and 20–24 years) have abated. Consequently, the expected number of lifetime years in the labour force ('work expectancy') for the current cohort of young people is projected to increase (Hunter 2017, pp. 241–2; PC 2013, p. 183).

As the system has matured, mandatory minimum superannuation contribution rates have risen significantly, which has added further momentum to the accumulation of balances (with rates to rise even further to 12 per cent by 2025). The threshold for mandated contributions (at \$450 before tax per calendar month) has also not changed with wage growth, pushing more younger and lower-income people into the super system. Maintaining the \$450 threshold meant that roughly half a million more employees were covered by the system in 2017 than would have been the case had the threshold been indexed to inflation (when its value would be more than \$1000 a month).

The combination of all these factors means that much more is at stake in financial terms than at the system's inception, and its performance is therefore of greater importance to members. Equally, the gains from acquiring knowledge about the performance of funds and the available retirement options are also greater.

Figure 1.8 Trends in the Australian labour market



Sources: ABS (*Labour Mobility, Australia*, Cat. no. 6209.0, various issues; *Forms of Employment, Australia*, Cat. no. 6359.0, various issues; 1997, 2009, 2013, 2017e, 2018b, 2018f, 2018g).

These aggregate trends have parallels for some sub-groups of members, and particularly women. Female participation rates for workers aged 25–34 years are now approaching that of males (figure 1.8), with a similar trend apparent for the rates for partnered women compared with single women (ABS 2005, 2017f). While hours worked and wage rates are lower for females, the super system will be increasingly important for them as a source of retirement funding, noting that about 37 per cent of female retirees currently rely on their partner’s income as the main source of funding for meeting living costs (ABS 2017g).

Maturation of the system has also put increasing focus on its role in providing income in retirement. Twenty-six years after its inception, many people have transitioned into retirement, and with that, the system's orientation to retirement products and risk management of post-retirement incomes has become far more prominent. Notwithstanding trends towards delayed retirement, life expectancy improvements are likely to outpace increases in work expectancy, so that people's retirement income must last for longer (PC 2013, p. 182).

Superannuation arose as a de facto pay rise, and this tied Australia's retirement savings policy to the workplace relations system. Super funds were inextricably linked to employers and unions, with industrial awards cementing the relationship (box 1.4). The workplace relations system has since changed, and the role of unions has diminished, but vestiges of that old system live on with specification of super funds in awards, workplace determination of default fund choices, and the opening of new accounts for default members when they change jobs. Nearly all defined benefit schemes have closed, severing another link between employers and retirement savings.

Box 1.4 The evolution of Australia's super system

The history of superannuation spans more than 150 years. It began in 1862 with the establishment of a defined benefit pension fund for the employees of the Bank of New South Wales. Superannuation followed this model for the next 100 years: defined benefit pension funds were established for a minority of employees, who were generally higher-paid white-collar employees in the private sector or civil servants in the public sector. Many of these earlier superannuation schemes were provided through life insurance companies.

Superannuation changed significantly with the 1985 Prices and Incomes Accord, agreed between the Australian Government and the Australian Council of Trade Unions. Under the Accord, wage increases would be traded off for a 3 per cent employer superannuation contribution from 1986. This was implemented through industrial awards, set by the then Conciliation and Arbitration Commission. It saw the extension of superannuation coverage to most employees covered by awards.

At this point, specific superannuation funds started to be named in awards as part of workplace relations processes. Several industry-based funds were established as not-for-profit entities to cater for employees in specific industries.

The modern system began with the introduction of the Superannuation Guarantee (SG) in 1992, which extended superannuation coverage to more employees. The SG rate was originally set at 3 per cent of earnings and has increased gradually to its current level of 9.5 per cent (and scheduled to rise further to 12 per cent in 2025). At the time the SG was introduced, the broad objectives were to provide an adequate level of retirement income, relieve pressure on the Age Pension, and increase national savings.

Since 2005, most employees have been able to choose their superannuation fund and (in effect) the product to which they want their contributions directed. Where employees have not made a choice, the funds named in awards have become the default option in many cases.

Sources: PC (2012, 2016a); Swoboda (2014); Treasury (2001, 2013); Weaven (2016).

Little is known with certainty about future labour markets and how these might shape people's retirement savings choices. It is not clear that people will face degrees of job interruption much greater than those evident now. For about the past decade, Australian labour markets have shown few changes in trends to contracting rates or job tenure despite significant technological change. Nevertheless, each year about one in every 12 employees change their employer. And when they do, there appears to be a higher tendency than in the past for employees to change industries (now more than half) or occupations (now close to half) (figure 1.8) — which, absent further policy change, will inevitably entail unintended multiple super accounts. And the incidence of workers holding multiple jobs has also seen a more than material uptick.

Nevertheless, the past is not necessarily a guide to future labour market conditions. Some expansion of the gig economy will occur, and even if digital disruption does not have net displacement effects, it could increase shifts of people between businesses, occupations and industries — which again reinforces the need to avoid the balance erosion that arises with multiple accounts. Moreover, people will face greater uncertainty about their likely future retirement balances, which will require more retirement income planning and engagement with super funds.

The likelihood that fewer people will be able to own their own dwellings also means that retirement asset portfolios will look quite different from today, with a reduced weighting on equity in people's own homes. While home ownership rates among older age groups have been steady over recent decades, rates for younger age groups have been steadily declining (Hall 2017). People may increasingly have to consider lifetime savings from outside the prism of just buying a house and compulsory super.

As superannuation becomes a more prominent component of national savings it will also play a growing role in intergenerational wealth transfer and wealth inequality. Compulsory super is one reason why wealth inequality is lower in Australia than in most other developed countries (PC 2018c).

At inception of the Superannuation Guarantee, the technologies for managing super accounts, communicating with members and achieving compliance with businesses' legal obligations were primitive by contemporary standards. Statements were paper based and neither the internet nor smart phones existed as avenues for member interaction. Although computers were used to manage accounts, the capacity to use data for product development and advice was limited, especially in the retirement phase. Testing compliance by small business with the requirements of the Superannuation Guarantee was costly. A modern super system can take advantage of technological developments and internet diffusion to streamline compliance processes. It can also give better opportunities for employees, not employers and employee representatives, to be the most active parties in decision making.

1.2 What does this inquiry cover?

There is little precedent in Australia and internationally for reviewing the efficiency and competitiveness of a superannuation or pension system in its totality. The broader efficiency and system-wide perspectives are unique to this inquiry and make it a challenging task.

Australia's system has been compared with its peers overseas on many occasions. Prominent examples include the Melbourne Mercer Global Pension Index and Allianz Pension Sustainability Index (PC 2016a). Both of these rank Australia very highly and have been used by some inquiry participants to claim that Australia's system is already performing at a high standard. However, such indexes focus mainly on the adequacy and sustainability of retirement incomes (which are mostly a function of policy settings), and shed little light on the performance (value-add) of superannuation funds and their trustee boards in delivering member outcomes (box 1.5).

Indeed, and perplexingly so, some continued to suggest in post draft report submissions to the Commission that the system is overall in good shape. For example, the Association of Superannuation funds of Australia submitted that:

... [I]t needs to be acknowledged that the Australian superannuation system is not broken, and is in fact a world-class private pension system. It is part of a broader retirement income system that is independently ranked as one of the best globally (behind only the Netherlands and Denmark) in terms of sustainability, adequacy and integrity. ... Australia's superannuation system is a success by any measure. (ASFA, sub. DR148, pp. 3–4)

Box 1.5 The Melbourne Mercer Global Pension Index

Several inquiry participants pointed to Australia's rank on the Melbourne Mercer index (now fourth, after the Netherlands, Denmark and Finland) as evidence that the superannuation system has delivered world-class outcomes (AIST, sub. DR130; ASFA, sub. DR148; HESTA, sub. 70; Qantas Super, sub. DR137). Some argued that the index shows that the best performing pension systems around the world are industrially based (for example, Cbus, sub. 58, ISA, subs. 5 and DR162).

However, these indexes predominantly consist of measures of the adequacy and sustainability of retirement income systems. In the case of the Melbourne Mercer index, this includes retirement ages, workforce participation and savings rates, which are heavily influenced by government policy, especially in Australia where private saving is compelled by the Superannuation Guarantee (ACFS 2018). The index also contains many factors more directly controlled by the Australian Government, including Age Pension eligibility and levels, mandatory income streams in retirement, and governance regulations on pension funds.

The efficiency and competitiveness of the non-government parts of retirement income systems feature in only a minor way in the Melbourne Mercer Index, such as concentration of assets in the largest providers (economies of scale), and exposure to growth assets and long-term net returns at a system level. These are intended as proxy measures for costs and investment returns respectively, which do not directly feature in the index.

The terms of reference for this inquiry request the Commission to base its assessment on the framework developed in stage 1. This framework for assessing efficiency and competitiveness was developed through extensive consultation with participants, including through meetings, submissions and roundtables, and was broadly supported by participants and international observers. It was also framed in terms of the overarching purpose of superannuation ‘to provide income in retirement to substitute or supplement the Age Pension’, as proposed by the Financial System Inquiry (Murray et al. 2014, p. 95).

The framework (table 1.1) is comprehensive and comprises three elements:

- five system-level objectives that are within the scope of influence of the super system and specific to the principles of efficiency and competitiveness
- 22 assessment criteria, linked to the objectives, that reflect attributes that a competitive and efficient super system would be expected to have
- 89 unique indicators that set out specific and measurable aspects of the system’s performance.

The framework has been designed from the perspective of members’ best interests. It spans the accumulation, transition and retirement phases of super, as well as the default, choice, self-managed and corporate fund segments, as required by the terms of reference. Defined benefit funds — as well as State and Territory Government funds exempt from regulation by APRA — are not out of scope, but are not a key focus of the assessment. In the case of defined benefit funds, as noted in stage 1, this is largely because these funds are collectively small and declining (outside the public sector), investment risk does not reside with members, and many aspects of competitiveness do not apply because accounts are not portable (PC 2016a). In addition, regulators and research firms publish only limited data on the performance of these funds.

The system-level objectives and criteria collectively form the questions that this inquiry has asked and answered. The indicators reflect the evidence base the Commission has drawn on to evaluate each criterion. Some indicators are quantitative, whereas others are more qualitative. Most have been benchmarked in some way, whether against others, against stipulated objectives, or over time.

The Commission’s analysis (and ultimately whether the system-level objectives are being met) requires interpretation of the available evidence base (including the indicators) and judgment. Most indicators cannot be interpreted in isolation — to do so would inevitably result in ambiguity. Others cannot support robust conclusions in isolation, due to problems of data quality or availability. And in some areas the Commission has drawn on broader forms of evidence than just the indicators, where this offers insights into system performance and the interpretation of indicators. The overall assessment — and the findings and recommendations that flow from it — is thus based on a collective interpretation of the indicators and evidence.

Table 1.1 System-level objectives and assessment criteria

<i>Assessment criteria</i>		<i>Number of indicators^a</i>
System-level objective #1: The superannuation system contributes to retirement incomes by maximising long-term net returns on member contributions and balances over the member's lifetime, taking risk into account		
E1	Are long-term net investment returns being maximised over members' lifetimes, taking account of risk?	4
E2	Are costs incurred by funds and fees charged to members being minimised, taking account of service features provided to members?	10
E3	Do all types of funds have opportunities to invest efficiently in upstream capital markets?	4
E4	Is the system effectively managing tax for members, including in transition?	3
E5	Are other leakages from members' accounts being minimised?	5
System-level objective #2: The superannuation system meets member needs, in relation to information, products and risk management, over the member's lifetime		
E6	Is the system providing high-quality information and intrafund financial advice to help members make decisions?	7
E7	Is the system providing products to help members manage risks over their life cycles and optimally consume their retirement incomes?	7
E8	Are principal-agent problems being minimised?	7
System-level objective #3: The efficiency of the superannuation system improves over time		
E9	Does the system overcome impediments to improving long-term outcomes for members?	6
E10	Are there material systemic risks in the superannuation system?	3
System-level objective #4: The superannuation system provides value for money insurance cover without unduly eroding member balances		
E11	Do funds offer value for money insurance products to members?	10
E12	Are the costs of insurance being minimised for the level and quality of cover?	7
System-level objective #5: Competition in the superannuation system should drive efficient outcomes for members		
<i>Market structure</i>		
C1	Is there informed member engagement?	8
C2	Are active members and member intermediaries able to exert material competitive pressure?	7
C3	Is the market structure conducive to rivalry?	2
C4	Is the market contestable at the retail level?	3
C5	Are there material anticompetitive effects of vertical and horizontal integration?	6
<i>Conduct and outcomes</i>		
C6	Do funds compete on costs/price?	6
C7	Are economies of scale realised and the benefits passed through to members?	5
C8	Do funds compete on member-relevant non-price dimensions?	5
C9	Is there innovation and quality improvement in the system?	3
C10	Are outcomes improving at the system level?	2

^a Many indicators are used multiple times. In total there are 89 unique indicators.

Source: PC (2016a, p. 10).

The assessment framework was designed in stage 1 to reflect factors that are within the control of the system. This meant that overarching policy settings were taken as given. However, this inquiry includes evaluation of the extent to which there are material policy or

regulatory impediments that constrain system performance, and uses this to inform its recommendations.

Moreover, the terms of reference set out specific policy areas that are to be considered by the inquiry. These include:

- costs, fees and returns — whether additional disclosure would improve outcomes for members, and what actions could be taken to ensure that low member balances are not needlessly eroded
- default fund members — whether policy changes to current default settings would be desirable, including whether an alternative allocation model would deliver net benefits
- insurance in super — the impact of insurance on retirement incomes and costs to governments (through social security payments), and whether policy changes could improve default insurance cover.

Finally, there are a large number of policy initiatives that have recently been announced, both by the Government and industry bodies (box 1.6). Some of these are in the process of being implemented. In undertaking its assessment and developing recommendations, the Commission has endeavoured to take this constantly evolving backdrop into account.

What was out of scope?

There are no league tables of individual funds in this report. The task is a system-wide assessment, with the overarching focus on how the system is performing for *members*. The Commission's analysis has, at times, examined the performance of specific segments of the super system — such as the default, SMSF and retirement segments — where this has meaningfully informed the inquiry task.

On the whole, factors beyond the system's control are also largely (but not entirely) out of scope. Among other things, these include overarching policy settings such as the Superannuation Guarantee rate and earnings threshold, the Age Pension level and eligibility requirements, taxation arrangements and government compensation schemes. This inquiry is not looking at the adequacy of retirement incomes or the impact of superannuation on national savings and equity. Those are the policy questions that ought be asked and answered before further increasing the Superannuation Guarantee rate.

As complaints handling has recently been reviewed, the Commission has drawn on the findings of that inquiry without undertaking further analysis of its own (Ramsay, Abramson and Kirkland 2017).

This inquiry has assessed how well current arrangements for insurance within super are working for members. However, it has not tackled the broader policy issue of whether insurance *should* continue to be bundled with super. That is an inquiry in itself, and would (amongst other things) need to analyse what the extent and form of underinsurance in Australia would be in the absence of government intervention, as well as the most effective

form of any intervention. In keeping with the terms of reference, the Commission has focused on how the current policy of providing insurance in super could be improved from a member's perspective.

Box 1.6 Policy initiatives already underway

Australian Government measures

In the 2018-19 budget, the Government announced the 'Protecting Your Super' package of legislative reforms. This package, which is still before Parliament, includes:

- a cap on annual fees of 3 per cent of balances for accounts with \$6000 or less
- a ban on exit fees
- a requirement to only offer insurance on an opt-in basis for new members aged under 25, and for all accounts below \$6000 or that have not received contributions for at least 13 months
- a requirement for all inactive accounts below \$6000 to be transferred to the Australian Taxation Office, which will be given powers to reunite these accounts with members.

These supplement other reforms announced in 2017 which have yet to be legislated, including a MySuper 'outcomes test', a directions power for APRA, a 'design and distribution obligation' for financial products, and a product intervention power for ASIC.

Since 2016, the Government has been developing requirements for trustees to offer a 'Comprehensive Income Product for Retirement' to members when they retire. This is to be introduced via a Retirement Income Covenant that compels trustees to consider the retirement income needs and preferences of their members. It was recently delayed to 2022.

Australian Securities and Investments Commission (ASIC)

ASIC is in the process of introducing requirements for improved disclosure of superannuation fees and charges in product disclosure statements. These requirements (known as Regulatory Guide 97) are intended to improve consistency across the industry and reduce under-reporting. They have been subject to several implementation delays, and were recently subjected to external review. The requirements are currently scheduled to be fully in place by 30 September 2019.

ASIC has also developed requirements for funds to provide consumers with information on the performance and costs of choice products in a simple format (known as product dashboards), as well as to disclose their total portfolio holdings. These were both scheduled to apply from 2017, but were recently extended to 1 July 2019 and 31 December 2019, respectively.

Insurance in Superannuation Working Group

In December 2017, the Insurance in Superannuation Working Group (comprising industry peak bodies that collectively represent the majority of Australia's superannuation funds) released a Voluntary Code of Practice. Under this code, trustees must assess the appropriateness and affordability of insurance cover for different segments of their membership when designing insurance benefits, must limit premiums to 1 per cent of estimated average salary, and must cease automatic insurance on inactive accounts (although only on low balance accounts in the case of life and disability insurance).

The Code commenced on 1 July 2018, and funds have until 30 June 2021 to fully comply. The code is to be independently reviewed no later than every three years.

Sources: ASIC (2017a, 2017g, 2018j); ISWG (2017); O'Dwyer (2017a); Treasury (2018c, 2018e).

In undertaking this inquiry, the Commission sought to avoid overlap with its inquiry into *Competition in the Australian Financial System*, which was completed in August 2018. While there are many and varied linkages between the super system and the broader financial system, some relevant elements of the assessment were covered in the other inquiry and are not duplicated here. The notable exception is financial advice, which is also covered in this inquiry (in relation to superannuation).

Further, the Government initiated the Financial Services Royal Commission (FSRC) in December 2017, which has mostly run in parallel with this inquiry. Subsequent to the release of the Productivity Commission's draft report, the FSRC held hearings on superannuation in August 2018. This was followed by an interim report in September (which did not directly cover superannuation) and a round of policy hearings in November (with some coverage of superannuation). The FSRC's final report is expected to be completed by February 2019, after this Productivity Commission report has been provided to Government.

While the FSRC is focused mainly on past misconduct, the Productivity Commission's inquiry is focused mainly on member outcomes across the super system and ways to strengthen competitiveness and efficiency (and thus overall performance) in future. But many areas of overlap have inevitably arisen, especially in areas such as fund governance, the roles of regulators, insurance in superannuation and financial advice. In undertaking this inquiry, the Productivity Commission has benefited from and drawn on (inquiry-pertinent) evidence presented at the FSRC, and sought as far as possible not to pre-empt the findings of that Commission.

The Commission's approach

In keeping with the *Productivity Commission Act 1998* (Cth), the Commission has conducted this inquiry using transparent and public processes, with an overarching concern for the wellbeing of the Australian community as a whole. In the superannuation context, this means consistently focusing on outcomes for members.

As part of the stage 3 inquiry, the Commission published an issues paper in July 2017, and has received 100 submissions in response. Over 40 meetings were held with key stakeholders and relevant experts prior to the draft report, as were two roundtables, one on economies of scale (in September 2017) and one on the funds survey (in October 2017). Following the release of the draft report in May 2018, a further 132 submissions were received and a round of public hearings conducted. The Commission also published a series of three supplementary papers (on investment performance, economies of scale and the fiscal costs of insurance), and held two further roundtables, on the products and advice needs of retirees (in August 2018) and on economies of scale (in October 2018).

This inquiry has also drawn on a significant amount of prior consultation across stages 1 and 2. This encompasses 217 submissions, four technical roundtables and meetings with over 80 parties in both Australia and overseas, including industry bodies, specialist firms,

individual super funds, academics and government officials. It also includes public hearings conducted in May 2017 after the release of the stage 2 inquiry draft report.

Further, the Commission invited brief comments through its website. A wide diversity of individuals shared their views and concerns in this way, with many focusing on personal experiences in dealing with super funds on account consolidation, insurance, fees and complaints handling. These comments have been published on the Commission's website. The comments provided important context for the recommendations.

In developing this report, the Commission has examined all assessment criteria and indicators for which evidence is available. As far as possible, this has involved drawing on existing data. The bulk of data were already in the public domain, or held by regulators or research firms (as noted in the stage 1 study). The Commission entered into contractual arrangements with several research firms to obtain data. Some of the data provided by regulators are confidential, and thus are only being reported in the aggregate.

However, new evidence was required in some areas, especially in relation to members' outcomes and needs. Most existing datasets — including those compiled by regulators — are oriented around funds and products. This reflects that much of the regulation and oversight of the system is focused on the supply side. The evidence base for members, on the demand side, is comparatively sparse. To give one example, there are no official datasets of the distribution of total balances across members (aside from some one-off surveys).

To address data gaps, the Commission ran five surveys, four before the draft report and a further survey after the draft report. As part of the stage 2 inquiry, an experimental survey that focused on member choice was conducted. For this stage 3 inquiry, the Commission conducted a survey of members (to better understand their experiences with the system), a survey of super funds (to gather data on fund inputs, operations and behaviour) and a survey of fund chief executive officers (CEOs) on fund governance (figure 1.9; box 1.7). Following release of the draft report, a 'second chance' supplementary funds survey was conducted to give funds another opportunity to provide key data (on investment returns, costs and related parties) that were not forthcoming from many funds the first time.

The surveys focused on relevant evidence gaps for the inquiry, and were designed to minimise the compliance burden on participants. The results have been de-identified to protect the confidentiality of respondents.

The response rate to the initial funds survey was disappointing in terms of fund numbers (albeit it had overall high coverage in terms of assets and member accounts for most questions), but this materially improved for the post-draft report funds survey. A higher response rate was achieved for the governance survey, and a diverse range of Australians completed the two members surveys. The Commission thanks participants in all five surveys for their input.

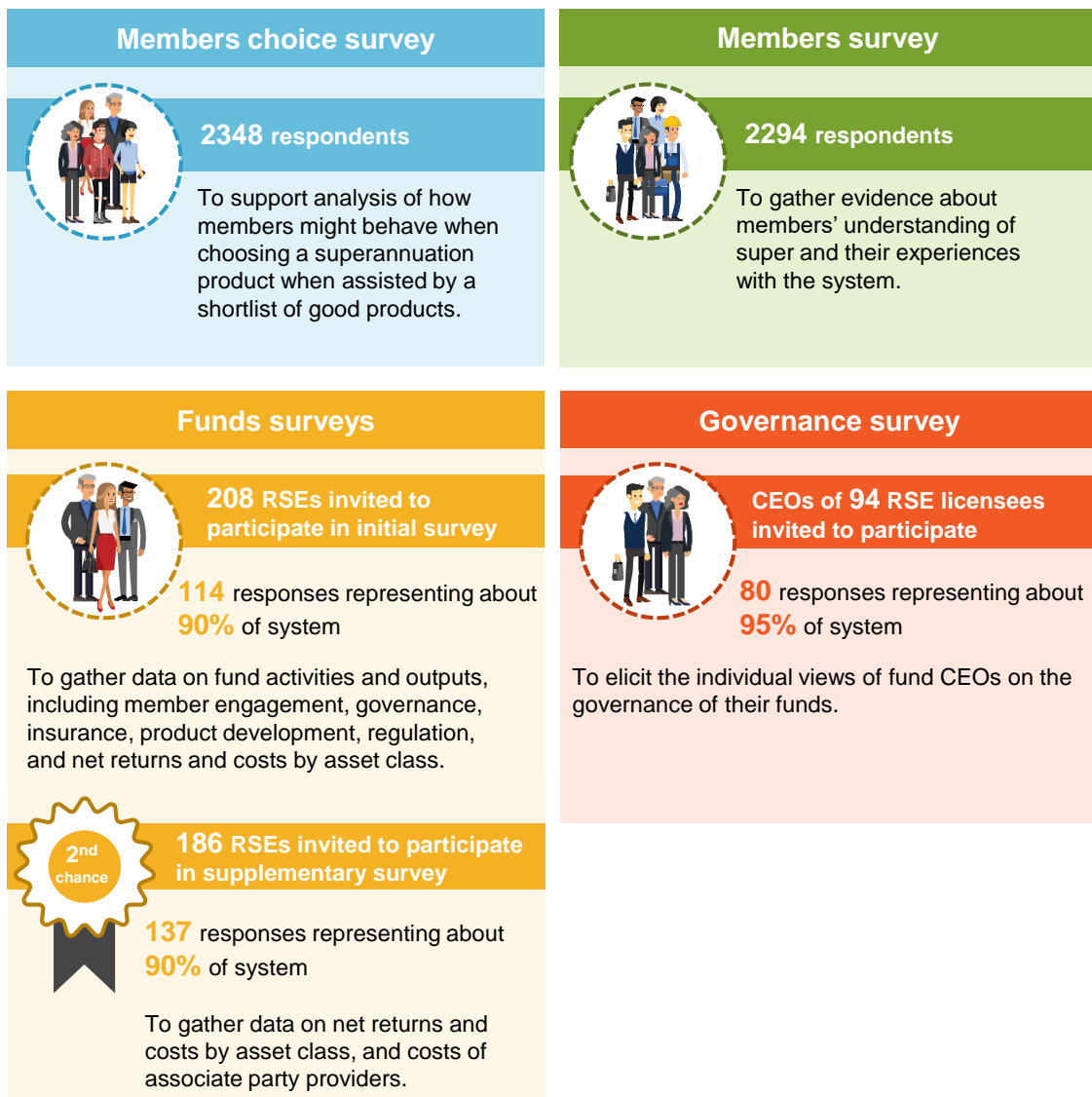
To provide further insight into the impact of fees, returns, multiple accounts and insurance policies, the Commission has also developed a series of 'cameos' (box 1.8). These are

illustrative calculations, based on a range of assumptions, that quantify how various factors can affect a member’s balance at retirement (such as multiple accounts, poor returns, high fees and high insurance premiums). In all cases, these factors compound over a member’s lifetime.

Appendix A includes a list of all inquiry participants and submissions (including for the stage 2 inquiry), and a list of (non-member) survey recipients and respondents. Appendix B outlines the data sources used, and appendix C provides further detail on the surveys.

During the course of the inquiry, the Commission advised the Government of the need to extend the timeframes for both the draft and final reports for reasons outside the Commission’s control.

Figure 1.9 The five surveys to address data gaps



Box 1.7 The five surveys

Five online surveys were undertaken by the Commission as part of this inquiry. Appendix C provides further details about each survey. Summary statistics and supporting results are available as technical supplements on the Commission's website.

Members choice survey (stage 2)

As part of its work on alternative default allocation models, the Commission undertook an experimental choice survey of member behaviour. Respondents were surveyed on their past and present experiences and attitudes towards superannuation, and also asked to complete some experimental tasks to enable the Commission to better understand how members make their decisions. The survey was primarily designed to gather evidence relevant to understanding how people would likely behave if they had to choose a superannuation fund without any assistance (unassisted choice), as well as in the presence of a shortlist of superannuation products (assisted choice). The survey was designed and conducted by Insight Analytics, in conjunction with a third-party panel provider.

Members survey

The members survey gathered new evidence to better understand members' experiences with the superannuation system. Among other things, the questions covered superannuation and insurance literacy; retirement; satisfaction, member services and information on funds; use of advisers, account monitoring, intrafund advice and beneficiary nominations; changing and claiming on insurance; fund and product switching; and financial literacy. The survey was conducted by Roy Morgan Research between 28 September and 20 October 2017. The final survey data have been weighted to be more representative of the broader population.

Funds survey

The funds survey gathered data on a range of fund activities and outputs, including general information about each fund, member engagement, governance, insurance, market contestability, fund activity and product development, regulation, and net returns and fees by asset class. The survey was conducted by Roy Morgan Research between 18 September and 22 December 2017.

'Second chance' funds survey

The supplementary ('second chance') survey gave funds a further opportunity to provide key data on net returns and fees by asset class, as well as on the share of expenses to associated and non-associated parties. The questions were similar to a narrower cohort of questions in the first survey for which the fund response rate was inadequate such that it substantively constrained the Commission's analysis. The survey was conducted by the Commission itself following release of the draft report, between 5 and 27 June 2018.

Governance survey

The governance survey was designed to elicit the personal views of fund CEOs on the governance of the funds for which they are responsible. It was based on a longstanding international survey on fund governance (Ambachtsheer, Capelle and Lum 2008), with several additional questions to address the evidence needs of this inquiry. Broad areas covered by the survey comprised general information about the respondent and the structure of the trustee board, as well as subjective questions concerning governance quality and challenges faced by the board. The survey was conducted by the Commission itself between 4 December 2017 and 15 January 2018.

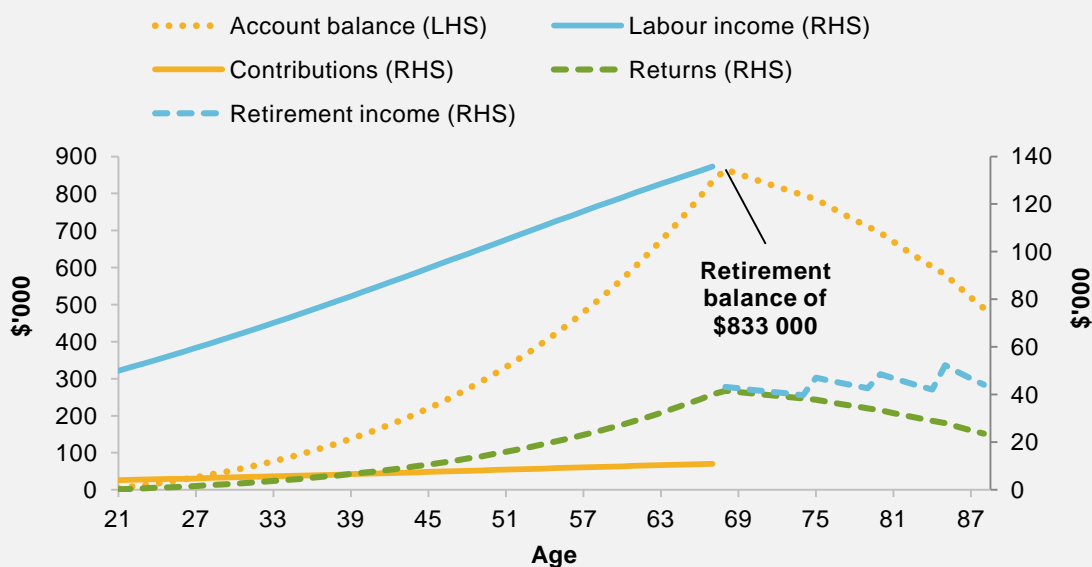
Box 1.8 The Commission's cameos

The Commission developed a cameo model to simulate the effect of changes in different variables on a hypothetical member's superannuation balance, either at or during retirement.

The model is premised on a representative member who enters the superannuation system at age 21, retires at age 67 and dies at age 88. The member starts with an annual salary of \$50 000, which grows over time due to economy-wide labour productivity growth (1.5 per cent a year, consistent with Treasury and Reserve Bank analysis), and an experience curve (that increases at a decreasing rate, based on previous Commission analysis). Superannuation contributions are 9.5 per cent of income (taxed at 15 per cent). In retirement, the member draws down their balance at the minimum required rates.

In the base case, the member's fund delivers an after-tax (but before fees) investment return of 5 per cent a year (adjusted for inflation), consistent with OECD analysis. Investment fees are 0.82 per cent of the account balance in accumulation and 0.87 per cent in retirement, and administration fees are \$69 per year in accumulation (plus 0.16 per cent of balance) and \$64 per year (plus 0.32 per cent of balance) in retirement. These values are based on APRA MySuper and SuperRatings data. The member is also charged 'light blue collar' death and disability insurance premiums, which vary by age (calibrated from Rice Warner data) and average \$340 a year over the member's lifetime.

The figure below shows how these parameters evolve over time in the base case. The cameos throughout this draft report model divergences in selected parameters.



Sources: APRA (2018j); ATO (2016c); D'Arcy and Gustafsson (2012) Forbes et. al. (2010); OECD (2015); PC (2016b); Treasury (2015); PC analysis of SuperRatings and Rice Warner data.

The default allocation mechanism

The stage 2 inquiry on alternative competitive models to allocate default members to products commenced in September 2016. The intention of that inquiry was to develop

workable alternative models for the Government’s consideration, and to be an input to this current inquiry.

In the context of issuing the terms of reference for stage 3, the Treasurer agreed with the Commission’s request (itself reflecting the overwhelming preference of inquiry participants) that the stage 2 work be incorporated into and finalised as part of the broader review of the efficiency and competitiveness of the super system. As a result, no standalone final inquiry report was issued for stage 2. Instead, final advice on alternative default models has been included in this final report for the stage 3 inquiry.

This stage 3 inquiry has assessed the default segment in two ways. First, the efficiency and competitiveness of the default segment as a whole — as it currently stands — has been assessed throughout this report. This is because the default segment (with half of member accounts) is a major part of the system and represents those members who have not exercised an active choice (about two-thirds of people default when starting a new job). This reality, coupled with the compulsory nature of super in Australia, suggests that the performance of default super should be held to a high standard — the system exemplar — for member outcomes. The default segment also cuts across many of the criteria and indicators.

Second, there is an assessment of the current default allocation model, both as it stands in practice and as currently legislated (but not fully implemented). This is done with reference to the criteria for assessing alternative models set out in the stage 2 inquiry draft report (member benefits, competition, integrity, stability and system-wide costs).

This further assessment serves the purpose of allowing the Commission’s alternative models to be compared with the existing model, and to make recommendations on policy changes. In making such recommendations, transitional costs and options have also been considered.

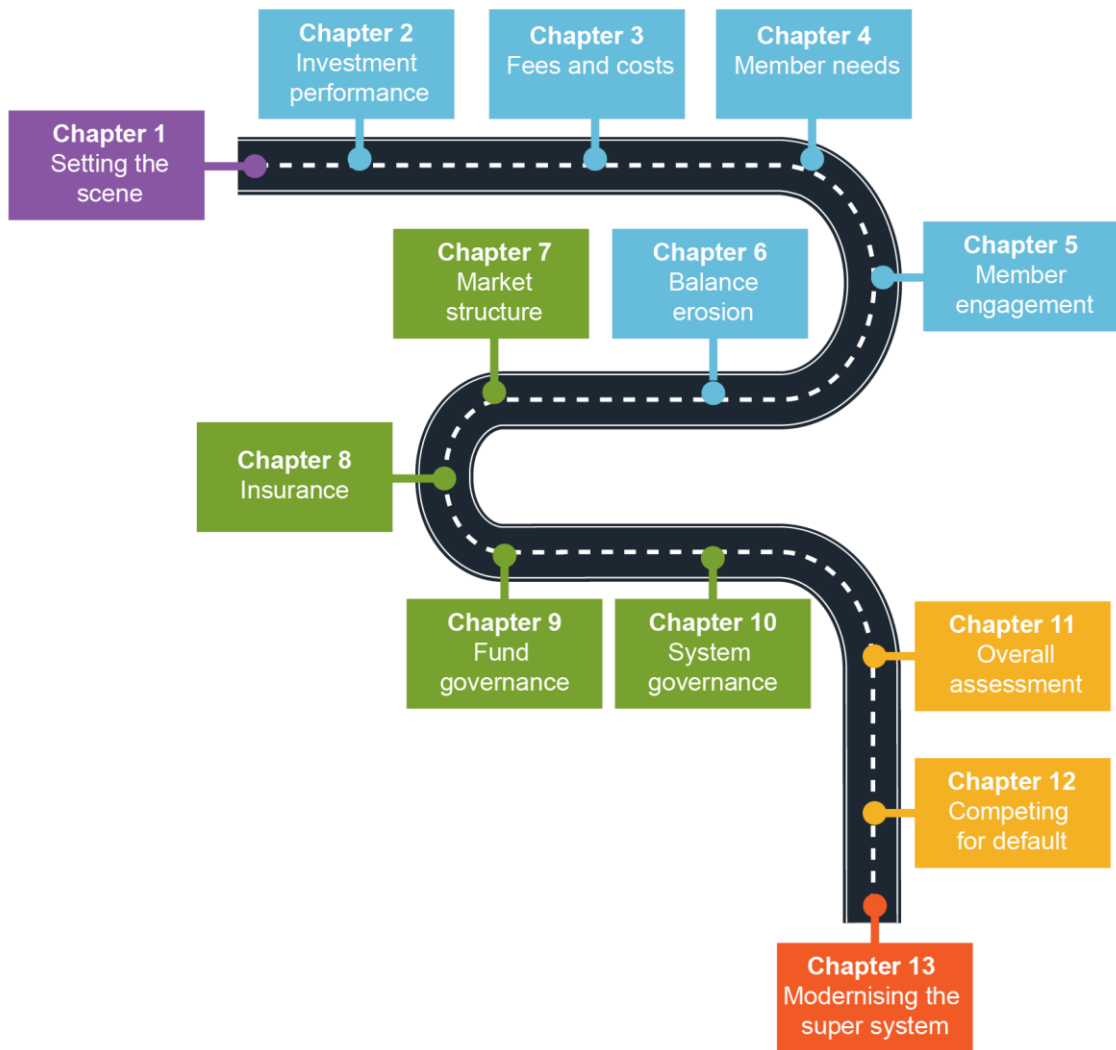
1.3 How is this report organised?

The remaining chapters in this report collectively provide the assessment against the criteria and indicators, with the results of the analysis presented as findings that are both material and policy relevant.

Figure 1.10 shows the roadmap for the report. The following five chapters (2 to 6) provide an overview of the system’s performance, with a focus on its outputs and outcomes. The subsequent four chapters (7 to 10) look more closely at market structure, insurance, fund governance and the regulators. Chapter 11 provides a summary against the assessment framework, then the default chapter (12) looks at policy options for default allocation. The final chapter (13) sets out recommendations for modernising the system to make it work better for all members.

The chapters of this report are supported by a suite of appendixes that explain how the Commission has sourced, analysed and applied data to its assessment. Additional technical material is also available on the Commission’s website in the form of technical supplements.

Figure 1.10 Superannuation system inquiry: report roadmap



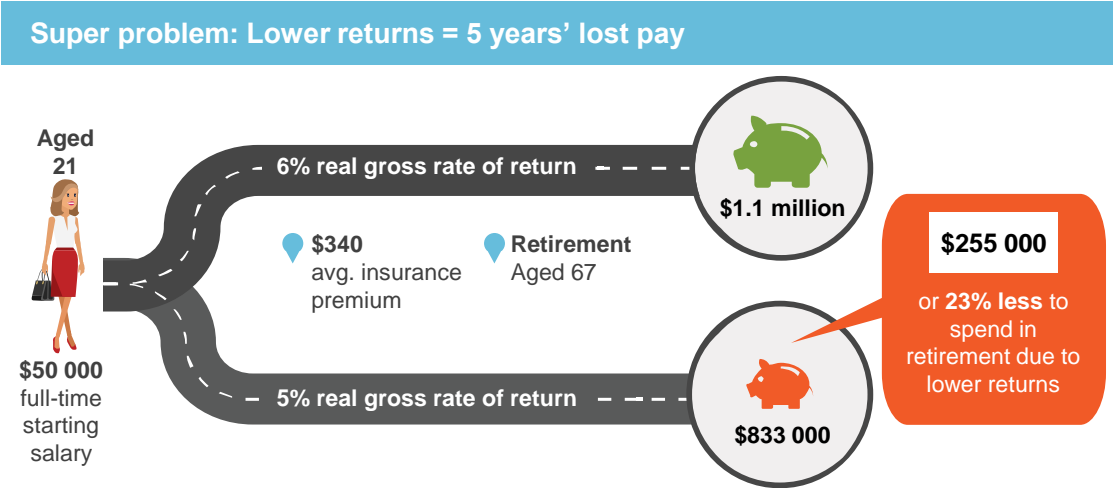
2 Investment performance

Key points

- Net returns are critical to members' retirement incomes. The Commission has assessed the system's long-term performance relative to benchmark portfolios that control for asset allocation. In constructing these benchmarks, the Commission has erred towards giving funds the 'benefit of the doubt' (given data limitations).
- Overall, the system has delivered mixed investment performance for members.
 - Over the 13 years to 2017, APRA-regulated funds delivered net returns of about 6.1 per cent a year on average. Over the same period, the default segment generated higher returns, of 7.3 per cent a year.
 - The retail segment delivered returns below benchmarks and significantly below the not-for-profit segment. There is an almost 2 percentage point gap in net returns between the segments that cannot be explained by differences in asset allocation, reported expenses or tax — and is most likely primarily due to asset selection (within asset classes).
- The Commission gathered survey data on net returns by asset class. The data are positively biased by missing data for funds that have exited the system or did not provide the data.
 - Nevertheless, the data suggest that, on average, responding funds performed above market indexes across individual asset classes, and that not-for-profit funds performed better than retail funds.
 - Funds responding to the survey also appear to have performed comparably to large pension funds in other countries, albeit such comparisons are difficult.
- Investment performance varies widely across funds and products, and this variation in performance best captures the real experience of members. Many members, in choice as well as default, could be doing a lot better.
- Over the 13 years to 2017, 29 funds (with 5 million member accounts) underperformed a benchmark tailored to their own asset allocation by more than 0.25 percentage points. Top performers were typically (but not always) larger, not-for-profit funds.
- Seventeen of today's MySuper products — that can be tracked back over 11 years — underperformed a benchmark tailored to their own asset allocation. These products represent 11 per cent (\$57 billion) of MySuper assets and 14 per cent (1.6 million) of member accounts in the sample. There is a material gap between top and bottom performers.
 - A member entering the system today into the median bottom-quartile MySuper product is projected to retire with 45 per cent less (\$502 000) in retirement than if they entered one in the median top-quartile product.
- While product heterogeneity in the choice segment makes product-level comparisons challenging, there is revealing evidence of material underperformance within this segment.
- The SMSF segment has delivered broadly comparable returns to the APRA-regulated segment, but SMSFs with balances under \$500 000 have materially lower returns than larger SMSFs on average.

Delivering investment returns to members (net of all fees and taxes) is the most important way the system contributes to delivering the best possible retirement incomes. Persistently below par returns can lead to large foregone retirement balances. For example, the difference between a 5 and 6 per cent return¹ can amount to a projected 23 per cent (\$255 000) difference in retirement balances for a typical full-time worker (cameo 2.1).

Cameo 2.1 A small difference in returns matters a lot^a



^a The assumptions underpinning this cameo are set out in chapter 1.

An assessment of whether the system is maximising long-term net returns to members is the key indicator of system efficiency. It also provides insights into whether and how competition in the system is promoting the best outcomes for members. For example, a wide dispersion of returns in default products could suggest insufficient competitive pressure.

Research and commentary often focus on a sub-sample of products within the system (such as ‘balanced’ or ‘growth’ products), but all too often are limited by the available data. The Commission’s analysis, while also limited by data, affords a view across the investment performance of the system as a whole.

To assess investment performance, the Commission has constructed a series of portfolios to benchmark the system and its segments. These are constructed using data on market returns across varying asset classes, and take account of differences in asset allocation within the superannuation system and across time. This approach aims to overcome the perennial ‘comparing apples and oranges’ adage levelled at previous analyses before this inquiry (section 2.1).

The assessment is not an exact science, but performance that exceeds the benchmark (on average over time) is likely to reflect good outcomes being delivered to members.

¹ In this chapter, returns are always annual rates of return, unless otherwise specified.

Conversely, performance that resides below the benchmark (on average over time) is likely to reflect that the system is not delivering competitive or efficient outcomes. And the results in this chapter need to be considered alongside other assessments (as brought together in chapter 11), because past returns can never be a perfect predictor of future returns.

With regards to the Commission's stage 1 framework (PC 2016a), the following criterion is assessed in this chapter.

- Are long-term net investment returns being maximised over members' lifetimes, taking account of risk? (E1)

This chapter starts with an overview of how the assessment is being conducted (section 2.1). It then examines performance at a system level (section 2.2), by product type and asset class (section 2.3), and by the main segments of the system (section 2.4). As system and segment averages can mask dispersion of outcomes, section 2.5 analyses the distribution of performance by funds and products. Section 2.6 analyses the performance of self-managed superannuation funds (SMSFs).

2.1 How is the system being assessed?

A focus on returns delivered to members (controlling for risk)

The Commission's overriding focus is on member outcomes. The most relevant outcome for members is the returns they receive after taxes and fees. In most cases, the analysis in this chapter is net of both investment and administration fees, and of taxes (although alternative approaches are taken where data limitations necessitate). Insurance premiums are considered separately in chapter 8.

In most cases, returns are calculated as a geometric average (to take account of compounding returns over time), in line with the approach used by the Australian Prudential Regulation Authority (APRA) and others. Average returns (across funds or products) are weighted by total assets, meaning larger funds have a larger impact on segment- and system-level performance. This is to reflect the average outcome realised by a member in the system.

The Commission is accounting for risk in two ways. First, and primarily, by controlling for differences in asset allocation across parts of the superannuation system, and across time. Second, returns are being benchmarked over the long term, meaning that a lot of short-term volatility is expected to 'wash out', in that a long-term net return will embed the impacts of diversification and average market volatility, and thus also be a risk-adjusted return. A separate analysis of volatility is also provided in technical supplement (tech. supp. 4).

In the stage 1 study, the Commission flagged that the returns analysis would be done over 5, 10 and 20 year periods. The Commission has been limited by the time series of data available, and has sought to use the longest time spans for which comparable returns data exist and for which benchmark portfolios can be constructed — in most cases, 13 years.

This chapter contains analyses that have been updated since the draft report, and incorporates analyses presented in the supplementary paper on investment performance that the Commission published following release of the draft report. The analysis has benefited from much participant input — by way of two technical workshops during the stage 1 study, consultation with industry experts, and public submissions on the draft report and the subsequent supplementary paper. The Commission has listened to the feedback it has received on its work and drawn on that feedback to refine the analysis presented in this final inquiry report. Full details of all changes adopted are outlined in technical supplement 4.

Benchmark portfolios provide insights into system efficiency

The analysis primarily consists of comparing long-term investment performance to a series of benchmark portfolios (PC 2016a). These portfolios are weighted averages of financial market indexes, with the weights determined by the asset allocation of the unit under analysis.

Figure 2.1 shows the two benchmark portfolios (BPs) used in this chapter: BP1 (a benchmark portfolio based on listed assets) and BP2 (a benchmark portfolio which is based on a blend of listed and unlisted assets). Box 2.1 sets out the key inputs and assumptions behind them. The Commission has endeavoured to be transparent and conservative in making assumptions, implementing the methodology and interpreting the analysis — affording funds the ‘benefit of the doubt’.

Figure 2.1 **Benchmark portfolios used in this chapter**

Level of analysis	System	Segment	Fund	Product/Option
Benchmarks	BP1 (listed)	BP1 (listed)		BP1 (listed) (choice)
	BP2 (blended)	BP2 (blended)	BP2 (blended)	BP2 (blended) (MySuper)

Since the draft report, the Commission has also used the BPs to help ‘decompose’ performance at the system, segment, fund and product (investment option) levels (box 2.2). The analysis decomposes net returns into several measured factors — asset allocation, tax and expenses — to attribute drivers of differences in investment performance, over the long term and relative to benchmark portfolios.² Importantly, this decomposition analysis starts with benchmarks that are *gross* of tax and expenses, rather than *net* of these factors (as used for the main benchmarking of net returns throughout this chapter). This is to allow for separate consideration of how the actual expenses and tax paid impact on the net returns that members receive.

² These decompositions use arithmetic (rather than geometric) annualised average returns for tractability.

Box 2.1 The benchmark portfolios explained

What are benchmark portfolios?

Benchmark portfolios (sometimes known as reference portfolios) provide the primary counterfactual used in the Commission's analysis to evaluate investment performance. They aim to account for many influences on investment markets which are beyond funds' control, while providing insights into the value added by funds for members.

The benchmark portfolios are weighted averages of financial market indexes, with the weights determined by asset allocation and indexes chosen as representative of their corresponding asset classes. The Commission has used index data from several providers, including Bloomberg, FTSE Russell, MSCI and S&P.

Two types of benchmark portfolios (BPs) were constructed:

- a listed benchmark portfolio (**BP1**) that captures investment performance (net of fees and taxes) of a set of investment strategies across a range of listed asset classes
- a blended benchmark portfolio (**BP2**) that captures investment performance (net of fees and taxes) of a set of investment strategies across a range of listed and unlisted asset classes that more closely represents how funds implement their asset allocation.

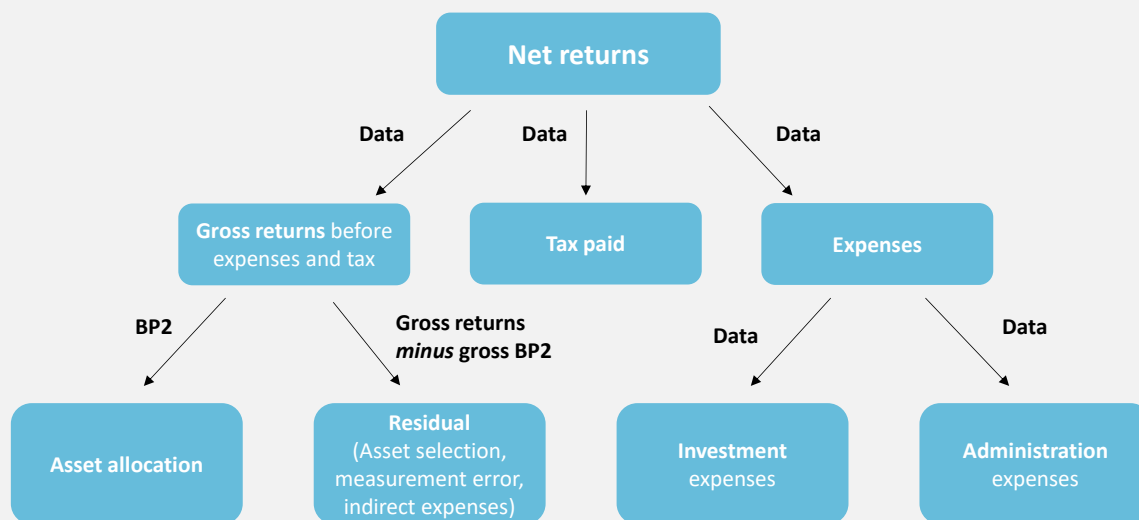
The Commission defines 'underperformance' as performance which falls below BP2 by at least 0.25 percentage points (25 basis points) on an annualised basis over the relevant time period.

What adjustments have been made to the benchmark portfolios?

Adjustments have been made to the BPs (where relevant) to account for taxes and investment and administration fees or costs. In some cases, assumptions were used to address gaps in the publicly-available evidence and data. These adjustments and corresponding sensitivity tests are fully documented in technical supplement 4.

- **Taxes** on investment earnings are incorporated in various ways depending on the unit under analysis. In some cases, BPs are gross of tax for simplicity. Tax was a particularly difficult issue to deal with (with systematic differences in average tax rates across segments in APRA data that cannot be easily explained). That said, the tax adjustment on performance against BPs has a small or modest impact on benchmarking results in most cases.
- **Investment costs** have been deducted in two ways. Fees charged on exchange-traded funds (investments which track indexes) have been used as a proxy for direct investment costs, with fees assumed to have declined by 5 per cent per year historically. A further amount of 0.1 percentage points was added to reflect indirect portfolio-level costs (such as custodian costs). Benchmark net returns are not overly sensitive to these assumptions, but may be under-estimated as a result.
- **Administration costs** have been deducted using the administration expense ratios that superannuation funds report to APRA, or administration fees reported to SuperRatings, depending on the returns data being used. In some cases, this is tailored to the relevant segment (such as choice or default).

Box 2.2 Investment performance decomposition methodology



As outlined in the figure above, the Commission has decomposed historical net returns into several components: asset allocation, tax, expenses and a residual. Asset allocation effects are calculated using the gross (of all fees and tax) return BP2 — that is, the return to a portfolio of market indexes. Tax and expenses are calculated using APRA or SuperRatings data, and then subtracted from the gross return benchmark.

The residual is the component of net returns that remains after the above factors have been subtracted. It is equivalent to the difference between the actual *gross* return for the unit of analysis (from APRA or SuperRatings data) minus the *gross* return benchmark. There are several potential drivers of the residual, including deviations from the benchmark asset allocation within a year, unreported costs and measurement error, and asset selection (within asset classes). It is likely that this latter driver (asset selection) is the primary contributor to the residual. It reflects how well a fund is doing at their intra-asset class investment strategies and the decisions of managers within those sub-classes (including for direct asset holdings).

Some participants suggested the residuals presented in the supplementary paper were too large to reflect a true measure of asset selection value-add (or ‘alpha’) (AustralianSuper, sub. DR222; MLC Wealth, sub. DR223; Rice Warner, sub. DR225). However, the analysis was not intended to be a classic performance attribution analysis (that would usually be conducted at an asset-class level). Rather, the intent was to look for factors that could explain differences in performance, using the available data. While the residual is not the usual alpha, it is still most likely to be primarily a measure of asset selection quality.

Full details of the methodology can be found in technical supplement 4.

Participants generally supported the Commission’s benchmarking approach, with some reservations

Inquiry participants were generally supportive of the Commission’s approach to benchmarking, though some had reservations on the validity of this approach and conclusions (box 2.3).

Box 2.3 **Participant reactions to the Commission's investment benchmarking**

Many inquiry participants supported the overall approach of benchmarking investment performance by controlling for asset allocation. For example:

AIST applauds the Productivity Commission for its work on developing several benchmarked portfolios to assess long-term investment performance. AIST has consistently advocated to the Productivity Commission, APRA, ASIC and Treasury that benchmarking of fees, costs and net returns is a vital but missing element of analysing the superannuation system. (AIST, sub. DR130, p. 16)

AustralianSuper commends the work of the PC in the construction of investment benchmark portfolios (BP1 and BP2) to assess the system's relative and absolute investment performance, agnostic of asset allocation. The PC's benchmarking work is a clear measure of whether funds are adding value against market performance and is a definitive tool to identify where there is long-term underperformance in the system. (AustralianSuper, sub. DR150, p. 1)

The analysis comparing fund performance versus tailored benchmarks is very revealing, and appears to 'do the trick' of teasing out potential problem areas. In particular, the kink down to a lower tail of underperformers is evocative. (Warren, sub. DR118, p. 4)

KPMG recognises the modelling undertaken by the Productivity Commission as a strong methodology for assessing investment performance across the superannuation industry. ... We believe that the assumptions that underpin the Commission's benchmark portfolios are sound, albeit there are some additional factors that will impact the performance of funds under certain segments and market conditions. (KPMG, sub. DR183, p. 3)

The Commission's benchmark portfolios provide a useful reference point as RSE licensees continue to review and enhance their approach to investment performance assessment. (APRA, sub. DR204, p. 8)

However, others questioned whether the analysis led to valid and reliable results. For example:

There are many problems with BP2 and the returns for BP2 appear to be significantly overstated based on a number of assumptions that have been made. We don't believe BP2 represents a fair benchmark as it currently stands. (Chant West, sub. DR191, p. 11)

It appears that the Commission may have formed an overly optimistic opinion as to the reliability and usefulness of this [benchmarking] approach. There are multiple weaknesses in basing the assessment of fund performance on asset allocation benchmarks. (Peterson Research Institute, sub. DR161, p. 1)

Net benchmarks are models, not facts, because of the added assumptions. By changing those assumptions, it is possible to raise or lower the yardsticks of comparison and thus to produce lower or higher relative performance — shifting the goalposts. (Investment Analytics Research, sub. DR192, p. 8)

Three themes in the feedback warrant scrutiny. First, some participants argued that asset allocation decisions by funds are a key source of value add and therefore should not be abstracted away from by the use of BPs (AustralianSuper, sub. DR150; Peterson Research Institute, sub. DR161; SunSuper, sub. DR197; Chant West, sub. DR224). While funds have varying degrees of discretion over how they set their strategic asset allocations — and to deviate from these in the short term — differences in asset allocation have often been cited to stymie attempts to compare performance across the superannuation system. In the words of one participant, such differences can become 'another smoke-screen to avoid comparison and competition' (IAR, sub. DR192, attachment 1, p. 8). Therefore, the Commission's analysis has continued to control for asset allocation.

Second, other participants objected to the inclusion of unlisted asset classes in the BPs (Chant West, sub. DR191; Sunsuper, sub. DR197). The key argument given is that unlisted indexes are not investible, thus the decision to invest in unlisted assets (and accept liquidity risk) is the value-adding activity in itself. The Commission agrees, but the decision to invest in unlisted assets is already reflected in a fund's asset allocation (which the benchmarking controls for). Unlisted indexes have been included in the benchmark as a measure of the returns an informed member could reasonably expect from an asset allocation with exposure to unlisted asset classes.

Third, some participants argued the Commission's 0.25 percentage point (25 basis points) margin of error for defining 'underperformance' was too low to account for randomness in investment performance (Warren, sub. DR118; Qantas Super, sub. DR137; ASFA, sub. DR148; Asher, sub. DR151; Peterson Research Institute, sub. DR161; MLC Wealth, sub. DR174). However, this margin was included to compensate for measurement error, not randomness. Randomness (and risk) is dealt with by analysing performance over the long term.

A full description of feedback on specific analyses is in technical supplement 4, which also includes detail on:

- data sources used in the analysis, their limitations, and how the Commission has dealt with those limitations
- the construction of benchmark portfolios, including assumptions made, the evidence supporting those assumptions and limitations
- sensitivity testing of key BP inputs and assumptions, including in relation to hedging ratios, tax, administration expenses and asset allocation. Many results are robust to different assumptions. Where there are sensitivities, the assumptions used are relatively generous to funds.

Some data limitations and trade-offs: mind the gaps

The Commission has made use of data from APRA and research firms for its benchmarking analysis. Both have their strengths and weaknesses.

APRA fund-level data have limitations, but are still useful

APRA data offer full coverage of the APRA-regulated system, unlike any other dataset. Given this inquiry is an assessment of the efficiency of the entire system, the value of full coverage should not be discounted. However, these data have some limitations. For example, comparable fund-level data are only available back to 2004 and some components of APRA's reporting framework only commenced in 2013 (including MySuper product data). Further, fund-level data do not allow the retirement and accumulation segments to be separately analysed (APRA 2017b; Chant West 2014). Some participants expressed concern with the use of fund-level data in the Commission's benchmarking analyses (box 2.4).

Box 2.4 Participant reactions to the use of fund-level data

Perhaps the most substantive issue raised by participants was that APRA fund-level data represent an asset-weighted average of different investment options offered by a fund. This means that fund-level outcomes are not necessarily reflective of the member experience in a particular option (such as a balanced option, or a member-directed platform product) (CFS, sub. DR163; MLC Wealth, sub. DR174; FSC, sub. DR186; Chant West, subs. DR191 and DR224).

The Commission accepts that fund-level returns will not capture heterogeneity across members within a fund, but rejects the assertion that this renders these data invalid. All averages conceal variation in underlying distributions, but are still informative of the overall outcomes that members are collectively receiving. (Indeed, recent research has found that product-level returns are highly correlated with fund-level returns (ISA 2018)). Since fund-level returns are weighted-averages of product-level returns, poor performance at a fund level *must* reflect that many members are earning poor returns, or that some are earning egregiously poor returns. Even though some participants (for example, Rice Warner, sub. 56; FSC, sub. DR218) argued that funds are not necessarily responsible for member-directed asset selection decisions in platform products, trustees are still ultimately responsible for the products they design and offer to their members.

The fund-level data also, by design, cover members in the large number of legacy and terminated products in the system (almost entirely from retail funds). Some participants argued that these products are irrelevant for an assessment of the system's performance (Chant West, subs. DR191, DR224; FSC, sub. DR218). The Commission firmly disagrees. The analysis is explicitly intended to cover all products that members are, or have ever been, in. Most members remain in the super system for many decades and thus past performance is just as relevant to their retirement income as current performance — for example, a 25-year old member who entered a product that then closes to new members shortly afterwards (thus becoming a legacy product) could remain in that product for the next 40 years unless they choose to switch. Even today, legacy products remain stubbornly embedded in the super system. Legacy products comprised an estimated 10 per cent (\$162 billion) of assets and 12 per cent of member accounts (3.2 million) in the APRA-regulated funds in 2017.^a

Further, in a system of thousands of products, measuring individual member outcomes in any comprehensive fashion is clearly impossible. So for a system-level assessment, some level of abstraction was inevitable. And in any case, the Commission has made use of product-level data from research firms where possible (with product-level analyses provided in section 2.5).

^a These estimates are based on the share of legacy product assets and accounts in the whole SuperRatings product-level dataset.

Research firm data offer more granularity, but less coverage

The Commission has used product-level data from research firms SuperRatings and, to a much lesser extent, Rainmaker. These datasets offer insights into member experiences in individual investment options. However, these data do not have full coverage of the system and are often reliant on voluntary reporting by funds. As such, they are likely to be subject to selection bias. This is because it is expected that poorer-performing products are less likely to be captured in research firms' datasets.

For example, the estimated long-term (2005–2017) returns to APRA-regulated funds using APRA data are 0.8 percentage points per year less compared with SuperRatings data. This suggests there may be upwards bias when using SuperRatings data to draw conclusions about the broader system.

Survivor bias could also be present, where potentially poorer-performing products that have exited the system are not captured in data for past years. However, this is only an issue for option-level analysis, where a certain time period of returns for each individual option is needed. In contrast, segment-level analysis aggregates up the performance of all options within a segment that were active in a given year.

Further problems with research firm data make it challenging to examine trends in products over time, such as changing product and option names, and variation in how returns are reported. These issues are explored in technical supplement 4.

2.2 How has the system performed?

Ideally, the starting point for a system-level analysis would be to take an aggregated view across all funds in the system (chapter 1). A system representative view is afforded by focusing on APRA-regulated funds and self-managed superannuation funds (SMSFs). Combined, they account for about 94 per cent of total system assets (the remainder consists mostly of State and Territory Government funds exempt from regulation by APRA) (chapter 1).

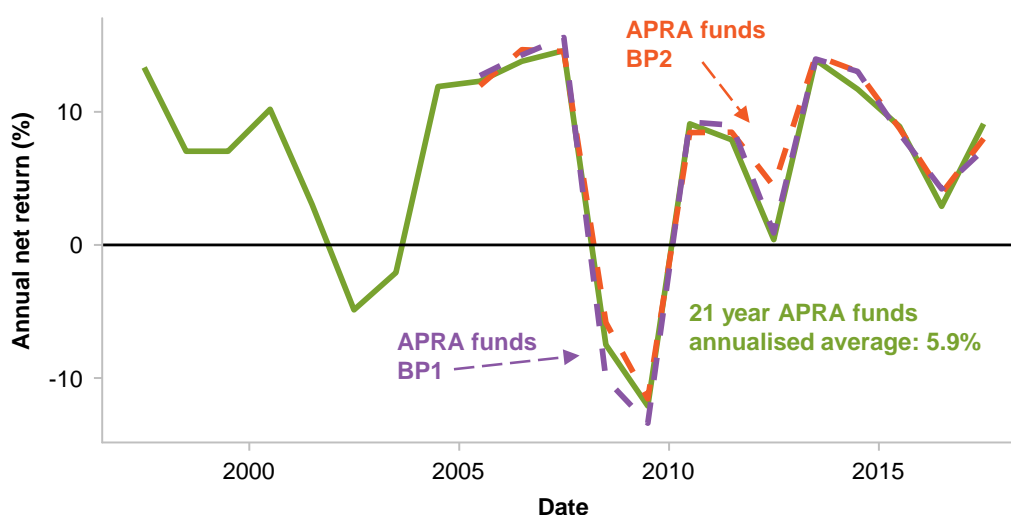
However, data for the APRA-regulated and SMSF segments are not directly comparable (ATO 2015b; Dixon Advisory, sub. 61). As such, the Commission has considered these segments separately, with this section covering the APRA-regulated segment and section 2.6 the SMSF segment.

System returns have moved with benchmark portfolios

Over the past 21 years (the longest period over which the Commission could estimate system returns), APRA-regulated funds have generated long-term annual net returns of 5.9 per cent a year on an asset-weighted basis (figure 2.2). In real terms, this is equivalent to 3.5 percentage points above inflation (CPI). Net returns broadly tracked the BPs over the past 13 years (the longest period over which the Commission could estimate BP returns) and reflect marked dips in performance (in 2008 and 2009) coinciding with the global financial crisis (GFC). Although the blended (listed and unlisted) benchmark (BP2) generates higher long-term net returns than the listed benchmark (BP1) (figure 2.2), in large part this appears to be attributable to a lower fall in returns for the unlisted benchmark during the GFC.

Figure 2.2 **System trends: the system has moved with benchmarks over 13 years^a**

Benchmarks adjusted for asset allocation, 1997–2017



Sources	PC analysis of APRA (2007, 2018b) data and financial market index data (various providers).		
Benchmark	BP1 and BP2.		
Coverage	All APRA-regulated funds after 2004, and only funds with over \$100 million in assets prior to that.		
Survivor bias	No.	Selection bias	No.

^a Observations pre-2004 have been originally provided based on APRA’s return on assets method. To facilitate consistency with observations from 2004 which are based on APRA’s rate of return method, these observations have been adjusted using a formula as suggested by Sy (2009), however differences in underlying data still exist.

Long-term system returns fall below BP2

APRA-regulated funds delivered average annual returns (less fees and taxes) of about 6.1 per cent over the 13-year period to 2017. The performance of APRA-regulated funds over this period was commensurate with BP1 (6.1 per cent) and below BP2 (6.9 per cent).³ Some industry practitioners report investment performance gross of administration expenses, arguing this better captures investment performance as administration fees are for a separate (non-investment) service provided by the fund. The result that APRA-regulated funds deliver returns just under a listed benchmark is not sensitive to assumptions made about reported administration expenses captured in the APRA reporting framework. A gross

³ This BP2 value is calculated using system-level data from APRA, and thus differs slightly from the system BP2 presented in the overview, which was calculated using more granular fund-level data from APRA (to allow for more consistent comparisons with the not-for-profit and retail segments).

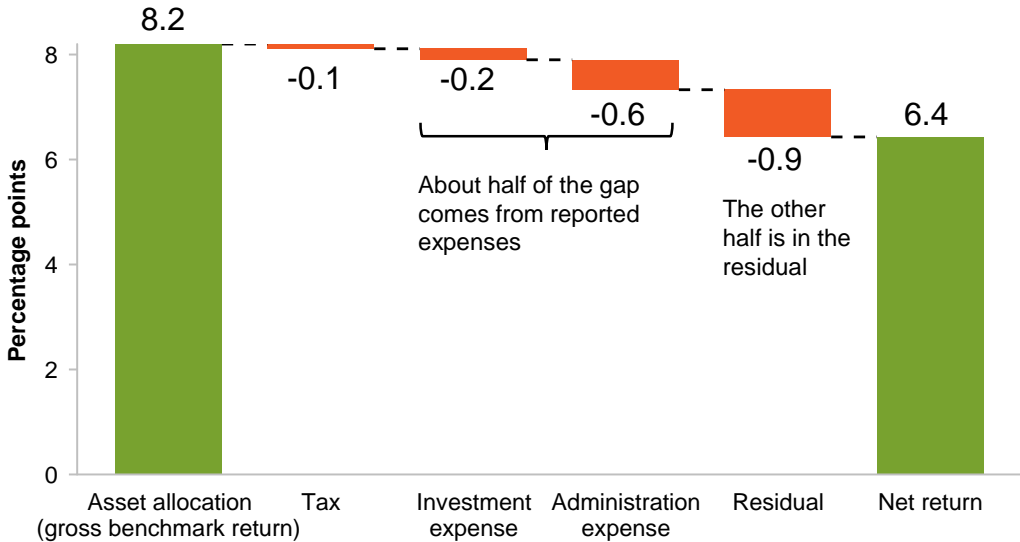
of reported administration expenses analysis yields a similar result, although with a slightly larger gap between APRA-regulated fund returns and BP1.

The result that APRA-regulated funds, on average, delivered returns below BP2 is consistent across different time periods (including 2008–2017 and 2013–2017), albeit with small differences subject to the period examined.

Decomposition shows that half the gap over 13 years cannot be fully explained

Over the 13 years to 2017, the system produced an arithmetic average net return of 6.4 per cent a year. This leaves an unexplained residual of 0.9 percentage points for the system after adjusting for asset allocation (the gross benchmark return), and reported tax, administration and investment expenses (figure 2.3). Some of this residual could reflect indirect (and unreported) investment expenses. However, SuperRatings data suggest that indirect investment expenses were in the vicinity of 0.4 to 0.5 percentage points in 2018. To the extent that this is representative of the overall period, this leaves 0.4 to 0.5 percentage points unexplained. What remains is most likely primarily due to asset selection within asset classes.

Figure 2.3 System performance: 0.9 percentage points cannot be fully explained
Performance decomposition, 2005–2017



Sources	PC analysis of unpublished APRA data and financial market index data (various providers).
Benchmark	System BP2.
Coverage	All APRA-regulated funds. Excludes exempt public sector superannuation schemes, eligible rollover funds, insurance-only superannuation funds and small APRA funds.
Survivor bias	No.
Selection bias	No.

2.3 How have option types and asset classes performed?

Members in balanced and growth options are doing well

Most members in the system are in some form of diversified investment option categorised as a ‘growth’ or ‘balanced’ option, partly because these are commonly the default options offered by funds (Chant West 2017; SuperRatings data). The precise number of members in these products is elusive (research firms do not collect these data).

Figure 2.4 shows net returns to a range of types of investment options in the SuperRatings dataset over 13 years (2005–2017). They are categorised by their allocations to growth and defensive assets (as defined in tech. supp. 4). The similarity in returns for balanced, growth and high growth options likely reflects the time period used. An alternative 5-year view (2013–2017) reveals a stronger relationship between risk and return — that is, options with a higher weighting to growth assets yielded much higher returns over this shorter time period.

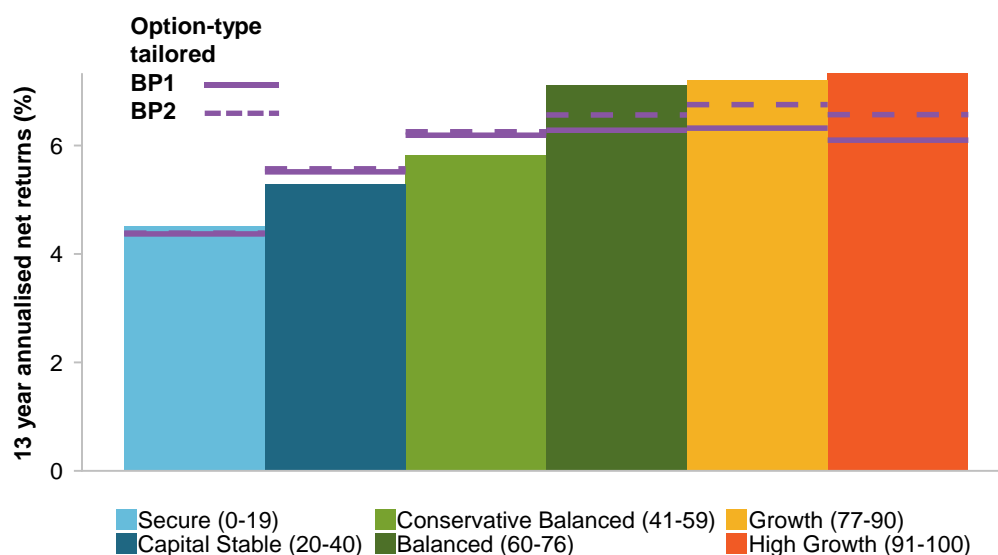
When compared with benchmarks, balanced, growth and high-growth options in the system delivered returns above their option-type tailored BP1 and BP2 on average over the period (with much variation across funds and products (section 2.5)). However, the performance of conservative options was not as favourable. The returns of capital stable and conservative balanced options fell below both their option-type tailored BPs, although secure options performed above their option-type tailored BP2 (but not BP1).

These benchmarking results are somewhat sensitive to the time period considered, with option types performing quite differently over the shorter 10-year period (tech. supp. 4). Further, individual assets within an asset class could have quite different risk-return profiles. For example, some assets classed as ‘defensive’, such as fixed income, could in fact have risk-return properties more typically associated with a growth asset (MLC Wealth, sub. 63 and DR223; CFS, sub. DR163; Wilkins, sub. DR169). In the absence of an agreed industry standard on the categorisation of particular assets, decisions about how to classify assets are typically left to trustees.

Nevertheless, these results generally paint a more positive picture of average system performance than the results in section 2.2, where the system of APRA-regulated funds delivered returns below both benchmarks. This is likely to reflect selection bias (as options reported in research firm data would tend to be from larger, better performing funds), including the exclusion of legacy products, or differences in how option-level and fund-level returns data are calculated. Data limitations notwithstanding, the results support the view that many members are doing *relatively* well in the superannuation system if they are in a diversified investment option.

Figure 2.4 **Option types: balanced and growth options beat benchmarks^{a,b}**

Benchmark adjusted for asset allocation, 2005–2017



Sources	PC analysis of unpublished APRA data, financial market index data (various providers) and SuperRatings data.
Benchmark Coverage^c	Option-type tailored BP1, BP2. Accumulation options from APRA-regulated funds. In 2005, funds included in the figure represent up to 61% of total assets and 64% of member accounts of APRA-regulated funds. In 2017, funds included in the figure represent up to 85% of total assets and 82% of member accounts of APRA-regulated funds.
Survivor bias	No.
Selection bias	Yes.

^a Net returns are gross returns less investment fees, taxes and implicit asset based administration fees. This means that some options may be reported gross of asset based administration fees. To be conservative the Commission's benchmark portfolios are adjusted assuming all options are net of asset-based administration fees. ^b The option type categories have been taken as given from SuperRatings data. ^c These coverage estimates are likely to be overestimates due to the estimation method (tech. supp. 4). The analysis excludes legacy products.

Survey data suggest funds perform well on average across different asset classes

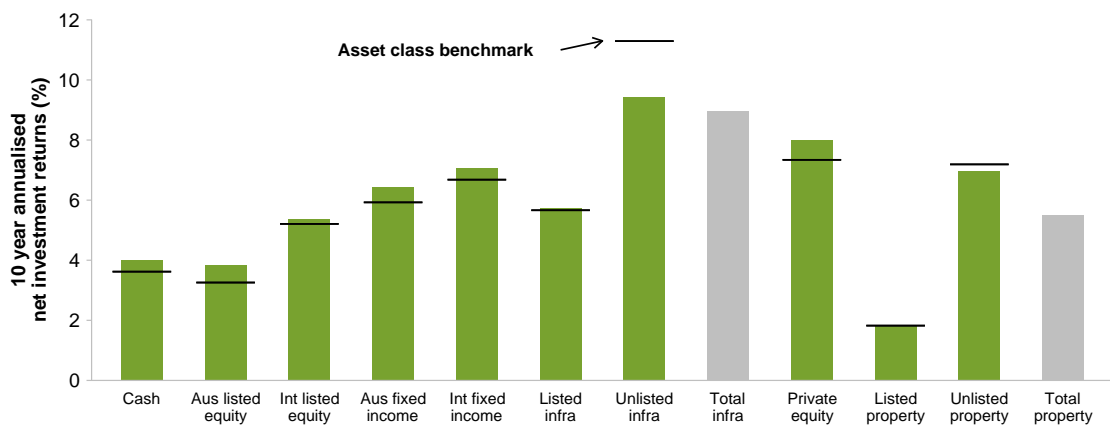
Another way of examining the performance of the system, or at least of APRA-regulated funds, is to consider returns at the asset-class level, as anticipated in the Commission's stage 1 study. Some participants supported this approach at a conceptual level. AIST (sub. 39) indicated that asset-class benchmarking is commonly undertaken by industry, and PWC (sub. 62) suggested more value should be placed on this analysis than a system- or segment-level view. The Commission concurs that there is much interpretive value to be gleaned from comparing net investment returns by asset class across the system, and then

internationally. Asset-class comparisons offer the most ‘like-for-like’ comparisons with benchmarks and across countries.

In its supplementary funds survey (described in appendix C), the Commission asked funds to provide returns by asset class for each year over the period 2008 to 2017. These data allowed for performance assessment by asset class for the system and segments, and an international performance comparison.

At a system level, funds on average perform close to or above benchmarks in all asset classes except for unlisted infrastructure⁴ (figure 2.5). These results suggest a slightly more positive picture of system performance than the system-level benchmarking based on APRA data (section 2.2). The discrepancy is unsurprising given these survey data are subject to both survivor bias (funds which were wound up during the period are not represented in the survey sample) and selection bias (poorer performing funds are assumed to be less likely to volunteer data in the survey or only partially volunteering data for some years).

Figure 2.5 Returns exceed benchmarks in most asset classes^a
System returns weighted by assets invested in the corresponding asset class, 2008–2017



Sources	Supplementary funds survey and financial market index data (various providers).
Benchmark	Asset-class benchmarks as per BP2.
Coverage	In 2008, the funds in this figure represented up to 66% of total assets and 69% of member accounts of APRA-regulated funds. In 2017, the funds in this figure represent up to 86% of total assets and 87% of member accounts of APRA-regulated funds.
Survivor bias	Yes.
Selection bias	Yes.

^a Annualised average returns for each asset class were calculated by taking the yearly system average return (weighted by fund assets) and calculating the geometric mean over the 10-year period. No benchmark has been applied to total (listed and unlisted) property and total infrastructure. Observations where funds did not split fixed income into Australian and international categories have been excluded.

⁴ Several participants argued this benchmark was too high (ASFA, sub. DR221; AustralianSuper, DR222), and that it may not be truly representative of the unlisted infrastructure sector.

Funds in the survey performed comparably to large international pension funds

International comparisons using overall net returns are fraught due to differences in asset allocation, regulatory requirements and tax systems between countries. However, it is possible to abstract from these differences by comparing returns at an asset-class level (gross of tax but net of investment fees). The Commission has compared the reported asset-class returns of Australian superannuation funds over the period 2008–2017 to those of (mostly larger) pension funds in other developed countries over the period 2007–2016 (gross of tax but net of all investment fees).⁵ The international data were purchased from CEM Benchmarking and are published in technical supplement 4.

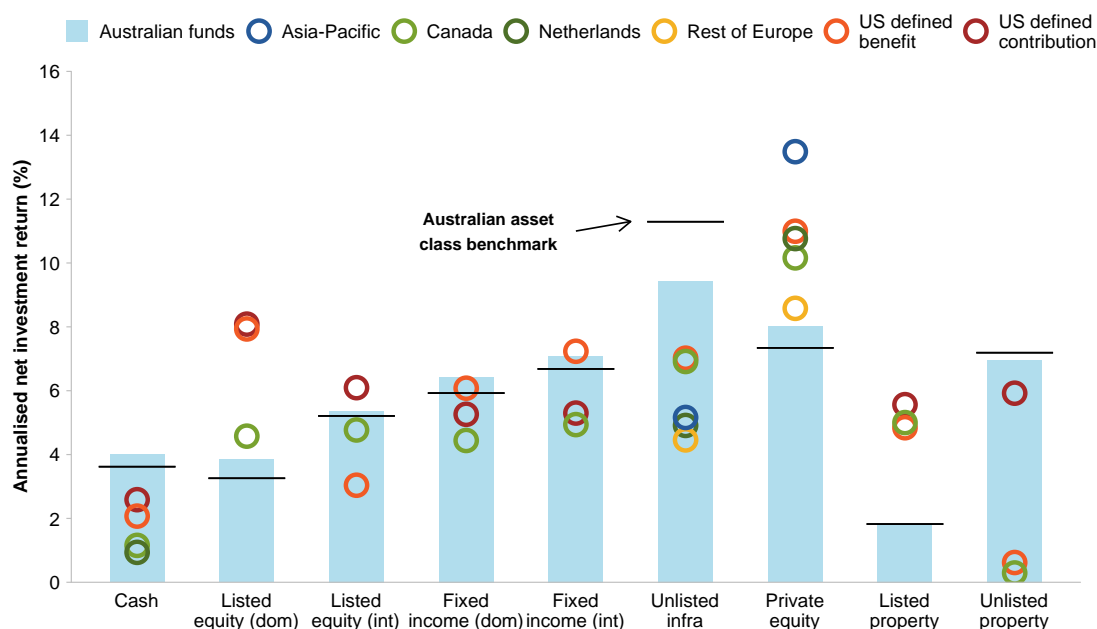
The comparison suggests that Australian funds performed better, on average, than their international peers in cash, fixed income (domestic and international), unlisted infrastructure and unlisted property (figure 2.6). The reverse is true for domestic listed equity, private equity and listed property. While Australia outperformed international funds on average in unlisted infrastructure, it was still below the benchmark for this asset class.

A key caveat, however, is that the time periods differ between the international data and the Australian data. Although both cover a 10-year period with only a one-year difference, there is scope for different economic conditions to influence the comparison, in particular, because 2007 was immediately prior to the GFC (this could explain the difference in listed property returns between Australian and international funds). Two further caveats, on all international comparisons, are that funds in different countries may report net returns using slightly different methods and that, naturally, ‘international’ and ‘domestic’ mean different things to different countries.

Several participants considered these to be major flaws in the analysis (FSC, sub. DR218; ASFA, sub. DR221; Chant West, sub. DR224; Rice Warner, sub. DR225; Vanguard Australia, sub. DR229). The Commission acknowledges that these caveats limit the value of the analysis. However, international comparisons in this field have historically been challenging, and the Commission maintains that this data collection and comparison exercise represents one of the more valid attempts to date.

⁵ Due to different data collection needs, the supplementary funds survey collected data for 2008–2017 rather than 2007–2016. While it may reduce comparability with CEM benchmarking data, the periods either side of the comparable time span (2006 and 2017) both had relatively high returns.

Figure 2.6 **International comparison of asset class returns^a**
10-year returns



Sources	Supplementary funds survey, CEM Benchmarking data, and financial market index data (various providers).
Benchmark	Asset-class benchmarks as per BP2.
Coverage	In 2017, the Australian funds in this figure represent up to 86% of total assets and 87% of member accounts of APRA-regulated funds.
Survivor bias	Yes.
Selection bias	Yes.

^a Australian returns are for 2008–2017 while other country returns are for 2007–2016. The solid line is the asset class benchmark for Australian funds over 2008–2017. The listed property benchmark is a weighted combination of domestic and international listed property, as described in technical supplement 4.

FINDING 2.1

The Commission’s funds survey suggests that superannuation funds on average outperformed a market index benchmark in most individual asset classes over the 10 years to 2017. Not-for-profit funds outperformed retail funds on average within most major asset classes over this period.

However, these survey results are positively biased due to missing data for funds that have exited the system (survivor bias) and that did not provide the requested data (selection bias).

While international comparisons add further data issues, compared with large pension funds in other developed countries, Australian superannuation funds appear to have achieved comparable returns on individual asset classes.

2.4 How have different segments performed?

While system-level analysis provides useful context, it potentially masks significant differences in outcomes across segments — such as the default, choice, accumulation and retirement segments — which have distinct characteristics (PC 2016a; AIST, sub. 39; ASFA, sub. 47; SMSF Association, sub. 67). This section considers the performance of particular segments of the superannuation system.

The default segment allocates more to ‘growth’ assets than the choice segment. Similarly, asset allocation in the retirement segment is also typically more conservative than the accumulation segment, and the taxation arrangements that apply to earnings are different in these phases.

To account for these differences, the Commission has tailored benchmark portfolios to reflect the average asset allocation in each segment for each year in the period. This is designed to, as far as possible (data limitations notwithstanding), mitigate the effects of systematic differences in performance across segments due to differences in asset allocation. As such, a segment’s performance should be compared with its respective tailored benchmark portfolios.

Analysis of default, choice, accumulation and retirement segment performance relies on research firm data (APRA data do not provide returns for these segments in isolation, with the exception of MySuper products since 2013). Given the potential for (positive) selection bias in research firm data (reflecting incomplete coverage), this means that the results do not necessarily accord with analysis based on APRA data.

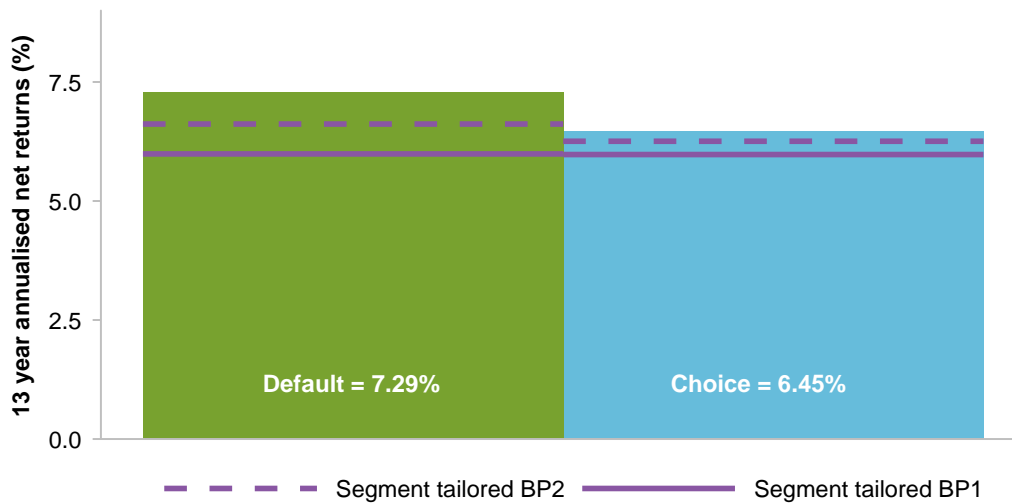
The default and choice segments

Many members rely on default arrangements to allocate them to good products. The default segment comprises one-quarter of assets in the system and, importantly, half of member accounts in APRA-regulated funds. Approximately two-thirds of members use the default selected by their employer on starting a new job (chapter 1). The performance of the default segment therefore matters from the perspective of a large proportion of (largely disengaged) members, particularly those entering the workforce.

The choice segment (excluding SMSFs) accounts for 41 per cent of total assets and 39 per cent of member accounts (chapter 1). In many ways, it is inherently different from the default segment. On the demand side, members are more likely to have exercised some level of choice about the product or option they are invested in. On the supply side, the products on offer are more heterogeneous, and some provide flexibility to adjust the mix of assets in the portfolio, such as through the use of platforms. As such, trustees may have less direct control over the asset mix ultimately selected by choice members (as noted in section 2.1).

Over the 13 years to 2017, the default segment (which includes only MySuper products and their direct predecessors) generated returns above segment-tailored BP1 and BP2 (figure 2.7). This segment’s relatively good average performance was noted by several inquiry participants (AMP, sub. 80; AustralianSuper, sub. 43; ISA, sub. 5).

Figure 2.7 Products by segment: default beats choice and its benchmarks, but selection bias materially lifts results^{a,b,c}
 Benchmarks adjusted for asset allocation, 2005–2017



Sources	PC analysis of SuperRatings data and financial market index data (various providers).
Benchmark	Segment tailored BP1, BP2.
Coverage^c	The chart shows accumulation options from APRA-regulated funds: In 2005, funds included in the figure represent up to 61% of total assets and 64% of member accounts of APRA-regulated funds In 2017, in the dataset represented up to 85% of total assets and 82% of member accounts of APRA-regulated funds.
Survivor bias	No.
Selection bias	Yes.

^a Technical supplement 4 presents a similar figure with the broader definition of default (including default investment options). Returns for default and choice are both lower in the Rainmaker dataset (tech. supp. 4). Current MySuper products were connected with pre-cursors with the support of SuperRatings where requested. ^b Net returns are estimated less investment fees, taxes and implicit asset based administration fees. This means that some options may be reported gross of asset based administration fees. To be conservative the Commission’s benchmark portfolios are adjusted assuming all options are net of asset-based administration fees. ^c These coverage estimates are likely to be overestimates due to the estimation method (tech. supp. 4). The analysis excludes legacy products.

The choice segment (excluding SMSFs) performed marginally better than both its segment tailored BP1 and BP2. Participants did not typically express views on the performance of the *entire* choice segment (including all types of funds), though some drew attention to underperformance within parts of the segment, the performance of retail funds, or member outcomes on switching into choice products offered by retail funds (ISA, subs. 5 and 87; Cbus, sub. 58).

Over different time periods (such as 2013–2017 and 2008–2017), the performance of the segments relative to their tailored benchmarks varied (tech. supp. 4). The results are also sensitive to tax, with the choice segment falling below its benchmarks under alternative tax assumptions.

Taking averages over particular segments masks a diverse range of products and fund types. For example, assets in the choice segment are evenly split between retail and not-for-profit funds (chapter 1). Other segmentations are also clearly relevant.

Not-for-profit and retail: a systematic performance divide

Many participants commented on the performance divide between not-for-profit and retail funds (or the more narrow comparison of industry and retail funds) as a group. Different reasons were provided as to the magnitude of any differences in performance (box 2.5).

The Commission’s analysis indicates that, on average, over the 13 years to 2017, not-for-profit funds generated materially higher net returns than retail funds, on average. To account for the potential effects of a more conservative asset allocation of retail funds, BPs were tailored to each segment’s average asset allocation (figure 2.8). The BPs of each segment were similar over the period. This may reflect a narrowing in the respective difference in segment allocations to growth assets over time (with retail funds having comparable allocations to equities in more recent years), as well as strong relative investment performance of fixed income assets over the period.

The BPs have been updated since the draft report to incorporate an additional year of data and adjustments to assumptions (tech. supp. 4). This update resulted in an upward change in the BP2 for the retail segment and a small downward change in the BP2 for the not-for-profit segment. The change is mainly driven by the change in administration expense assumptions (using a system median rather than segment medians), as well as differences in how the various asset classes performed in 2017. The drivers of the changes are set out in greater detail in technical supplement 4.

Once these systematic differences in asset allocation are accounted for (to the extent possible), the not-for-profit segment performs above its segment-tailored BPs and the performance of the retail segment falls below its segment-tailored BPs. Performance of the segments relative to BPs appears worse over shorter time periods, including the 5 and 10 year periods up to 2017. The results are somewhat sensitive to the way asset allocations were estimated prior to 2014, and the assumed rate of hedging for international equities, but are robust to alternative tax assumptions (tech. supp. 4).

Box 2.5 Participants' views on the performance gap between not-for-profit and retail funds

Several participants argued that a performance gap arises from fundamental differences in incentives and governance structures between retail and not-for-profit funds (for example, ISA sub. 5). Several others pointed to differences in asset allocation (and greater exposure by industry funds due to unlisted assets because of more certainty over inflows due to being default-listed funds in awards) as the driving explanatory factor (for example, BT sub. 32).

Industry Super Australia (ISA, sub. 59) submitted that over the 10-year period to May 2017, not-for-profit funds generated net returns of 5.3 per cent compared with retail funds 3.5 per cent (a gap of 1.8 percentage points). In an earlier comparison, ISA (2016) indicated that the not-for-profit funds generated returns of 2.2 percentage points above retail funds over the 10 year period to March 2016. ISA and several other participants argued that the performance divide could be explained by retail funds being for-profit entities (for example, Vision Super sub. 30; AustralianSuper sub. 43; Cbus sub. 58).

However, Chant West (2016) noted that ISA's (2016) analysis failed to account for systematic differences in the way that industry and retail funds report their returns. In particular, many retail funds have legacy products (now closed to new members) that deduct adviser commissions (as well as investment fees, taxes, and administration fees) to calculate net returns. Once these differences are accounted for, Chant West's analysis identified a gap of 0.9 percentage points over 10 years.

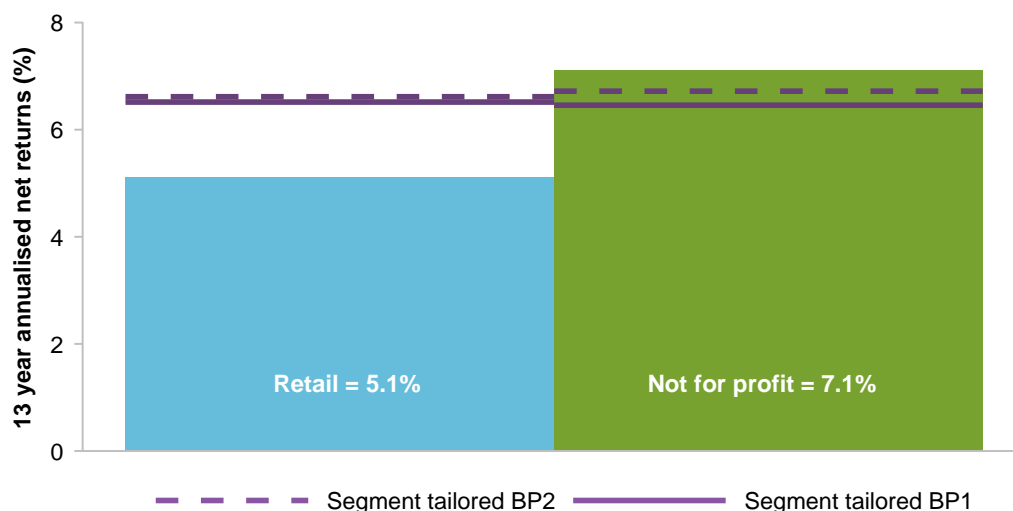
In more recent research, ISA (2018) demonstrated the divide in performance using option-level data and some distributional analyses. It found that the 25th percentile of annualised 10-year returns to cash options in industry funds' retirement accounts was higher than the 75th percentile for the same types of options in retail funds. Further, ISA commissioned research by Sy (2018) that found asset allocation was unlikely to explain the lower performance of retail funds, instead attributing the performance to differences in cost structures.

Chant West (2017a) undertook analysis of 'growth' options (61–80 per cent growth assets) over the past 5, 10 and 15 years to 2017. (Unlike other analyses, this was net of investment fees and taxes, but not administration fees.) The analysis found that industry funds outperformed retail funds by 0.8 percentage points over the previous 10 years to 2017, and 0.9 percentage points over the previous 15 years. Chant West attributed this result to the fact that industry funds as a group have had higher long-term exposure to unlisted assets (on average 20 per cent of their growth options compared with 5 per cent in the case of retail funds), partly because they have more certainty of inflows due to being default funds being listed in awards.

This is not to say that individual funds of both types have not beaten benchmarks. This aspect is explored further in section 2.5 in the assessment of the all-important distribution of performance across funds and products, which best captures the real experience of members. However, the results suggest that — despite accounting for differences in asset allocation as far as possible — there is still a clear performance divide, with not-for-profit funds clearly outperforming retail funds, on average.

Figure 2.8 Fund-type segments: not-for-profit funds outperform their benchmarks on average

Benchmark adjusted for asset allocation, 2005–2017



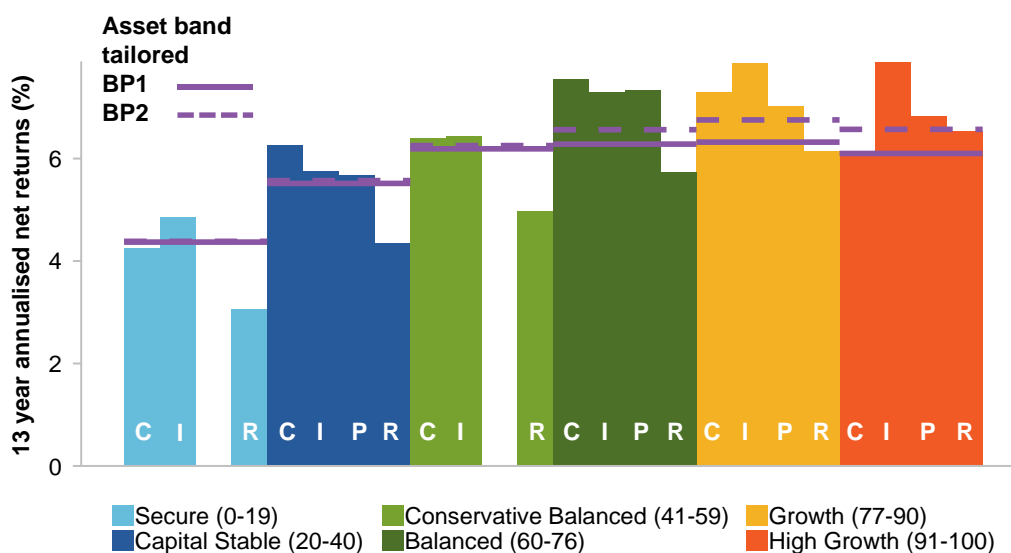
Sources	PC analysis of unpublished APRA data and financial market index data (various providers).		
Benchmark Coverage	Segment BP1 and BP2.		
Survivor bias	No.	Selection bias	No.

Option-level data tell the same story

A performance divide between not-for-profit and retail funds is also apparent in the Commission’s analysis of SuperRatings investment option-level data (figure 2.9). Separating options by both fund type and option type shows that, on average, retail options have produced lower returns than not-for-profit options.

Figure 2.9 **Fund-type and option-type segments^{a,b,c,d}**

Benchmark adjusted for option-type asset allocation (percentage allocation to growth assets); corporate (C), industry (I), public sector (P), and retail (R) options; 2005–2017



Sources	PC analysis of unpublished APRA data, financial market index data (various providers) and SuperRatings data.
Benchmark	Option-type tailored BP1, BP2.
Coverage^c	The chart shows accumulation options from APRA-regulated funds. In 2005, funds in the dataset represented up to 61% of total assets and 64% of member accounts of APRA-regulated funds. In 2017, funds in the dataset represented up to 85% of total assets and 82% of member accounts of APRA-regulated funds.
Survivor bias	No.
Selection bias	Yes.

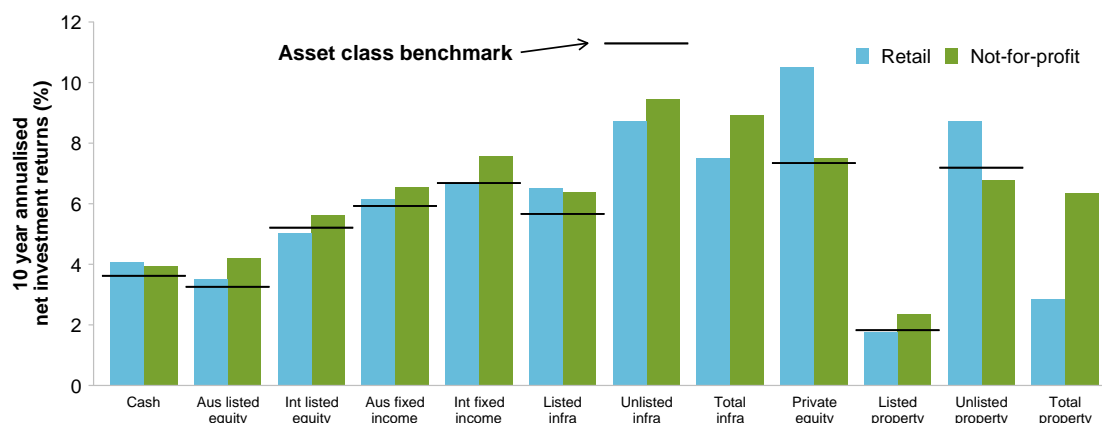
^a Net returns are estimated as gross returns less investment fees, taxes and implicit asset-based administration fees. This means that some options may be reported gross of asset based administration fees. To be conservative, the Commission’s benchmark portfolios are adjusted assuming all options are net of asset-based administration fees. ^b The option type categories have been taken as given from SuperRatings data. ^c These coverage estimates are likely to be overestimates due to the estimation method (tech. supp. 4). ^d This analysis excludes legacy products.

Asset-class data also tell the same story

Consistent with the performance by segment analysis, the supplementary funds survey data suggest that not-for-profit funds on average outperform retail funds in key asset classes (figure 2.10). Over the 10 years to 2017, not-for-profit funds recorded a return of 4.2 per cent for Australian listed equities (compared with 3.5 per cent for retail funds) and 5.6 per cent for international listed equities (compared with 5.0 per cent for retail funds). Not-for-profit funds also outperformed retail funds, on average, in fixed income (both Australian and international), unlisted infrastructure and listed property. Retail funds outperformed not-for-profit funds, on average, in cash, private equity and unlisted property, though the latter two results are based on data from a relatively small selection of retail funds.

Figure 2.10 Not-for-profit returns exceed retail returns in most asset classes^a

Segment returns weighted by assets invested in the corresponding asset class, 2008–2017



Sources	Supplementary funds survey and financial market index data (various providers).
Benchmark	Asset-class benchmarks as per BP2.
Coverage	In 2008, the funds in this figure represent up to 66% of total assets and 69% of member accounts of APRA-regulated funds. In 2017, the funds in this figure represent up to 86% of total assets and 87% of member accounts of APRA-regulated funds.
Survivor bias	Yes.
Selection bias	Yes.

^a Annualised average returns for each asset class are calculated by taking the yearly system average return (weighted by fund assets) and calculating the geometric mean over the 10 year period. No benchmark has been applied to total property and total infrastructure. Observations where funds did not split fixed income into Australian and international categories have been excluded.

Most of the divide cannot be fully decomposed using the available data

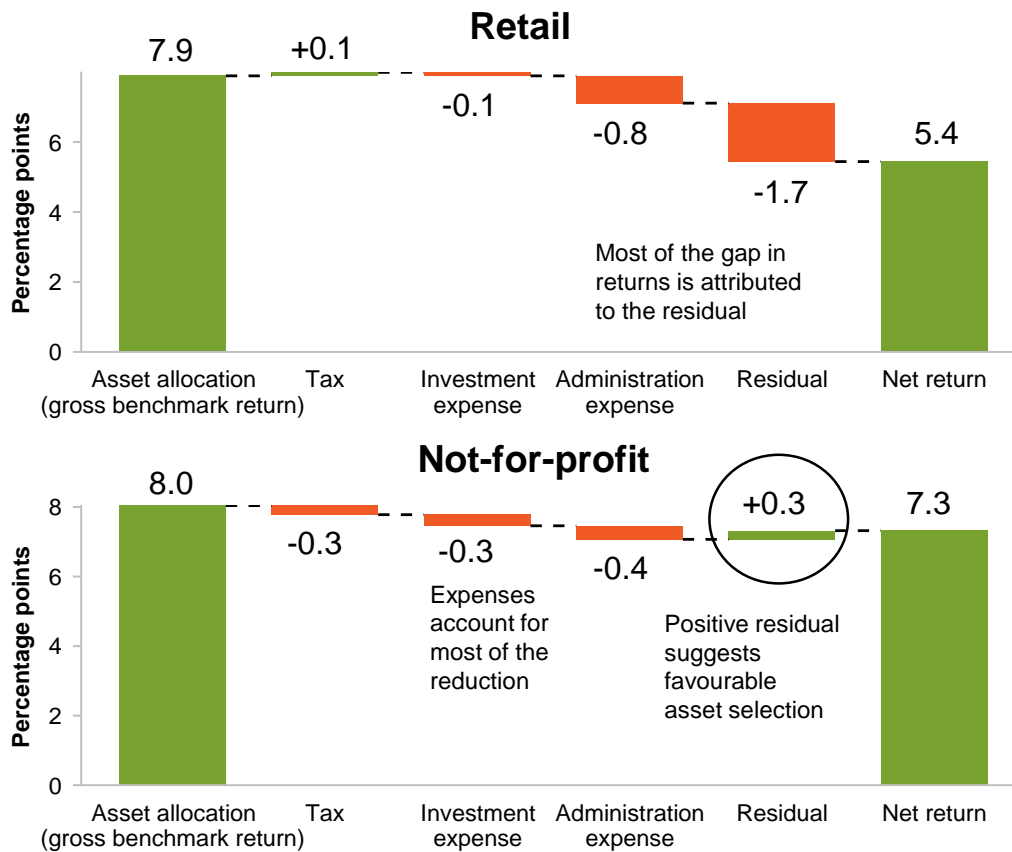
Decomposition analysis reveals that while the retail segment appears to have relatively high administrative costs, most of the underperformance is in the residual (figure 2.11). This large unexplained residual could be due to retail funds having, on average, higher indirect investment expenses. However, SuperRatings data suggest this is not the case. In 2018, the median indirect investment fee for retail products was 0.3 percentage points. Assuming these indirect investment expenses are representative (and ignoring the selection bias in SuperRatings data), this would leave the majority of the residual (about 1.4 percentage points) unexplained.

But the gap is most likely primarily due to asset selection (within asset classes)

Figure 2.12 shows a *relative* outperformance decomposition of the not-for-profit segment against the retail segment. In this context, ‘tax’ (and analogously for investment expenses, administration expenses and the residual) refers to the difference between the not-for-profit

segment's tax and its benchmark tax, minus the retail segment's tax and its benchmark tax. Full details of the methodology can be found in technical supplement 4.

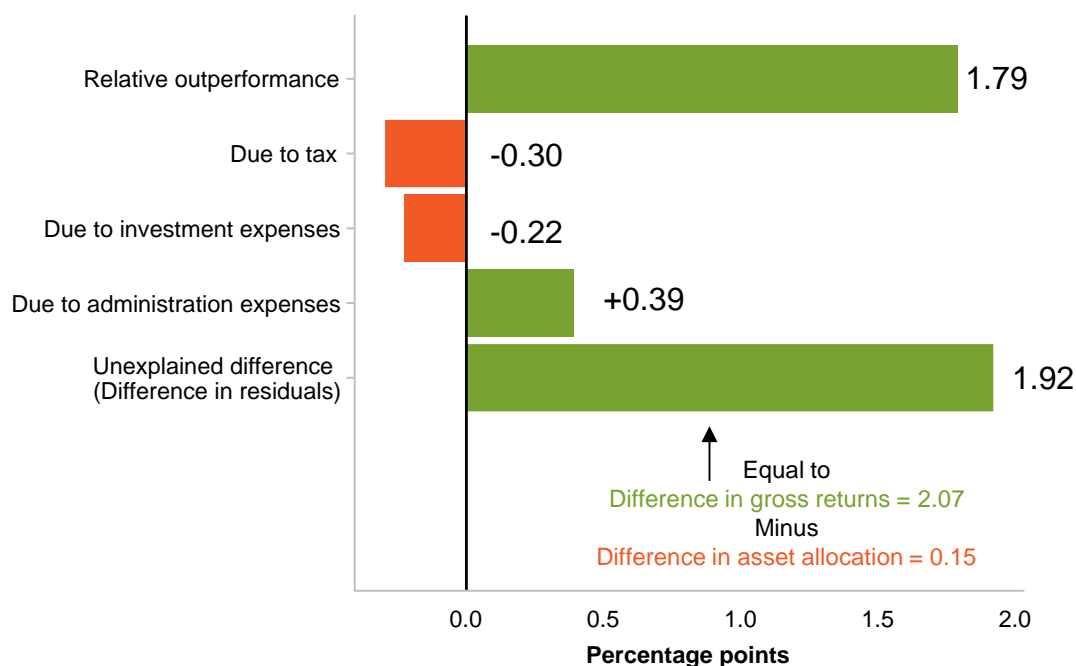
Figure 2.11 Decomposition analysis: a large, unexplained residual of underperformance for retail funds^a
2005–2017



Sources	PC analysis of unpublished APRA data and financial market index data (various providers).
Benchmark	Segment-tailored BP2.
Coverage	All APRA-regulated funds. Excludes exempt public sector superannuation schemes, eligible rollover funds, insurance-only superannuation funds and small APRA funds.
Survivor bias	No.
Selection bias	No.

^a The net returns presented in this figure differ from figure 2.8 due to being arithmetic, rather than geometric, averages (box 2.2).

Figure 2.12 Relative outperformance decomposition: not-for-profit to retail funds
2005–2017



Sources	PC analysis of unpublished APRA data and financial market index data (various providers).
Benchmark	System BP2.
Coverage	All APRA-regulated funds. Excludes exempt public sector superannuation schemes, eligible rollover funds, insurance-only superannuation funds and small APRA funds.
Survivor bias	No.
Selection bias	No.

The outperformance gap in tax is actually negative (and thus cannot explain the relative outperformance gap between the segments). This negative gap can be explained by not-for-profit funds paying less tax compared with their BP tax than retail funds, on average.⁶ This does not necessarily mean that not-for-profit funds fare better on tax management. It could be due to differences in the proportion of assets in the retirement phase between segments, or inaccuracies in the assumptions used to add tax to the benchmarks.

⁶ Despite the tax rates being tailored to the segments, the amount of tax paid can differ in the benchmark because of the returns being different in the benchmark. This is because the same tax rate (percentage of investment earnings) can have a different contribution to net returns in percentage points, depending on the level of benchmark returns it is applied to.

Not-for-profit funds have a larger negative outperformance gap in *reported* investment expenses compared with retail funds, on average. This may reflect the effect of indirect investment expenses in the retail segment. By contrast, not-for-profit funds have a positive outperformance gap in reported administration expenses compared with retail funds. This could be interpreted as the average not-for-profit fund having lower administration expenses than the system median administration expense, and the average retail fund having higher administration expenses than the system median administration expense.

Most notably, the difference in outperformance between the two segments is almost entirely driven by the difference in residuals (almost 2 percentage points). Based on SuperRatings data, this difference does not appear to be driven by differences in indirect investment expenses (0.1 percentage points). Though SuperRatings data may not reflect the full extent of differences in investment expenses, they nevertheless would suggest that the bulk of the difference in residuals is attributable to other factors, most likely to be primarily asset selection (within asset classes), and also, potentially, measurement error. This is consistent with results based on the Commission's funds survey data, where not-for-profit funds performed better than retail funds (on average) in most asset classes.

The residual can also be defined as the difference in gross returns (before expenses and taxes are deducted) between the segments (1.96 percentage points), minus the difference in asset allocation (0.15 percentage points). This suggests that differences in asset allocation itself across the segments have not been a major driver of differences in returns, as noted earlier.

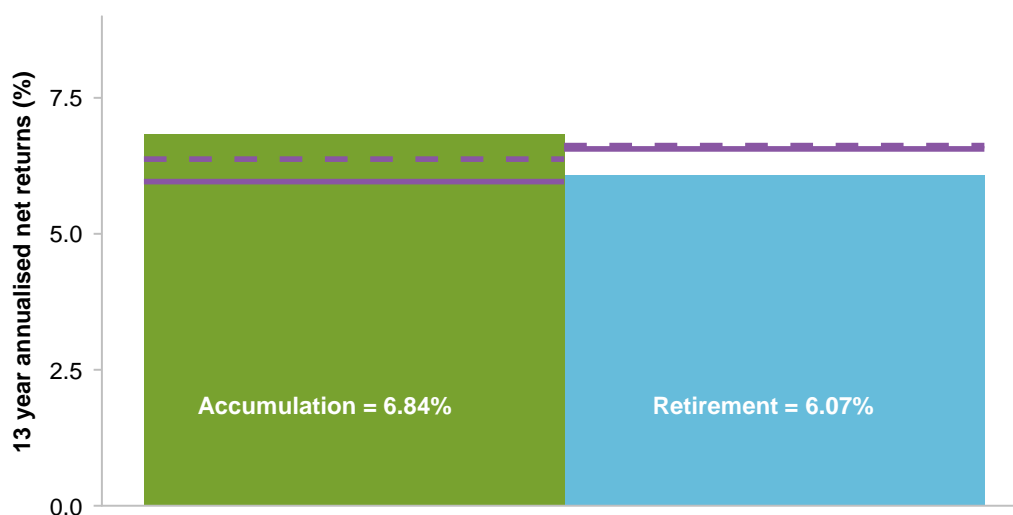
The accumulation and retirement segments

The main purpose of most accumulation products is to grow balances for members' retirement. Retirement products, on the other hand, typically adopt relatively more conservative investment strategies to reduce the risk of losses (Rice Warner, stage 1, sub. DR112, p. 27; chapter 4; SMSFA, sub. 67, p. 8; chapter 4).

Over the 13 years to 2017, the accumulation segment performed above its segment-tailored BP1 and BP2. By contrast, the retirement segment performed below both its segment-tailored BP1 and BP2 (figure 2.13). However, these results vary significantly depending on the time period considered. For example, over the 10 years to 2017, the retirement segment performed above accumulation and above its segment tailored BP2. The retirement segment also has lower volatility of returns compared with the accumulation segment, which is consistent with its more conservative asset allocation (tech. supp. 4).

Figure 2.13 Products by segment: the retirement segment performed below its benchmarks^{a,b}

Benchmark adjusted for asset allocation, 2005–2017



Sources	PC analysis of SuperRatings data and financial market index data (various providers).	
Benchmark	Segment-tailored BP1, BP2.	
Coverage^a	The figure shows accumulation options from APRA-regulated funds. In 2005, funds in the dataset represented up to 61% of total assets and 64% of member accounts of APRA-regulated funds In 2017, funds in the dataset represented up to 85% of total assets and 82% of member accounts of APRA-regulated funds.	
Survivor bias	No.	Selection bias Yes.

^a Net returns are estimated less investment fees, taxes and implicit asset based administration fees. This means that some options may be reported gross of asset based administration fees. To be conservative the Commission's benchmark portfolios are adjusted assuming all options are net of asset-based administration fees. ^b These coverage estimates are likely to be overestimates due to the estimation method (tech. supp. 4). The analysis excludes legacy products. These coverage estimates are likely to be overestimates due to the estimation method (tech. supp. 4).

FINDING 2.2

APRA-regulated funds have delivered investment returns to members over the past 21 years (net of all fees and taxes) of 5.9 per cent a year, on average. The majority of members and assets in the system are in products that have performed reasonably well. But there is significant variation in performance within and across segments of the system that is not fully explained by differences in asset allocation.

Not-for-profit funds, as a group, have systematically outperformed retail funds. This outperformance cannot be fully explained by asset allocation, tax or expenses. Much of it is likely due to differences in asset selection (within asset classes) between the segments.

2.5 What is the variation in performance within the system and segments?

Assessing the performance of system and segment averages provides an important check on the overall efficiency of the superannuation system. However, averages can hide significant variation in performance within the system and particular segments. This variation matters for the experience of members and provides key insights into the competitive dynamics of the system.

The Commission has analysed distributional outcomes within the system and segments to ascertain the magnitude of under- and over-performance by funds and products compared with benchmarks. This section considers distributional outcomes over time and across all funds (using fund-level data) before focusing on the default and choice segments (using product-level data).

There is evidence of an underperforming tail of funds

The Commission analysed the performance of all APRA-regulated funds over the 13-year period to 2017. Due to limited asset allocation data prior to 2014, assumptions had to be made based on MySuper data, meaning that this analysis only covers funds that provided a MySuper product as at June 2017 (tech. supp. 4). The limited sample means the results need to be carefully interpreted as the funds in the sample are more likely to be industry funds and less likely to be retail funds.

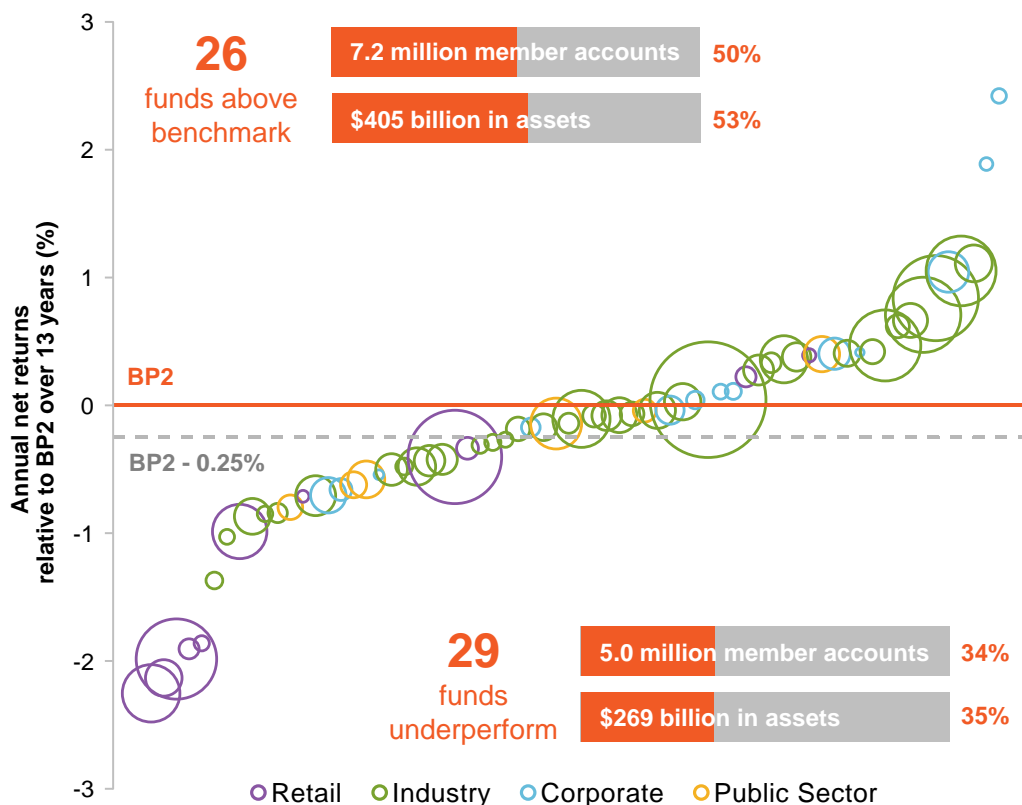
Collectively, the funds in this analysis represent just over half of all member accounts (14.6 million accounts) and almost a third of assets in the system (\$759 billion). When compared with a benchmark portfolio tailored to each fund's asset allocation (BP2), approximately 43 per cent of funds (some 29 funds) underperformed their tailored benchmark portfolio by 25 basis points or more (figure 2.14). These funds represented 35 per cent of assets and 34 per cent of member accounts in this sample.

It is important to note that all fund-level analysis is conducted on a gross-of-tax basis. In refining its assumptions following feedback on the draft report, the Commission determined that an 'across-the-board' tax assumption did not adequately allow for heterogeneity across funds (tech. supp. 4).

The underperforming funds comprise 9 retail funds (of 11 in the sample), 14 industry funds (of 38), 3 corporate funds (of 13) and 3 public sector funds (of 6). But this does not quite capture the overrepresentation of retail funds in the tail of underperformers relative to other types of funds. 82 per cent of retail funds (in this sample) underperformed, compared with 37 per cent of industry funds, 23 per cent of corporate funds and 50 per cent of public sector funds. Underperforming retail funds also account for a larger share of accounts (77 per cent) and assets (72 per cent) than other types of funds.

Figure 2.14 Individual funds (with MySuper products): 5 million accounts are in underperforming funds

Performance relative to individual funds' benchmark portfolios, 2005–2017
 Size of circles indicates the size of each fund's assets under management



Sources	PC analysis of APRA unpublished data and financial market index data (various providers).
Benchmark Coverage	Fund tailored BP2. APRA-regulated funds with a MySuper product in the dataset over the full period (60% of assets and 66% of member accounts in all APRA-regulated funds with a MySuper product in 2017). Excludes exempt public sector superannuation schemes, eligible rollover funds and insurance-only superannuation funds. Over the entire super system, the figure represents 68 funds, 30% of assets and 51% of member accounts in 2017.
Survivor bias	Yes.
Selection bias	Yes.
Further results	13 funds performed between BP2 and 25 basis points below BP2 (2.4 million member accounts and \$85.5 billion in assets).

On the other hand, half of accounts and assets (50 and 53 per cent, respectively) in this sample are in funds that perform above their tailored benchmark. Many of these funds are large not-for-profit funds.

These results have deteriorated since publication of the draft report — the number of funds above the benchmark (as well as member accounts and assets) fell, and the number of funds, assets and accounts that underperform significantly increased. These changes are the result

of adding an additional year of data, minor changes to the benchmarking assumptions, and the contraction of the overall sample from 74 to 68 funds (mostly due to merger activity).

An alternative approach is to assume a static asset allocation over the period based on each fund's asset allocation in 2017. This analysis is presented in technical supplement 4 and captures a much larger proportion of the super system (about \$1.3 trillion in assets and about 20 million member accounts). Though this assumption is less robust, the analysis reveals a much larger proportion of underperforming assets and accounts (56 and 64 per cent, respectively), suggesting that there may be many underperforming funds that do not offer a MySuper product (and thus are not captured in figure 2.14). Retail funds continue to be over-represented in the tail of underperforming funds in this latter analysis.

Large, unexplained fund-level residuals suggests asset selection plays a role

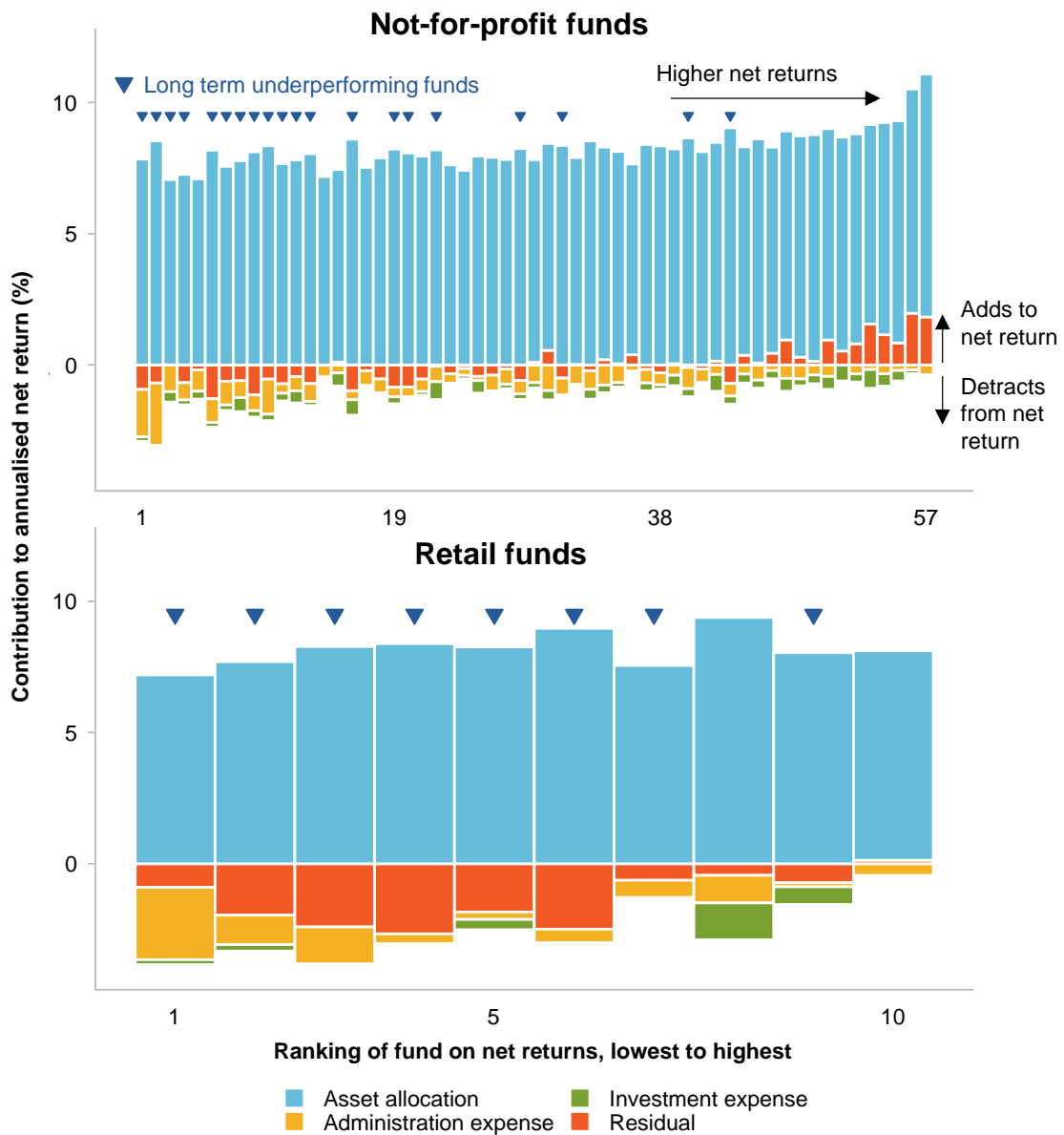
Asset allocation is the largest driver of total net returns across the board for funds (figure 2.15), but is not the predominant source of variation across funds. Variation in fund-level residuals (a standard deviation of about 0.9 percentage points) is much larger than in fund-level asset allocation effects or administration expenses (a standard deviation of about 0.5 percentage points each).

Funds on the right hand side of both graphs in figure 2.15 generally have lower expenses, though these do not appear to differentiate the best funds from the funds in the middle of the two distributions. The higher net returns of the funds on the right-hand side seem to be partly reflected in the larger positive residuals. At least in part, this likely reflects better asset selection within asset classes. By contrast, funds on the left-hand side typically have larger administration expenses, as well as substantial negative residuals. There are some funds that outperform their benchmark, but deliver relatively low net returns (in absolute terms). However, most funds that outperform their benchmark tend to deliver higher net returns.

The Commission has also undertaken an exploratory analysis of fund-level residuals (on a gross-of-tax basis) to identify other factors that may be driving variation in the residuals. Factors considered include proxies of fund governance 'efficacy'— as an attempt to discern any distinguishable (albeit partial) effects of governance on performance. There is some evidence that fund level residuals are correlated with proxy measures for fund governance efficacy. These measures of 'efficacy' include fund readiness to introduce a MySuper product, how fast the fund transferred default members to the MySuper product, and fund use of related parties. The analysis is presented in technical supplement 4.

The Commission has also explored the relationship between fund size (scale) and net returns for funds operating between 2014 and 2017 (tech. supp. 8). Larger not-for-profit funds were found to obtain higher net returns, but no corresponding relationship was observed for retail funds. For example, the largest industry funds experienced average net returns that were two percentage points higher than the smallest funds.

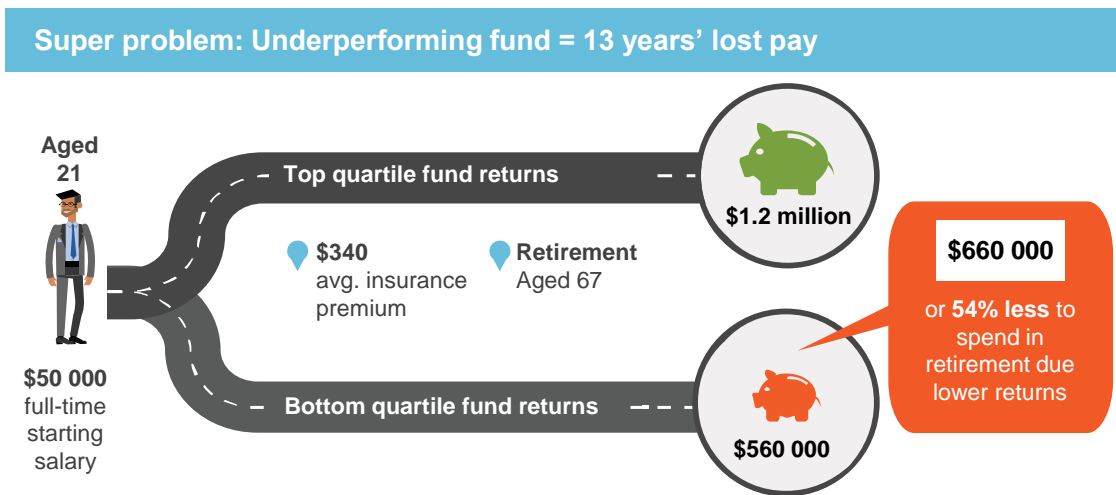
Figure 2.15 Fund-level absolute performance decomposition (total net returns)
2005–2017



Sources	PC analysis of unpublished APRA data and financial market index data (various providers).	
Benchmark	Fund-tailored BP2.	
Coverage	APRA-regulated funds with a MySuper product in the dataset over the full period (60% of assets and 66% of member accounts in all APRA-regulated funds with a MySuper product in 2017). Excludes exempt public sector superannuation schemes, eligible rollover funds and insurance-only superannuation funds. Over the entire super system, the figure represents 67 funds, 27% of assets and 47% of member accounts in 2017.	
Survivor bias	Yes.	Selection bias Yes.

The variation in performance across funds matters because differences in investment performance can compound to large differences in retirement balances. The Commission’s cameo model suggests that a member receiving the median top quartile fund return could end up with 54 per cent less (or \$660 000) at retirement compared with a member receiving the median return of the bottom quartile fund (cameo 2.2).

Cameo 2.2 Differences in fund-level performance matters^a



^a The assumptions underpinning this cameo are set out in chapter 1.

The full analysis, including a relative outperformance decomposition at the fund level, is detailed in technical supplement 4.

FINDING 2.3

There is wide variation in performance at the fund level. About 5 million member accounts and \$270 billion in assets are in 29 funds that underperformed conservative benchmarks tailored to each fund’s own asset allocation over the 13 years to 2017. About 77 per cent of member accounts and 72 per cent of assets in underperforming funds were in retail funds, even though retail funds represented just 9 of the underperforming funds. Of the other underperforming funds, 14 are industry funds, 3 are corporate funds and 3 are public sector funds.

While asset allocation is the largest determinant of returns at the fund level, most of the variation across funds cannot be explained by asset allocation, tax or expenses. Rather, it is most likely primarily due to differences in asset selection (within asset classes) between funds.

Performance varies in the default segment over time

The default segment is difficult to analyse for the key reason that the MySuper regime represents a significant ‘break’ in these data. For nearly half of the current MySuper products, there are no data available on a precursor product (if there was one) prior to the MySuper reforms commencing in 2013. Therefore, comprehensive product-level analysis is constrained to four years of data. However, the Commission has conducted a longer-term analysis of a sub-sample of products using research firm data, which identified precursor products and thus provided an 11-year time horizon for performance in the default segment. Importantly, this sub-sample represents most MySuper assets and member accounts (at least 75 per cent of both).

There is a significant spread of short-term performance among MySuper products

There is a significant spread of short-term performance across MySuper products, even after controlling for differences in asset allocation (figure 2.16). These results need to be viewed with caution as it is investment performance over the longer term that matters most and is of robust interpretive value. Despite this, short-term outcomes can be still be informative, particularly on the question of dispersion, given the near-completeness of the MySuper data.

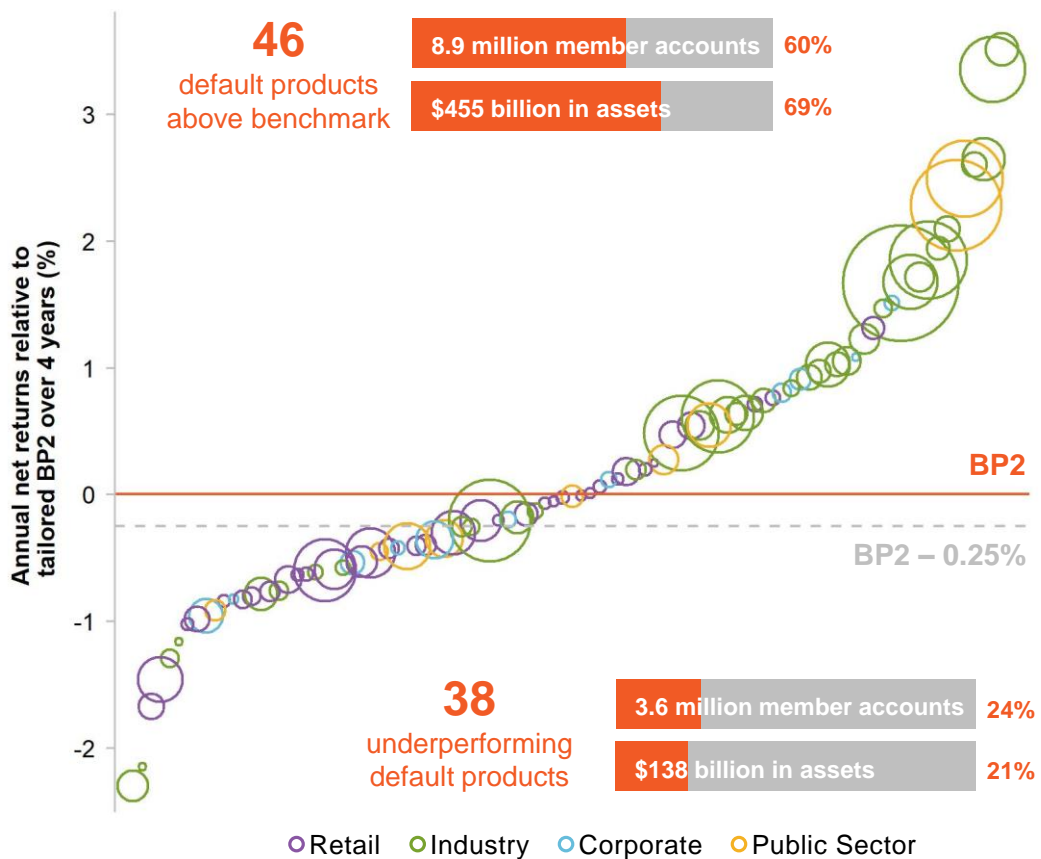
Over the past four years, 38 of the 96 MySuper products in the sample underperformed their BP2 by at least 25 basis points. These underperforming products represent \$138 billion of assets in 3.6 million member accounts, and comprise 19 retail fund products (of 37 in the sample), 10 (of 39) industry fund products, 5 (of 11) corporate fund products, and 4 (of 9) public sector fund products. These underperforming MySuper products yielded a median annual net return of 6.9 per cent, and include 14 of the 25 life-cycle products in the sample.

At the other end, products performing above their BP2 were mostly offered by not-for-profit funds (35 of the 46). These products yielded a median annual net return of 8.2 per cent. They are typically larger than underperforming products, with an average of \$10 billion in assets and 193 000 member accounts, compared with \$3.6 billion and 94 000 respectively for underperforming products.

The Commission has also benchmarked the four-year sample of MySuper products against two common benchmarks: a BP2 built from the MySuper segment-average asset allocation, and the median MySuper target. The segment-average BP2 analysis produced 29 underperformers (\$69 billion in 1.8 million accounts), and the median MySuper target analysis produced no underperformers. Full details are in technical supplement 4.

Figure 2.16 **MySuper products: many MySuper products have underperformed in the short term^{a,b,c}**

Performance relative to individual products' benchmark portfolios, 2015–2018
Size of circles indicates the size of each product's assets under management



Sources	PC analysis of APRA (2018a, 2018k), and financial market index data (various providers).
Benchmark	Product-tailored BP2
Coverage	96 of 105 MySuper products active as at December 2017 representing 97% of current MySuper assets (\$658b) and 98% of current MySuper accounts (14.8m).
Survivor bias	Yes.
Selection bias	Yes.
Further results	12 MySuper products performed less than 25 basis points below BP2 (\$65 billion in 2.3 million accounts).

^a Life-cycle product returns and asset allocation are derived as the asset-weighted average of individual stages. ^b BP2 does not include unlisted infrastructure due to data limitations. ^c Net returns are net of investment fees, taxes, and administration fees. BP2 is net of the 25th percentile administration fee of the sample. Net return and BP2 administration fees are calculated as those charged on a \$50 000 balance.

Dispersion of performance is also evident over the longer term

The short time series of MySuper data can be overcome by using research firm data covering a longer time period (in this case, from SuperRatings). However, this comes with the key limitation of a smaller sample, given not all current MySuper products have direct precursor products from the pre-MySuper era. Further, these data also likely suffer from upward selection and survivor biases — better products are both more likely to have been reported to SuperRatings and to have survived for the longer period.

Many participants argued that current MySuper products should not be connected with their precursors due to higher fees and embedded adviser commissions in default products in the pre-MySuper era (Chant West, sub. DR191; FSC, sub. DR186; Rice Warner, sub. DR202). The Commission accepts that the pre- and post-MySuper ‘break’ in these data limits the interpretative value of the analyses for relatively new or prospective default members. However, the Commission strongly rejects the assertion that the ‘break’ means long-term analyses of default member experiences should not be conducted. There would be (millions of) members who experienced 11 continuous years in particular MySuper products and their precursors. If, at any time, their net returns have been impacted by high fees or commissions, this should be accounted for, especially when assessing the default segment.⁷

In the draft report, the Commission benchmarked MySuper products against a common BP2 built from the MySuper segment-average asset allocation. Some of the distribution in performance against the default segment average BP2 may have been due to differences in asset allocation between individual products and the BP2 (ASFA, sub. DR148; Chant West, sub. DR191). Therefore, the Commission has benchmarked the performance of 53 MySuper products and their relevant precursors over the 11 years to 2018 against a BP2 tailored to each product’s individual asset allocation.

This analysis reveals 17 MySuper products underperformed over the 11-year period (by at least 25 basis points), representing 1.6 million member accounts and \$57 billion in assets (figure 2.17). These underperforming products include 7 (of the 15 in the sample) life-cycle products. 10 of the 17 underperforming products were offered by retail funds (of 13 in the sample), with the remaining being 6 (of 30) industry fund products and one (of 7) public sector fund product. These underperforming products produced a median return of 3.8 per cent a year.

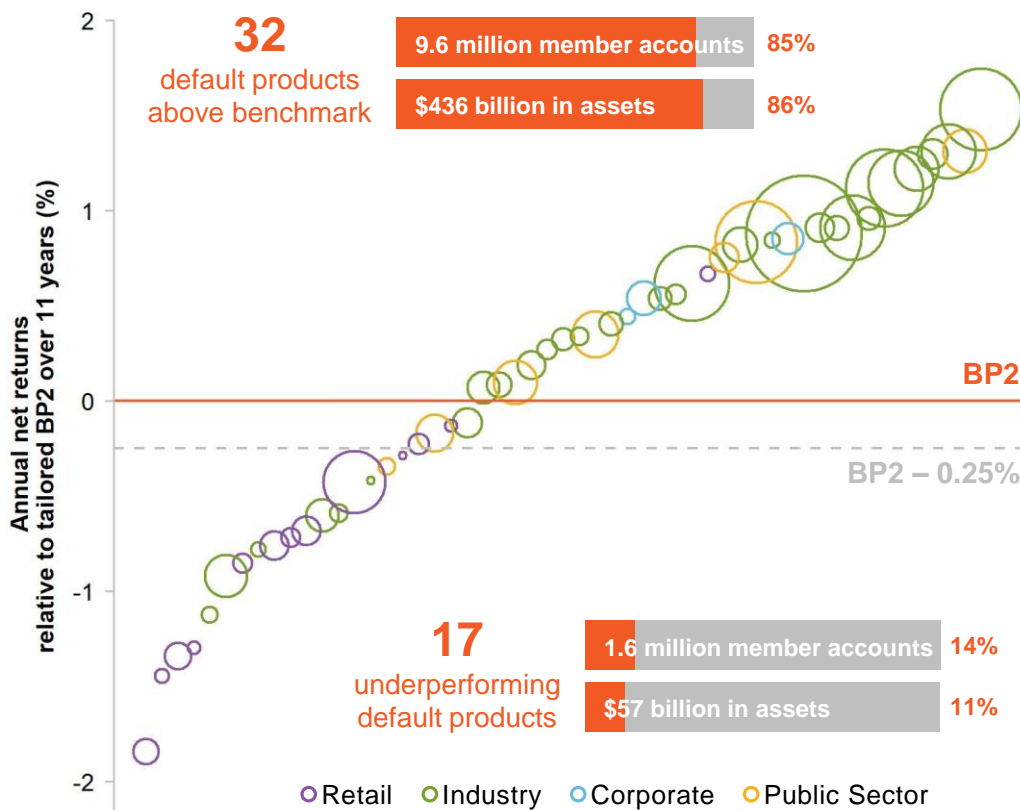
The 32 products that performed above their tailored BP2s represent nearly 10 million accounts and nearly \$440 billion in assets. All except one were offered by not-for-profit funds. These products generated a median return of 5.5 per cent a year. As with the four-year analysis, the products that performed above their BP2 were typically larger than those that underperformed, with average assets and member accounts of \$13.6 billion and 302 000 compared with \$3.4 billion and 95 000 respectively.

⁷ The analysis in this chapter presents returns net of administration fees (which can embed trailing commissions paid by funds to financial advisers) and investment fees. Sufficient data were not available to evaluate returns net of other forms of advice fees; these are considered separately in chapter 3.

Figure 2.17 **Default products: 1.6 million member accounts in products underperforming relative to a tailored benchmark^{a,b,c}**

Performance relative to individual products' benchmark portfolios, 2008–2018

Size of circles indicates the size of each product's assets under management



Sources	PC analysis of APRA (2018a, 2018k), financial market index data (various providers), and SuperRatings data
Benchmark	Product-tailored BP2
Coverage	53 of 105 current MySuper products covering 76% of member accounts and 75% of assets in all MySuper products as at June 2018.
Survivor bias	Yes.
Selection bias	Yes.
Further results	Four products performed less than 25 basis points below BP2 (150 000 member accounts and \$12.6 billion in assets).

^a Current MySuper products were connected with pre-cursors with the support of SuperRatings where requested. Fifteen life-cycle products are represented by their largest 'balanced' (according to SuperRatings definitions) stage, but only the assets and accounts in the representative stage are counted. ^b BP2 asset allocation adjustments are detailed in technical supplement 4. BP2 does not include unlisted infrastructure due to data limitations. ^c Net returns are net of investment fees, taxes, and implicit asset-based administration fees. BP2 is net of the 25th percentile asset-based administration fee of the sample.

The tailored BP2 analysis presented in figure 2.17 did not produce materially different results to a segment-average BP2 analysis (21 underperformers representing \$55 billion in 1.6 million member accounts). This suggests that differences between the product-level and segment-average asset allocations did not strongly influence the dispersion in performance against the segment-average BP2. Of the 17 products that underperformed a tailored BP2,

only one did not also underperform the segment-average BP2 (tech. supp. 4).

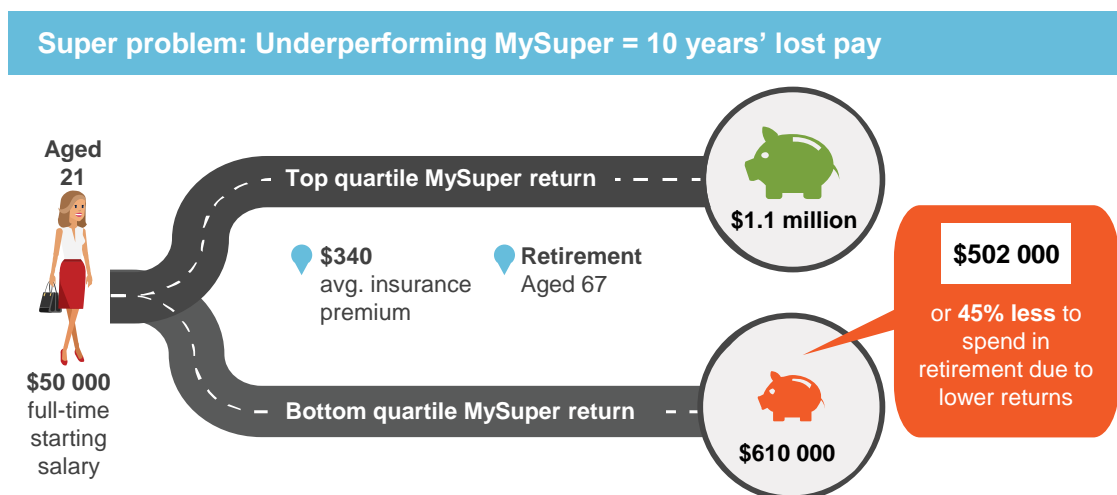
Aside from tailoring BP2 to individual products, the differences in the results from those presented in the draft report are mostly driven by a change to the tax rate applied to BP2. The shift from a raw system median to an adjusted MySuper average tax rate led to results that are broadly consistent with the relevant sensitivity testing in the draft report. The relatively larger changes to the four-year results are driven predominantly by a change in the asset allocation data source (from SuperRatings data to more comprehensive APRA data) (tech. supp. 4).

Large, unexplained MySuper residuals suggests asset selection plays a role

Asset allocation is the largest driver of total net returns for MySuper products, but is not the predominant source of variation across products (figure 2.18). Variation in the product-level residuals (a standard deviation of 0.73 percentage points) is much larger than in product-level asset allocation effects (0.41 percentage points), administration fees (0.40 percentage points) or investment fees (0.19 percentage points). This indicates that much of the variation in performance across MySuper products cannot be explained with the available data, and that at least some of the variation is most likely primarily due to differences in asset selection within individual asset classes.

The variation in performance across MySuper products matters because differences in investment performance can compound to large differences in retirement balances. The Commission's cameo model suggests that a member receiving the median bottom-quartile default product's return could end up with 45 per cent less (or \$502 000) at retirement compared with a member receiving the median return of the top-quartile products (cameo 2.3).

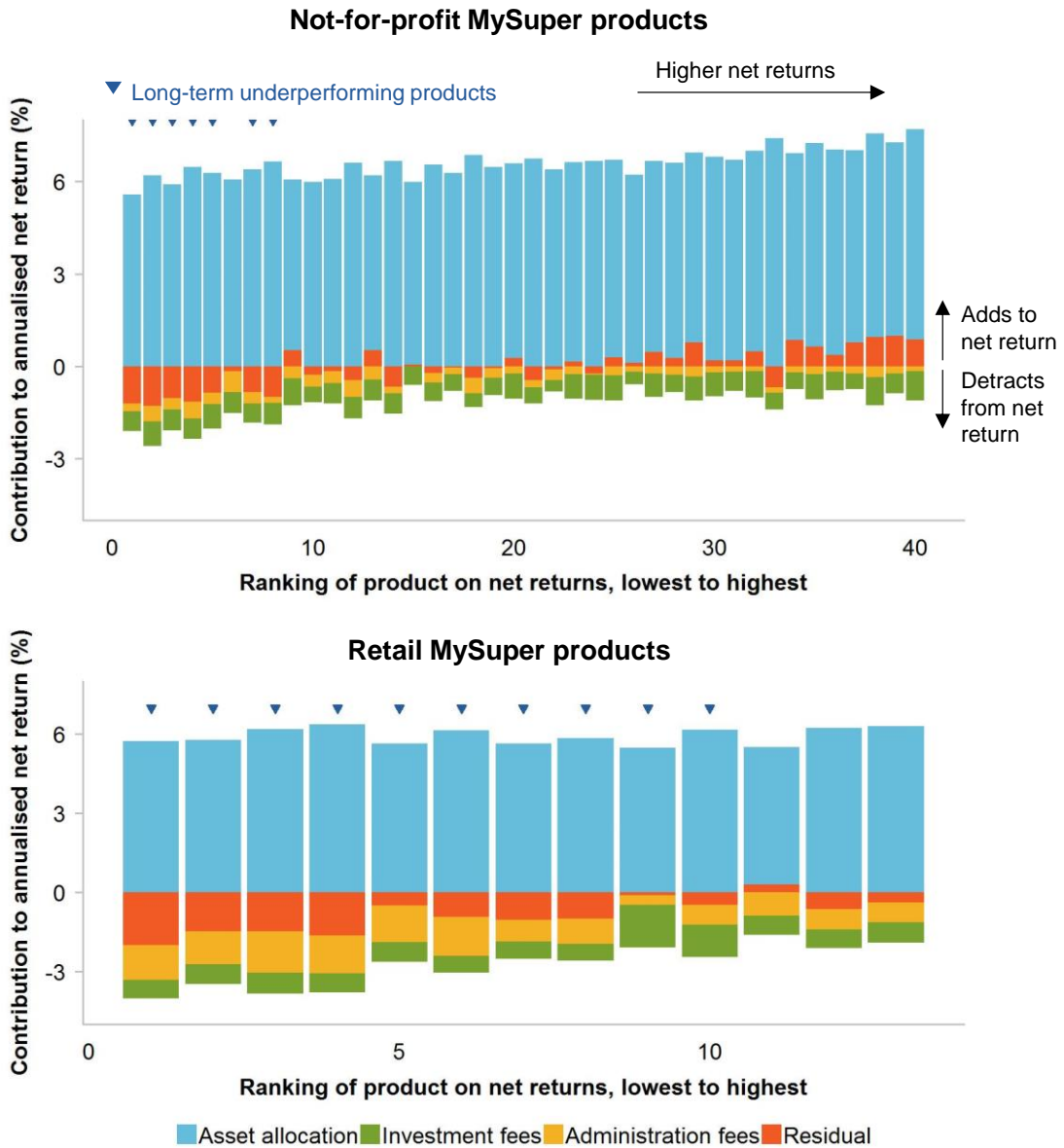
Cameo 2.3 MySuper returns can be a lottery for default members^a



^a The assumptions underpinning this cameo are set out in chapter 1.

Figure 2.18 **MySuper products: Most variation in performance is unexplained^{a,b,c}**

MySuper product-level performance decomposition, 2008–2018



Sources	PC analysis of APRA (2018k, 2018a), financial market index data (various providers), and SuperRatings data.
Benchmark Coverage	Product-tailored BP2. 53 of 105 current MySuper options covering 76% of member accounts and 75% of assets in all MySuper products as at June 2018.
Survivor bias	Yes.
Selection bias	Yes.

^a Administration fees are calculated as those charged on a \$50 000 balance. ^b Current MySuper products were connected with pre-cursors with the support of SuperRatings where requested. Fifteen life-cycle products are represented by their largest 'balanced' (according to SuperRatings definitions) stage. ^c BP2 (the asset allocation bars) does not include unlisted infrastructure due to data limitations.

FINDING 2.4

There is wide variation in performance in the default segment. About 1.6 million member accounts and \$57 billion in assets are in MySuper products that underperformed conservative benchmarks tailored to each product's own asset allocation over the 11 years to 2018. This suggests that many members are currently being defaulted into underperforming products and could be doing better.

If all members in bottom-quartile MySuper products received the median return from a top-quartile MySuper product, they would collectively be \$1.2 billion a year better off. Being in the median bottom-quartile product means that, on retirement, a typical worker (starting work today) is projected to have a balance 45 per cent lower (or \$502 000 less to retire with).

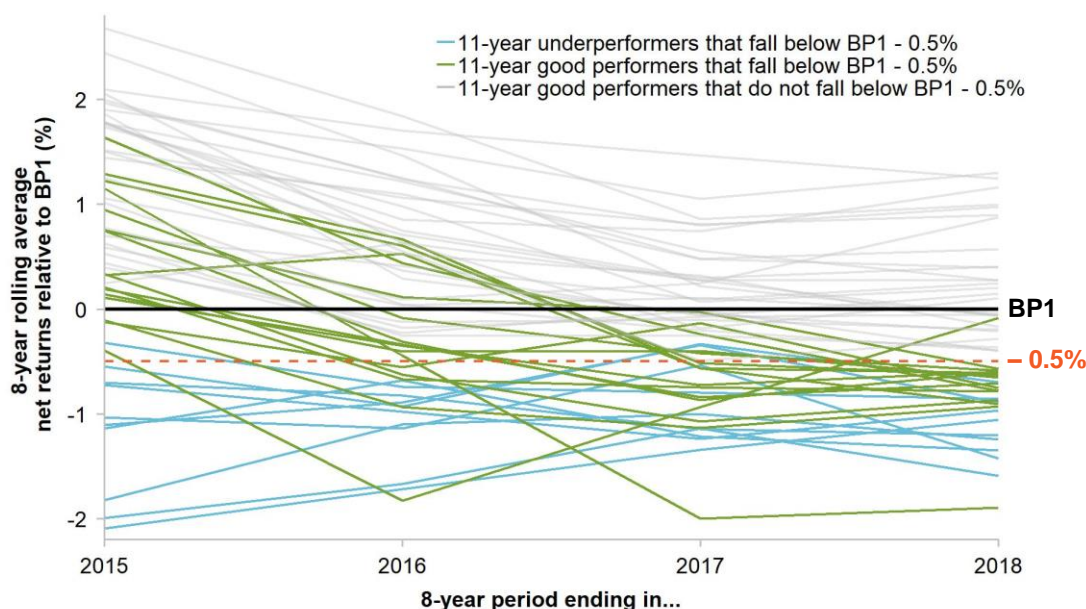
Rolling 8-year returns are reasonably predictive of longer-term performance

As part of an elevated outcomes testing regime to be applied by APRA, the Commission is proposing that all MySuper and choice investment options be compared with a listed benchmark (BP1) tailored to their asset allocation (chapter 13). Options that fall below this BP1 by 0.5 percentage points or more over an 8-year period (to abstract from much of the year-to-year volatility of investment markets) would have to be remediated within 12 months or withdrawn. The Commission envisages this 'right to remain' test to be applied in the near future (2022) when enough high-quality data on investment options have been collected, by both funds and the regulator.

The historical data on MySuper products analysed above suggest that all products that underperformed over the 11 years of available data would have failed the 'right to remain' test at some point on an 8-year rolling basis.

However, some other products (that did not underperform) would also have failed, based on the historical data (figure 2.19). Most of these products typically beat their BP1 during the GFC by a large margin, which pushed up their 11-year average performance even though they underperformed over one or more subsequent 8-year period (the average deviation from BP1 in 2009 was 3 per cent, from an average actual return across all products of -12.7 per cent). This is likely due to the relatively large shares of 'other' assets in the asset allocation data used for the BPs (comprising alternative assets such as hedge funds and commodities). During the GFC, it is likely that these alternative asset classes performed better than the listed asset classes (equities and fixed income) used to proxy for 'other' assets in the BPs, thus accounting for the large positive deviations from BP2. With more granular asset allocation data, which would allow more specific indexes to be used in the benchmarks, such abnormalities would be unlikely to arise when such a test is applied in future.

Figure 2.19 MySuper products: 8-year performance^{a,b}
 Rolling 8-year average performance against a tailored BP1, 2008–2018



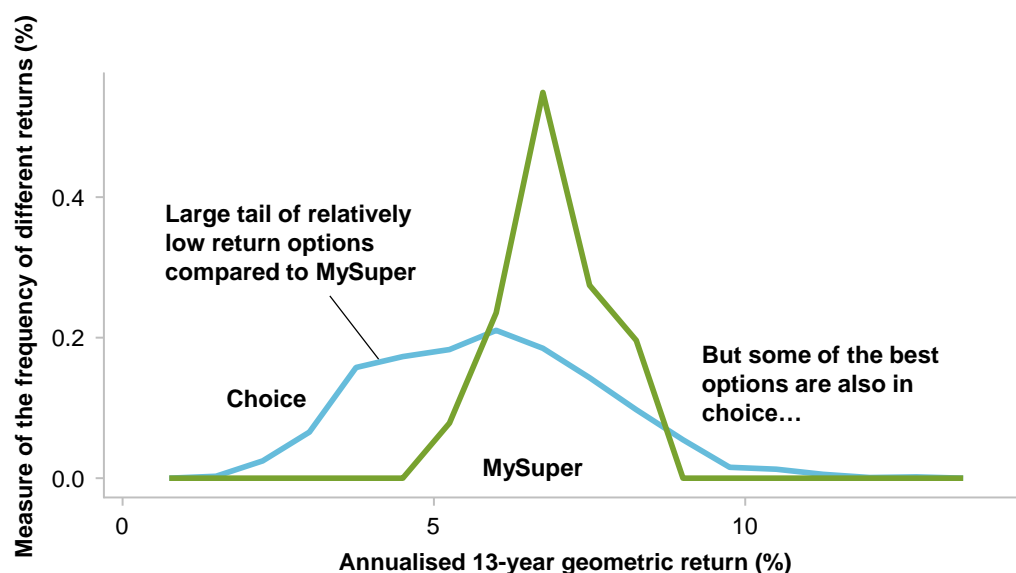
Sources	PC analysis of APRA (2018k, 2018a), financial market index data (various providers), and SuperRatings data.
Benchmark	Product-tailored BP1.
Coverage	53 of 105 current MySuper options covering 76% of member accounts and 75% of assets in all MySuper products as at June 2018.
Survivor bias	Yes.
Selection bias	Yes.

^a Net returns are net of investment fees, taxes, and implicit asset-based administration fees. BP1 is net of the 25th percentile asset-based administration fee of the sample. ^b Current MySuper products were connected with pre-cursors with the support of SuperRatings where requested. Fifteen life-cycle products are represented by their largest 'balanced' (according to SuperRatings definitions) stage.

Performance also varies in the choice segment

The choice segment is highly heterogeneous, and this makes it inherently challenging to evaluate at a disaggregated level. Some of the products and options offered by funds in this segment (particularly retail funds) provide members with a greater level of discretion and control over the asset mix of their portfolios (chapter 4). Products may also have different (non-investment) service features attached to them which result in different fee structures. Not surprisingly, there is much dispersion in investment performance across products, especially compared with the default segment (figure 2.20).

Figure 2.20 Choice investment options: wider variation in choice than default^a
2005–2017



Source	PC analysis of SuperRatings data.		
Benchmark	Option tailored BP1, BP2.		
Coverage	555 choice accumulation options from APRA-regulated funds with a combined \$161 billion in assets.		
Survivor bias	Yes	Selection bias	Yes.

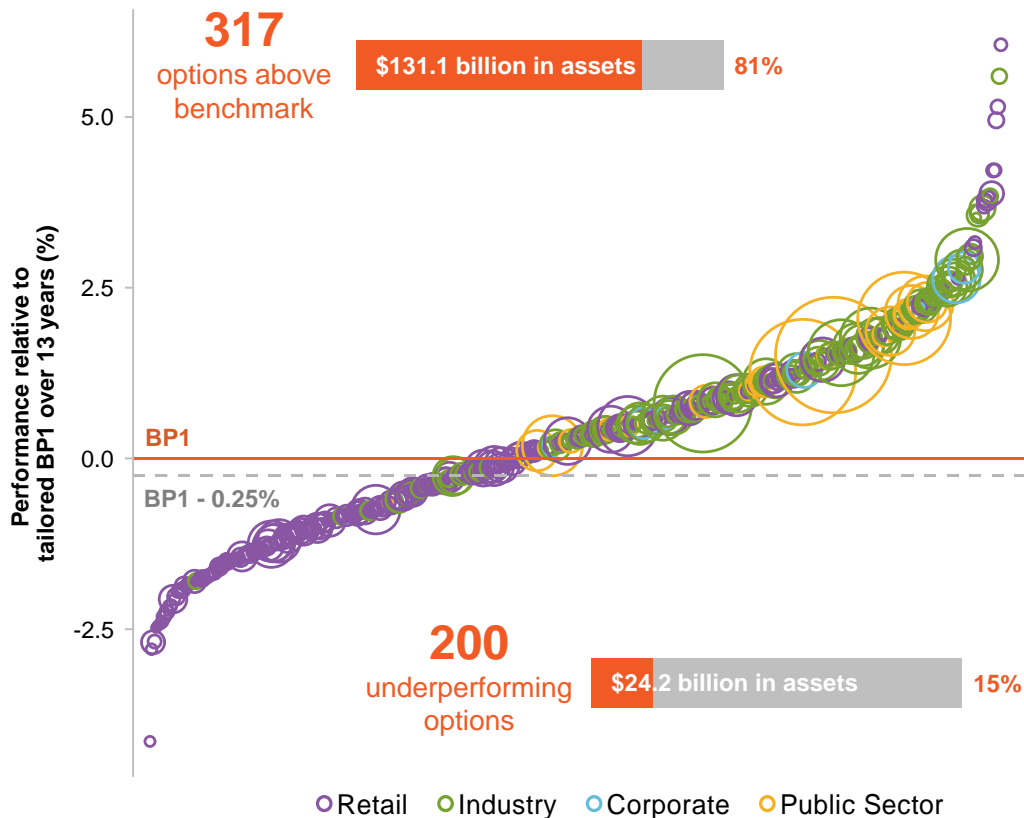
^a This figure is an empirical density with a bucket size of 0.75 per cent. The analysis only includes ‘open’ options. Not all options have assets data so the absolute coverage metric is an underestimate.

To accommodate these differences, the Commission has benchmarked individual choice investment options to their own individual asset allocations. The analysis is confined to options in the accumulation phase on which sufficient data are available and which are still active today — which comprise 555 options with an estimated \$161 billion in assets (about 16 per cent of assets in the entire choice segment). Data on the number of member accounts in these options were not available.

The analysis shows that about 36 per cent of the choice investment options (accounting for 15 per cent of assets with data available, or \$24.2 billion) delivered returns more than 25 basis points below their tailored benchmark (figure 2.21). Notably, almost all of these underperforming options were offered by retail funds, and accounted for 53 per cent of all retail options in the sample. Only 5 per cent and 1 per cent of underperforming options were offered by industry and public sector funds respectively, and accounted for 7 and 4 per cent of all industry and public sector fund options.

Figure 2.21 **Substantial tail of underperforming accumulation choice options^{a,b}**

Performance relative to option-tailored benchmark portfolios, 2005–2017
Size of circles indicates the size of each option's assets under management



Sources	PC analysis of financial market index data (various providers) and SuperRatings data.
Benchmark	Option tailored BP1.
Coverage	555 accumulation options from APRA-regulated funds with an estimated \$161 billion in assets in the choice segment.
Survivor bias	Yes.
Selection bias	Yes.
Further results	38 options performed less than 25 basis points below BP1 (\$5.9 billion in assets).

^a This analysis only includes options which are open today. Not all options had assets under management data so absolute coverage metrics are an underestimate. ^b For this analysis, BP1 (not BP2) is used to benchmark performance, as asset allocation data on unlisted assets are limited.

These results are different from those presented in the draft report, where a greater share of choice accumulation options underperformed. This is primarily due to the Commission's response to feedback about the effects of tax. The Commission has used the imputed MySuper average tax rate as an approximation of the tax rate that would apply to a balanced option in the accumulation phase, and applied this to all choice options (as more granular tax data were not available) (tech. supp. 4). This tax rate averages out to be substantially higher than the tax rate calculated from APRA fund-level data, but is more appropriate for

this analysis as the returns data are calculated using crediting. These revised results are broadly consistent with the sensitivity testing conducted in the draft report.

An important caveat is that SuperRatings returns data are net of investment fees *and* implicit asset-based administration fees. As such, some of the options which perform below the tailored benchmark may have high administration fees that reflect members' preferences for more costly 'non-investment services' — which ultimately detract from net returns. However, the results vary only slightly even when allowing for substantially higher administration fees in the retail segment of well over one percentage point each year (tech. supp. 4).

Scaling up these results to the entire choice segment would suggest that at least \$150 billion in assets (or 15 per cent of choice assets) are in underperforming investment options. While data are not available for the rest of the choice segment, to the extent that the SuperRatings dataset is more likely to capture relatively good options, the percentage assets in underperforming options is likely to be an underestimate.

FINDING 2.5

There is wide variation in performance in the choice segment that is not fully explained by differences in asset allocation. Almost \$25 billion in assets are in investment options that underperformed conservative benchmarks over the 13 years to 2017. Many choice members could be doing a lot better.

2.6 How have SMSFs performed?

As a whole, the SMSF segment delivered annual returns (less fees and taxes) of about 5.7 per cent a year over the 11 years to 2016, compared with 5.3 per cent for the APRA-regulated segment over the same period. This difference in performance could be driven by superior investment performance by SMSFs within asset classes, by differences in the underlying asset allocation between the segments, or by differences in how returns data are collected and reported by the ATO and APRA.

There are clear differences in asset allocation between SMSFs and APRA-regulated funds, with SMSFs holding a higher proportion in unlisted property and domestic equities, and less in international equities and fixed income (tech. supp. 4). However, asset allocation data for SMSFs are not collected on the same basis as for APRA-regulated funds. Some SMSF asset categories comprise managed funds but these data do not 'look through' to the underlying assets (which could span a range of other asset classes). This precludes the construction of a tailored benchmark portfolio for SMSFs. (More comparable data provided by Class Limited indicate that the share of growth assets was broadly similar between the two segments, at least in 2016 (tech. supp. 4).)

The comparison of SMSF and APRA-regulated fund returns is further complicated by differences in the method used to estimate rates of return in each segment (ATO nd). Indeed, several inquiry participants questioned the validity of SMSF return and cost data published in the Commission's draft report. Class Ltd. (sub. DR190) and the SMSF Association (sub. DR194) submitted that differences in the approaches used by the ATO (for SMSFs) and APRA (for APRA-regulated funds) understate SMSF returns relative to the APRA formula. With the assistance of additional data provided by the ATO and Class Limited, the Commission confirmed this to be the case, with the aggregate impact on reported SMSF returns in the order of 1 percentage point a year (tech. supp. 4). While full comparability of returns calculations remains elusive, the Commission has attempted to reduce the disparity by applying a simple adjustment to SMSF return data to make them more comparable with APRA return data (Sy 2009).

There is a clear relationship between SMSF size and returns

Larger SMSFs have consistently delivered higher net returns over the five years to 2016, compared with smaller SMSFs (figure 2.22).⁸ Over the same period, all but the largest SMSFs appear to have earned lower net returns than APRA-regulated funds, on average (which returned 7.3 per cent a year, compared with 6.0 per cent for SMSFs). Expense ratios are the main driver of differences across SMSFs of different size brackets (chapter 3). SMSFs with under \$500 000 in assets have relatively high expense ratios (on average), and this remains the case once recently established SMSFs are excluded from the sample — suggesting that initial establishment costs are not driving the results. Many SMSFs (42 per cent) with under \$500 000 in assets have been in existence for two or more years, and thus are likely to have persisted with high average expenses and low net returns (chapter 3).

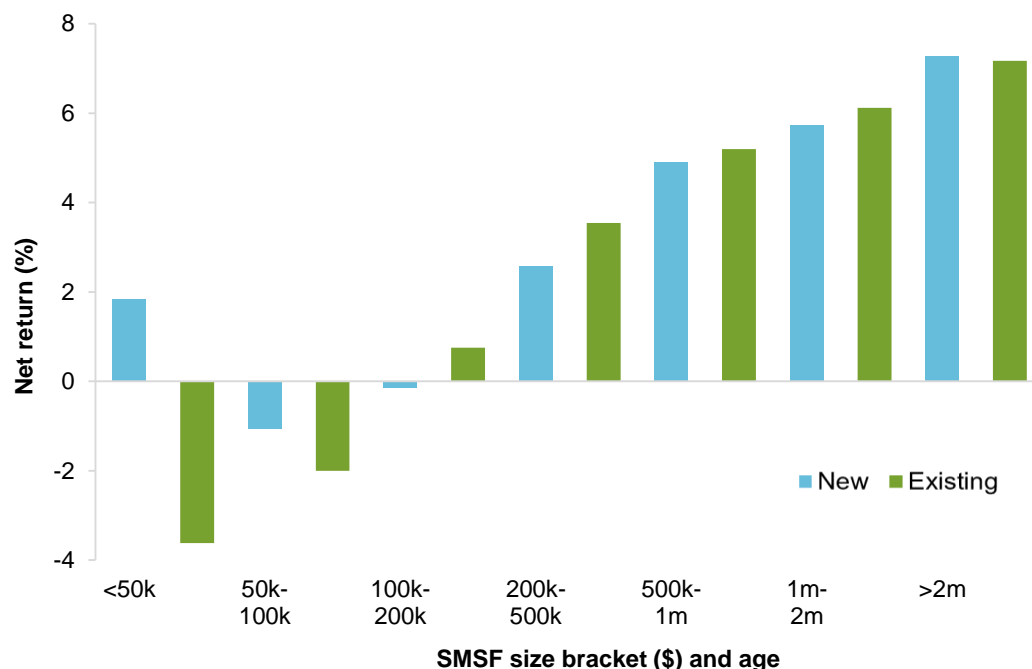
However, this does not mean that all members in smaller SMSFs will be receiving poor returns. As noted in chapter 3, some may be earning high net returns, or have tax advantages that are not fully reflected in the net returns data. Some may also have been set up as part of broader strategies to manage members' financial risks, with regard to their assets outside of superannuation.

FINDING 2.6

The SMSF segment has delivered broadly comparable investment performance to the APRA-regulated segment, but many smaller SMSFs (those with balances under \$500 000) have delivered materially lower returns on average than larger SMSFs.

⁸ The figures used in this chapter on SMSF returns and expenses by size category are derived from data obtained from the ATO, which classify SMSFs into size brackets based on the value of assets at the start of a year, rather than the average value of assets during the year (tech. supp. 5). The limited availability of these data account for the shorter time span in these analyses.

Figure 2.22 There is a clear relationship between SMSF size and returns^a
 Annualised adjusted net returns, 2012–2016



Sources	PC analysis of ATO (pers. comm., 24 September 2018).
Coverage	All SMSFs.
Survivor bias	No.
Selection bias	No.

^a Adjustments have been applied to SMSF returns data to approximate a 'rate of return' calculation, as per Sy (2009). 'New' SMSFs are defined as those established within the past two years. Size brackets are defined using assets at the beginning of the period.

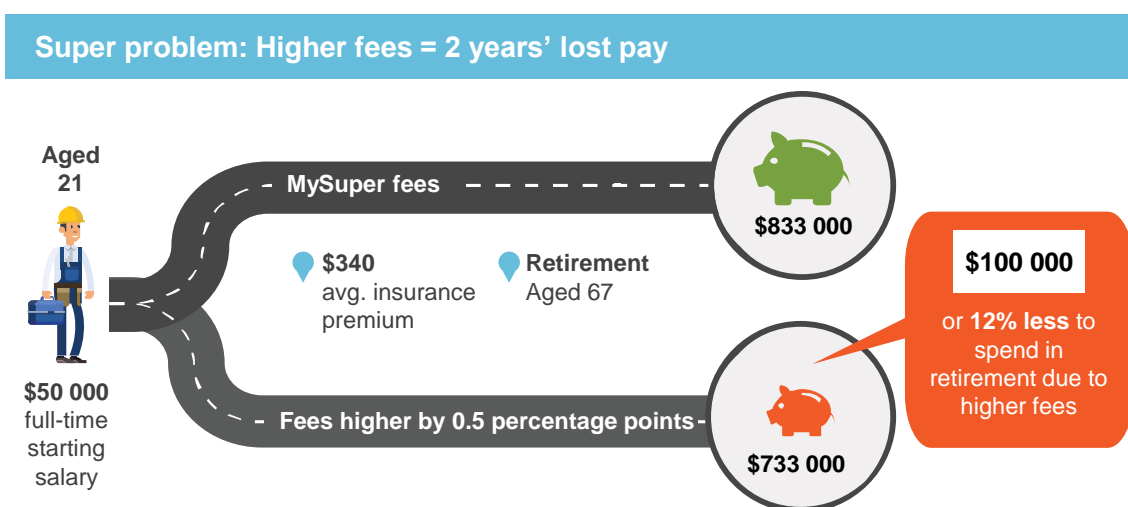
3 Fees and costs

Key points

- Fees matter. When excessive, they unnecessarily detract from members' returns and, ultimately, their retirement incomes.
- Members pay over \$30 billion a year in fees (excluding insurance premiums). Fees in Australia are high by international standards, partly reflecting the absence of effective member-driven competition and a tendency towards active investment management in some segments. There is evidence that investment management costs for some major asset classes (such as equities) exceed those of pension funds in other countries.
- Total fees (as a proportion of balances) have fallen by about 0.2 percentage points since the global financial crisis. But there is much variation across segments.
 - Fees have fallen for retail funds (to 1.6 per cent of balances on average) but still remain markedly higher than fees for industry funds, particularly administration fees on choice products.
 - A 'tail' of high-fee products (with fees exceeding 1.5 per cent of balances) accounts for an estimated 17 per cent of assets and 15 per cent of member accounts in APRA-regulated funds. These are predominantly choice products in the retail segment and about half are closed to new members.
 - The MySuper reforms appear to have contributed to lower fees within the default segment (especially for retail funds), with some likely spillover to the choice segment. Declining fees in the choice segment may also reflect competitive pressure from the growth of SMSFs.
 - High fees for financial advice are prevalent in parts of the system. Ten retail funds account for over 90 per cent of reported advice fee revenue (of \$1.6 billion in 2017). Trailing commissions are also further costing at least 636 000 member accounts of some retail funds more than \$400 million annually.
- Funds that charge higher fees typically do not deliver better net returns over time to members. High-fee funds tend to persistently have higher fees over time. This indicates scope for substantial system-wide improvement in member outcomes from mechanisms which ensure members are actively choosing or are defaulted into lower-fee and better-performing products.
- Members in SMSFs with balances under \$500 000 pay materially higher costs (relative to assets) and earn lower net returns than members in APRA-regulated funds, on average. While 42 per cent of all SMSFs are under \$500 000 in size and have been established for two or more years, the proportion of small SMSFs has decreased over time.
- The Commission, in laboriously gathering data from funds, is acutely aware of data limitations. Data gaps, underreporting and incomplete and inconsistent disclosure all contribute to poor data quality and ultimately harm members and are symptomatic of unchecked system malaise. Despite regulator awareness for at least 14 years, many funds significantly underreport their investment costs, with many unbelievably reporting zero. This lack of transparency harms members and needs immediate (albeit overdue) redress by regulators.

Fees matter. When excessive fees are charged they unnecessarily detract from the net returns received by members and, ultimately, from retirement incomes. Fees are not only the biggest drain on long-term net returns across funds, but are also a much more predictable indicator of a fund's investment performance (*ex ante*) than gross returns. Even small differences in fees can significantly impact retirement incomes (cameo 3.1). Higher fees of just 0.5 percentage points can cost a typical full time worker about 12 per cent of their balance (or \$100 000) by the time they retire.

Cameo 3.1 Higher fees materially erode balances at retirement^a



^a The assumptions underpinning this cameo are set out in chapter 1.

In a competitive system, funds would have an incentive to minimise their costs for a given return and to align their fees with those costs. They would also have an incentive to pursue greater scale (including through mergers) where this brings efficiencies that would further reduce fees. And in an efficient system, fees would reflect the value of the service funds are providing. Fees that are too high can mean suppliers are benefiting at the expense of members' retirement incomes. This can be due to a lack of demand-side pressure, and practices such as funds paying inflated costs to related parties.

Movements in fees over time, along with the costs incurred by funds, are an indicator of competition and efficiency in the superannuation system. What is happening to fees and costs can reveal whether larger average fund scale, growth in average balances and government regulations (such as MySuper, which imposed limits on the type and extent of fees a default member can be charged) have flowed through to benefit members (in the form of lower fees, and thus better net returns).

But fees and costs cannot be looked at in isolation. They need to be considered in tandem with broader system characteristics like contestability, and with the quality of service being provided (such as investment returns and member services). This chapter examines whether funds are competing on price and minimising their costs — which come in a range of types

(box 3.1). It discusses performance on fees and costs over time, including against international comparators (section 3.1), across the Australian Prudential Regulation Authority (APRA) system in aggregate (section 3.2) and across different segments of the APRA system (section 3.3). It considers how better disclosure of fees and costs would improve transparency and member outcomes in the APRA system (section 3.4) before assessing the relationship between fees and net returns (section 3.5). This chapter closes with an assessment of the performance of the self-managed superannuation fund (SMSF) segment (section 3.6).

The following criteria (from the Commission's stage 1 study) are addressed in this chapter.

- Are costs incurred by funds and fees charged to members being minimised, taking account of service features provided to members? (E2)
- Do funds compete on costs/price? (C6)

While much of the assessment is at the system level, there is also a focus on specific segments where the data allow: the default and choice segments, the APRA-regulated and SMSF segments, and the accumulation and retirement segments.

Several data sources are used in this chapter, including data from regulators and private research firms (appendix B), and data collected directly from the Commission's funds surveys (appendix C). In drawing on these sources, the Commission has become acutely aware of their limitations. Data gaps, underreporting and incomplete and inconsistent disclosure all contribute to poor data quality.

One critical issue here is the significant underreporting of *indirect* investment costs. Indirect investment costs are deducted by a fund's outsourced provider from an investment return before those returns are paid back to the fund (and in turn the member). But because they are not charged directly to the member (in the form of an explicit charge), they are not captured in some datasets. Underreporting of these costs materially influences estimates of fees and costs, including measured trends over time.

The different data sources used in this chapter differ mainly in terms of how well they capture these indirect investment costs. Advertised fees (drawn from product disclosure statements (PDSs)) generally include an estimate of indirect investment costs, although may not capture their full extent for all funds and products. Fee and cost data reported to APRA generally do not capture most of the indirect costs in the system (discussed below), meaning that APRA data need to be interpreted cautiously.

As such, the data in this chapter cannot provide categorical evidence of whether a segment of the market is efficient or not, but they can provide evidence of where issues may lie in the system, where efficiency gains have been realised, and where there is scope for improvement.

Further details on the quantitative analysis in this chapter, limitations of the data, and the methodological issues encountered in undertaking the analysis are in technical supplement 5.

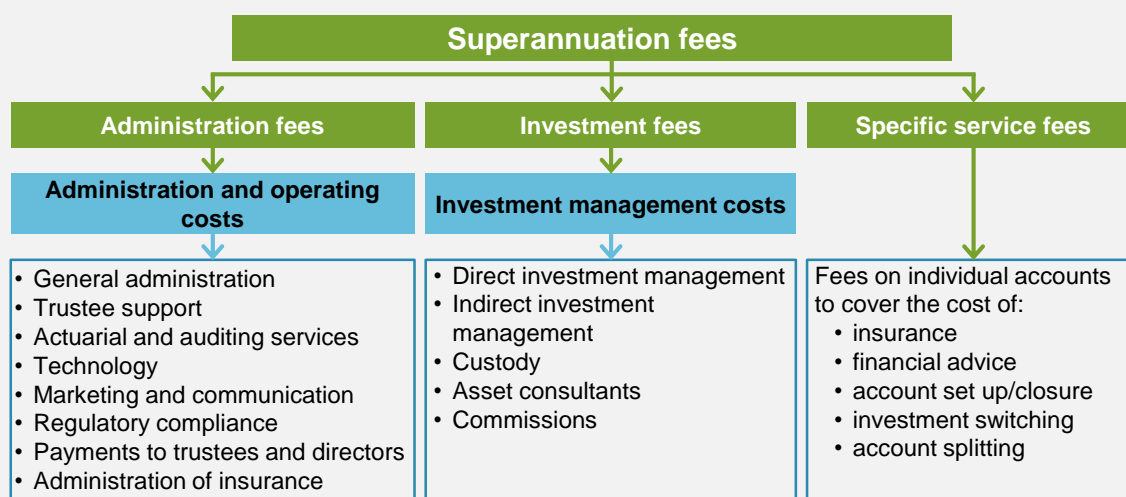
Box 3.1 Key definitions of fees and costs

This report distinguishes between **fees** (which are paid by members to funds) and **costs** (which are incurred by funds in managing members' accounts). Fees generally include:

- *administration fees* — which can be levied as a dollar charge over time (for example per month) or as a percentage of a member's assets
- *investment fees* — which are typically levied as a percentage of a member's assets
- *insurance fees* — the cost of administering any insurance policy that is on a member's account
- *specific service fees* — such as switching fees, withdrawal fees and fees for financial advice (which are levied based on a member's individual activities).

Insurance premiums are different from insurance fees, the latter only covering the cost of administering members' policies. Both are generally excluded from the analysis in this chapter.

Members can sometimes pay lower than advertised fees because their fund provides discounts (for example, given their account balance, or due to employer discounts).



This chapter uses a mix of data on advertised fees (which are the fees advertised in product disclosure statements) and fee revenue (which is the amount in fees collected by funds). The choice of metric is influenced by what data are available. For advertised fees, a 'representative' member has been used to show the fees a member would pay for a given account balance (tech. supp. 5). Advertised fees are for a \$50 000 asset balance unless otherwise indicated. Making fee comparisons is difficult because how fees are charged differs across funds, and because of inconsistent disclosure by funds (which, among other things, gives rise to a further distinction between reported and unreported fee revenue). Further, the actual fees incurred by a member can differ depending on the product and option their assets are in, as well as costs associated with particular types of services and features they may use.

Costs, by contrast, are incurred by superannuation funds to administer and manage retirement savings on behalf of members. They include investment costs, payments to trustees and directors, professional services from auditors and actuaries, administration costs and other management costs. They can be either direct costs (that must be reported to the Australian Prudential Regulation Authority) or indirect costs (all other costs, for example, costs incurred by a third party investment entity). For self-managed superannuation funds, costs are conceptually analogous to fees in that they detract from net returns and, ultimately, retirement incomes.

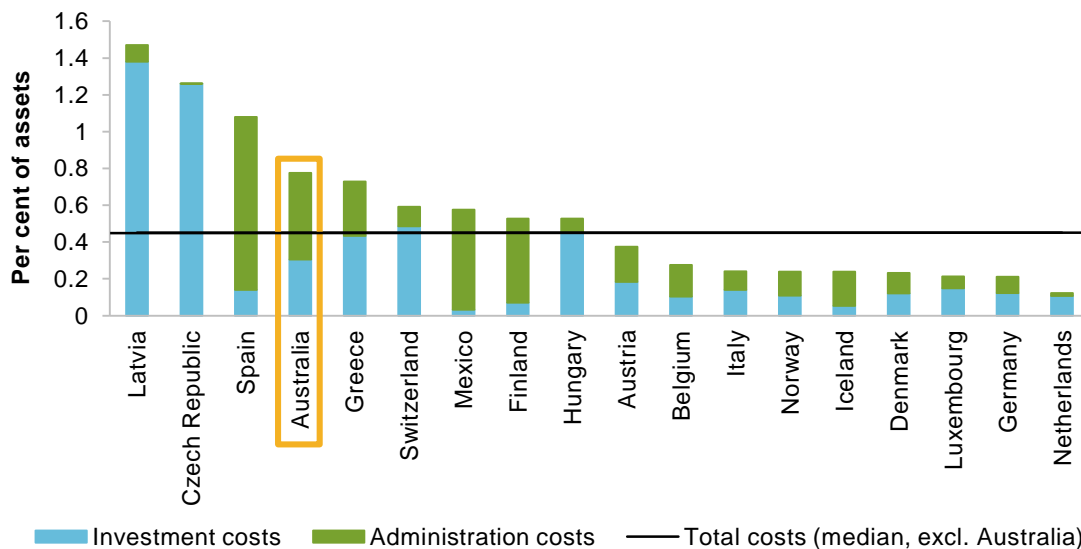
Sources: Minifie, Cameron and Savage (2014, 2015); Rice Warner (2014b).

3.1 How does Australia compare?

In total, Australians pay over \$30 billion a year in fees on their superannuation accounts (excluding insurance premiums), an estimate that is consistent with Rainmaker’s Fee Study (Pash 2018).⁹ The available evidence indicates that these fees are high by international standards.

Notwithstanding large differences in pension systems across countries, especially in asset allocation and administration, the costs incurred by Australian superannuation funds are some of the highest in the OECD (figure 3.1). The OECD has argued that Australia’s relatively high investment and administration fees reflect the high prevalence of SMSFs and defined contribution (as opposed to defined benefit) plans, as well as a relatively large number of smaller funds with higher average costs (OECD 2017a). The Reserve Bank of Australia made similar contentions in its submission to the Murray inquiry, adding that Australia’s compulsory system resulted in a greater degree of member disengagement than there would otherwise be — which detracted from competitive pressure on providers to contain costs and margins (RBA 2014, pp. 178–9).

Figure 3.1 **Administration and investment costs are high^{a,b}**
Operating costs as a proportion of assets, 2016



^a The OECD’s measure of ‘operating expenses’ comprises costs arising from investment management and administration. ^b Chart only shows countries with non-zero reported administration and investment costs. Source: OECD (2017a, figure 8.9).

⁹ The Commission’s (conservative) figure includes all reported fees collected by APRA-regulated funds (including insurance fees but excluding insurance premiums), an estimate of unreported fee revenues and indirect investment costs of APRA-regulated funds (based on advertised fees), the aggregate annual costs reported by SMSFs and the estimated costs of other regulated funds including for example, exempt public sector superannuation schemes.

There are limitations to the data used in this OECD comparison (figure 3.1), as outlined in Mercer’s submission to this inquiry (sub. DR175, pp. 15–16). There are differences in regulatory structure, in taxation, in administration practices, in reporting requirements and in the extent to which the data provided to the OECD covers the entire pension system of each country. These differences detract from the accuracy of the comparison.

To side-step most of the factors that confound international cost and fee comparisons, the Commission has compared the investment management costs of Australian superannuation funds in 2016 — as reported in the supplementary funds survey (appendix C) — to that of international pension funds (incorporating all direct and indirect costs) by asset class. The international data were purchased from CEM Benchmarking and are published in technical supplement 5 (tech. supp. 5).

The comparison suggests that Australian funds incur much higher investment costs for domestic and international equities, and international fixed interest, compared with most other countries in the dataset (figure 3.2). Some of this difference could be attributed to a greater use of active management by Australian superannuation funds, at least for equities.

Australian funds also pay marginally higher costs for cash and domestic fixed income on average. By contrast, the investment management costs for Australian superannuation funds are relatively comparable to international pension funds for unlisted assets (including unlisted infrastructure, unlisted property and private equity).

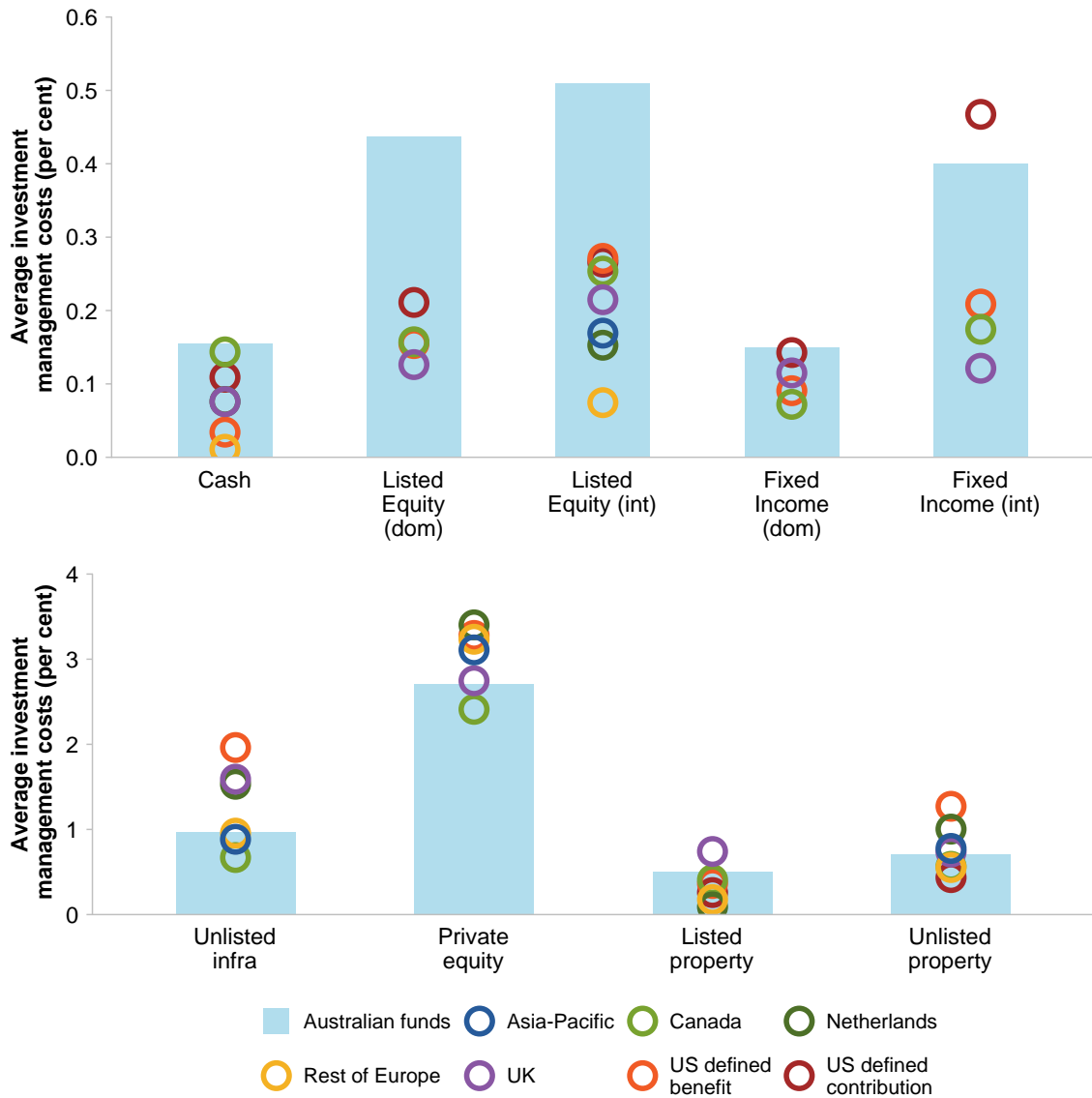
The margin between Australia and other countries across most of the main asset classes indicates that there is likely scope to reduce investment management fees and thereby improve members’ net returns. The Commission’s proposed (elevated) outcomes test and other initiatives to eliminate poorly performing products (chapters 10 and 13) will assist in this regard by increasing the incentive for funds to reduce costs.

FINDING 3.1

Superannuation fees in Australia are higher than those observed in other OECD countries. This may be partly because Australian funds face higher expenses. While international comparisons are not straightforward, there is evidence (by asset class) that Australian investment management costs are generally high by international standards, including for significant asset classes (such as equities and international fixed income).

Figure 3.2 Australian investment costs are typically higher for listed assets and lower for unlisted assets^a

International comparison of investment management costs weighted by assets, 2016



Sources	Supplementary funds survey, CEM Benchmarking data and financial market index data (various providers).
Coverage	In 2016, the Australian funds in this figure represented up to 73% of total assets and 63 per cent of member accounts of APRA-regulated funds.
Survivor Bias	Yes.
Selection Bias	Yes.

^a The scale on the two panels differs. In all other countries except the United States, pension schemes are defined contribution schemes.

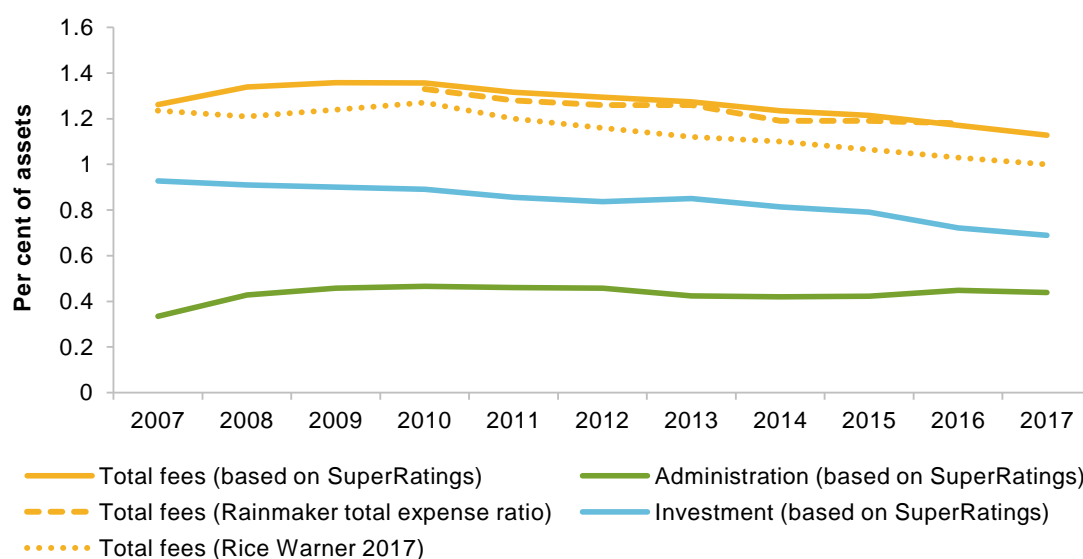
3.2 How have fees changed over time in the APRA-regulated system?

Fees have trended down in aggregate

Total fees have been falling across APRA-regulated funds in Australia at least since the global financial crisis (GFC) in 2008-09 (figure 3.3).¹⁰ This is a common finding (Burke 2017; Minifie, Cameron and Savage 2014, 2015; Rice Warner 2017g).¹¹

The rise in average fees around the time of the GFC may reflect an increase in direct investment management costs charged by external investment managers as they sought to build reserves and profit margins (Rice Warner 2014b). But since then, there has been a downward trend in fees, particularly in investment fees (which have fallen from 0.9 to 0.7 per cent of assets).

Figure 3.3 Total fees have fallen slightly^a
Advertised fees as percentage of assets, APRA-regulated funds, 2007–2017



Sources	Rainmaker (2017a, 2017b, table 2), Rice Warner (2017g, 2018c), PC analysis of SuperRatings data.
Coverage	362 products covering 78% of total assets and 76% of member accounts in APRA-regulated funds in 2017.
Survivor Bias	Yes.
Selection Bias	Yes.

^a Average product fees are calculated as the asset-weighted average of the fees of individual products.

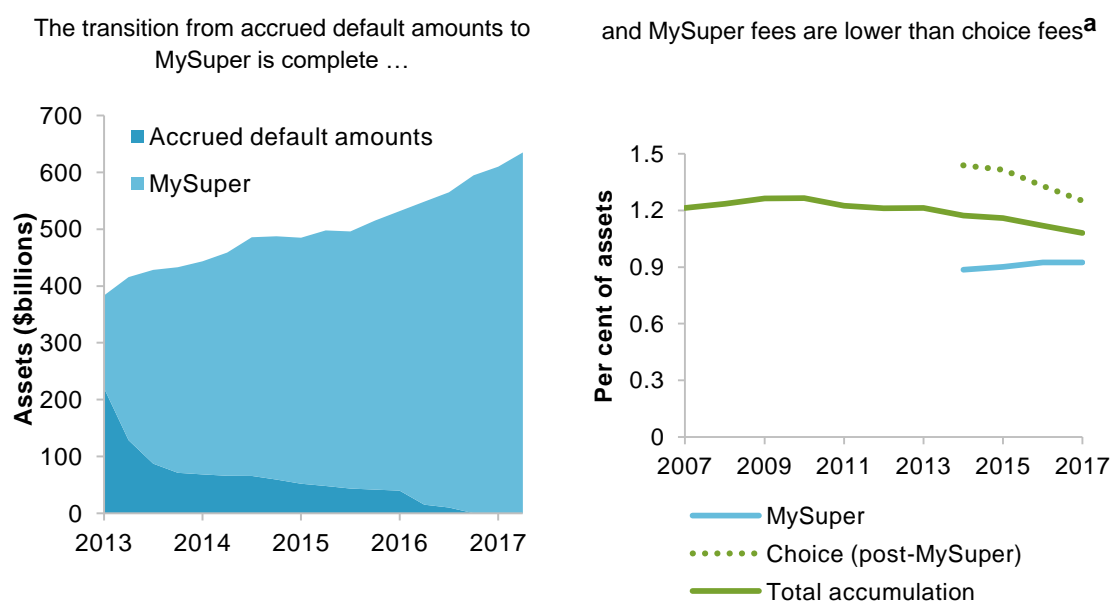
¹⁰ Unless otherwise evident, ‘total’ fees are the sum of administration and investment fees.

¹¹ This finding is not to be confused with the analysis of the median fund in technical supplement 8, which does not capture the decline in fees in the largest retail funds that dominate the retail segment.

The downward trend in fees reflects various factors including the influence of policy change and regulation (chapter 10), SMSF-driven competition (chapter 7) and growth in average fund scale (chapter 7). It could also reflect the requirement for all default balances to be transferred to MySuper products (by 1 July 2017) showing up in the data (figure 3.4). By June 2017, MySuper assets totalled just over \$594 billion (figure 3.4, left panel), representing 24 per cent of Australia’s superannuation assets. This transition into MySuper products may have contributed to lower fees in aggregate, given that fees on MySuper products are lower, at around 0.9 per cent of assets in aggregate, than average fees for choice products in APRA-regulated funds (at 1.3 per cent in 2017).

Figure 3.4 The transition to MySuper may have lowered fees ...

Assets (2013–2017) and Fees as percentage of assets (2007–2017), APRA-regulated funds



Sources	PC analysis of APRA (2015d, table A; 2017d, 2017e, 2018j, table 1a; 2018n, Key Statistics) and SuperRatings data.
Coverage	APRA data are for all APRA-regulated funds with MySuper products. The SuperRatings sample comprised 362 products covering 78% of total assets and 76% of member accounts in APRA-regulated funds in 2017.
Survivor Bias	Yes for SuperRatings.
Selection Bias	Yes for SuperRatings.

^a The slight upward trend in MySuper fees is observed across all balance sizes.

SuperStream reforms may also have put downward pressure on aggregate fees. The Australian Taxation Office (ATO) estimated that SuperStream would increasingly lower aggregate fees relative to the counterfactual as cost savings from enhanced administrative processes increasingly offset the initial additional administrative costs (box 3.2).

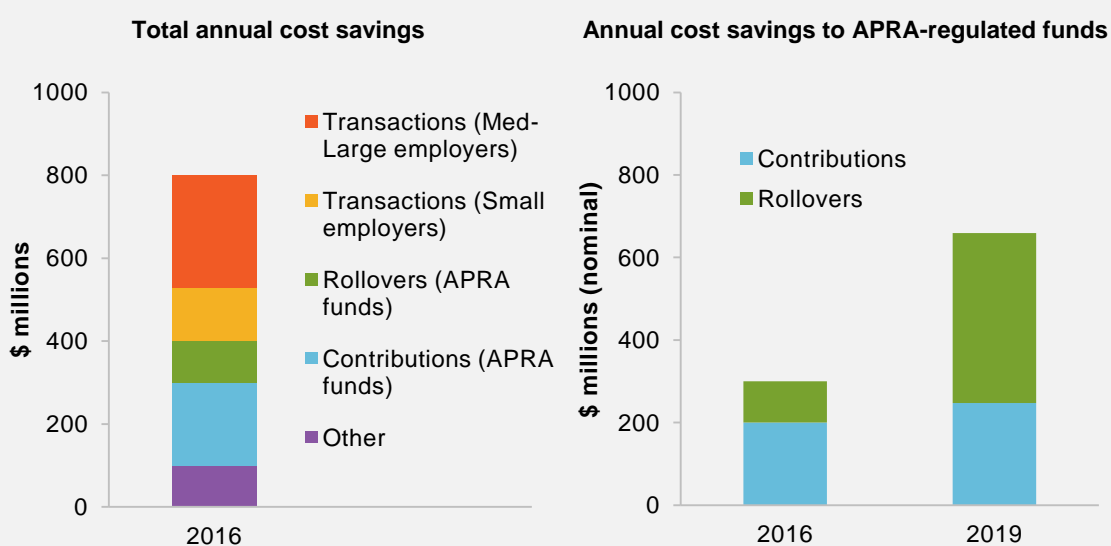
Box 3.2 Estimated cost savings from SuperStream

The SuperStream reforms were introduced to improve the efficiency of payments processing and to enhance the ability of regulators to track transactions in the system. While there was an upfront cost in implementing the new systems, the reforms were designed to reduce administrative costs in the superannuation system over time. The Australian Taxation Office (ATO) has estimated total implementation costs of SuperStream at \$1.5 billion (over the period 2012 to 2018), with Australian Prudential Regulation Authority (APRA) regulated funds bearing \$900 million and employers bearing \$600 million. Most funds and employers made upfront capital investments in new equipment and processes to comply with SuperStream. In addition, APRA-regulated funds are required to pay a mandatory cost recovery levy (to cover the implementation costs to government), from which over \$400 million has been raised thus far. The annual levy started at \$122 million in 2013 and has been gradually phased down each year. It is currently at \$32 million for 2018. Many of these costs would have been passed on to members in the form of higher administration fees.

The administrative costs associated with SuperStream will be offset as cost savings accrue to APRA-regulated funds, SMSFs and employers. The ATO has estimated that SuperStream has generated administrative cost savings of approximately \$800 million per year (relative to a 2010 baseline of how contributions were processed prior to SuperStream), split evenly between superannuation funds and employers.

For APRA-regulated funds, improvements in contributions and rollovers processing were estimated to have led to avoided costs of \$200 million and \$100 million respectively in 2016, and the annual benefits are expected to increase to \$660 million by 2019.

The ATO also estimated annual aggregate benefits to members of \$2.4 billion per year, mainly from the recovery of lost accounts and closure of duplicate accounts (eliminating additional fees on those accounts). Of this total, 9 per cent (\$206 million a year) was directly attributed to lower member fees resulting from SuperStream’s impact on fund level costs going forward. The impact of SuperStream on member fees may grow over time as the capital costs of implementation are fully amortised by funds and the remaining components of SuperStream are put in place.



Source: ATO (2017f, p. 5,12,27,39 and 41).

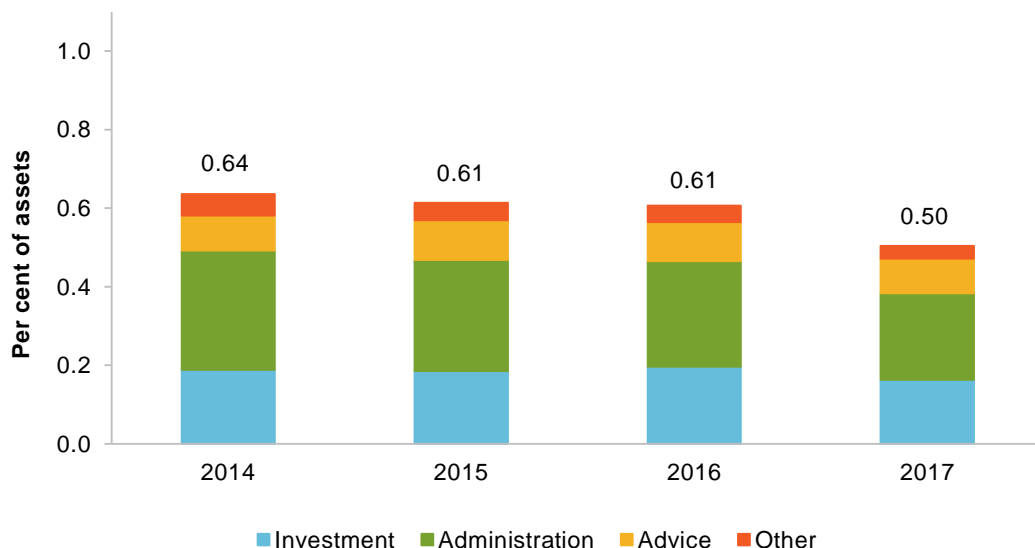
Fee revenue (as a proportion of assets) has also fallen

Another way of analysing fees is by looking at APRA data on fee revenue collected by funds (available from 2014 onwards only). Fee revenue data are useful in that they are expressed in dollar terms, and indicate how much members, in aggregate, actually pay in fees. Having said that, APRA fee revenue data are incomplete because they exclude indirect investment costs and because of poor disclosure by some funds (section 3.4).

In total, \$9.4 billion in direct fees were paid to APRA-regulated funds in 2017, or \$8.8 billion excluding insurance fees. The large majority of this fee revenue was for administration and investment management, although retail (for-profit) funds also source a significant amount of fee revenue from financial advice services (section 3.3).

Annual aggregate fee revenue (again, excluding insurance fees) rose by \$1.1 billion between 2014 and 2017. However, as a proportion of assets, fee revenue fell from around 0.64 to 0.50 per cent of assets, driven almost entirely by falls in administration fees (figure 3.5). This reflects that the absolute dollar value of fee revenue has grown due to a combination of growth in the number of members in the system alongside strong growth in average account balances over the period.

Figure 3.5 **Fee revenue has fallen as a proportion of assets^{a,b}**
Fee revenue as percentage of assets, APRA-regulated funds, 2014–2017



Sources	APRA (2018t, table 7; 2018b, tables 4a, 6b).
Coverage	These data may only account for around 50 per cent of the fee revenue of the APRA-regulated system due to significant under-reporting of fee data.
Survivor Bias	No.
Selection Bias	Yes.

^a These data include the effect of some funds providing rebates on fees (for example, to certain employers). Further detail is in technical supplement 5. ^b 'Advice' fees include activity-based fees collected in return for advice. 'Other' fees combine sitching, exit, activity fees that are not related to advice, and other fees.

That advertised fee levels remain above that of direct fee revenue (by about 0.6 per cent as a proportion of assets in 2017) largely reflects incomplete disclosure of direct fees to APRA and that APRA’s fee revenue data do not include indirect investment costs flowing to upstream providers (which nonetheless detract from returns).

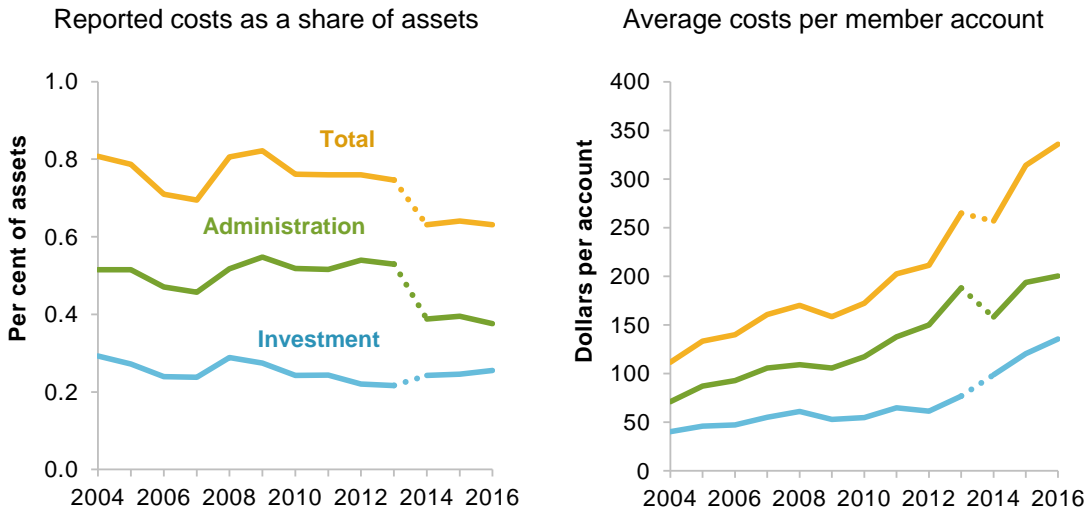
By contrast, indirect investment costs are captured to some extent in advertised fees, as are direct administration and investment fees. This is because the Australian Securities and Investments Commission (ASIC) requires funds to disclose all fees in their PDSs (section 3.4). That investment fee revenue has remained largely flat over 2014 to 2017, while advertised investment fees have fallen, suggests that the downwards movement in advertised fees is being driven by a reduction in indirect investment costs and possibly by some reduction in undisclosed investment fees.

Reported costs have also fallen slightly in aggregate

Reported costs for APRA-regulated funds followed the trends in fees, having fallen over the past decade (figure 3.6, left panel).

Figure 3.6 Costs have fallen (as a share of assets) but increased per account^{a,b}

Costs as percentage of assets and per member account, APRA-regulated funds, 2004–2016



Source	PC analysis of APRA unpublished data.
Coverage	These data may only account for around 50 per cent of the investment and administration costs of the APRA-regulated system due to significant under-reporting of cost data.
Survivor Bias	No.
Selection Bias	Yes.

^a Funds that report zero investment costs are excluded. ^b APRA revised its reporting methodology in 2014, resulting in a discontinuity in the series (indicated by dashed lines).

Reported investment management costs (as a share of assets) have been largely unchanged over time. This is *not* indicated in advertised investment fees (which have trended down over the period), and likely reflects problems with APRA’s investment cost data, as noted above.

Administration costs (as a share of assets) have come down over time. The series break in figure 3.6 in 2014 is an artefact of APRA revising its reporting framework from June 2013 onwards (in conjunction with the MySuper reforms). The new framework requires funds to report administration costs in greater detail.

Nonetheless, on a *per member account* basis, average costs have increased over time (figure 3.6, right panel). This reflects the rise in average balances and that many costs, for example investment management costs, tend to rise with assets under management. It also reflects significant account consolidation over the observable period (accounting for around a quarter of the increase). Account consolidation reduces the costs of managing multiple accounts, but also reduces the extent to which multiple account holders cross-subsidise other members. While this improves the efficiency in the system, removing the cross-subsidy (in and of itself of merit) tends to lead to higher costs on a per member account basis. There remains significant scope for further account consolidation (chapter 6), meaning this process may continue over the coming years.

FINDING 3.2

In aggregate, total fees in APRA-regulated funds (for administration and investment management services) have been trending down as a proportion of assets over the past decade, from 1.3 per cent in 2008 to 1.1 per cent in 2017.

3.3 How have fees varied across segments?

Trends in aggregated fees for APRA-regulated funds mask wide variation across segments, both in terms of trends and relative fee levels.

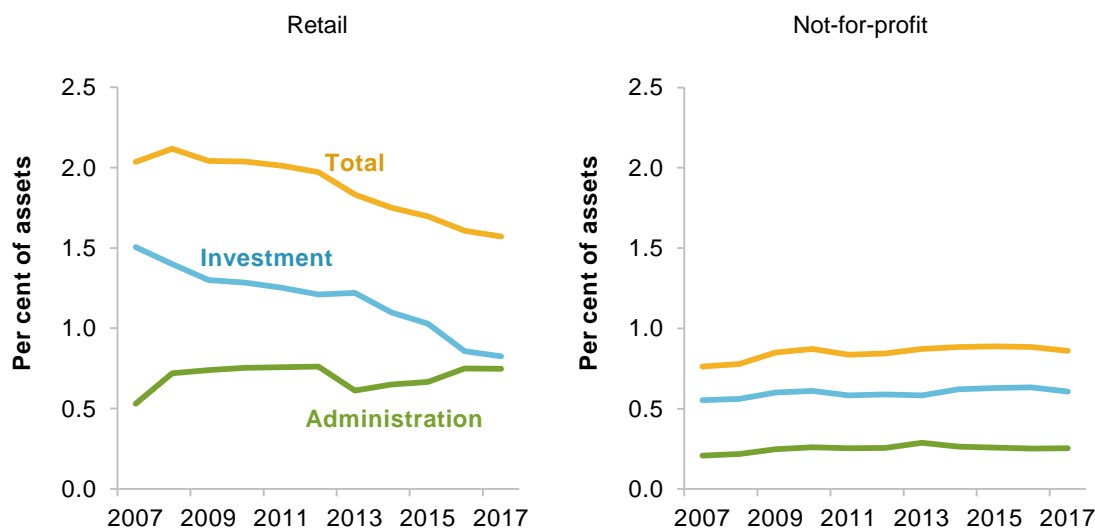
Behind the reduction in aggregate fees

Aggregate reductions in fees are due mainly to reductions in fees among retail funds, while fees among not-for-profit funds have remained comparatively steady (figure 3.7) (SMSFs are addressed separately in section 3.3).

Advertised fees for both administration and investment management have fallen in retail funds, particularly from 2013 and the introduction of MySuper (figure 3.8). Based on the fees that funds charged for their default option prior to MySuper, it appears that fees in default products fell markedly for retail funds, while they remained largely unchanged for industry funds.

Figure 3.7 Total fees have fallen for retail funds, but from a higher base

Fees as percentage of assets, APRA-regulated funds, 2007–2017

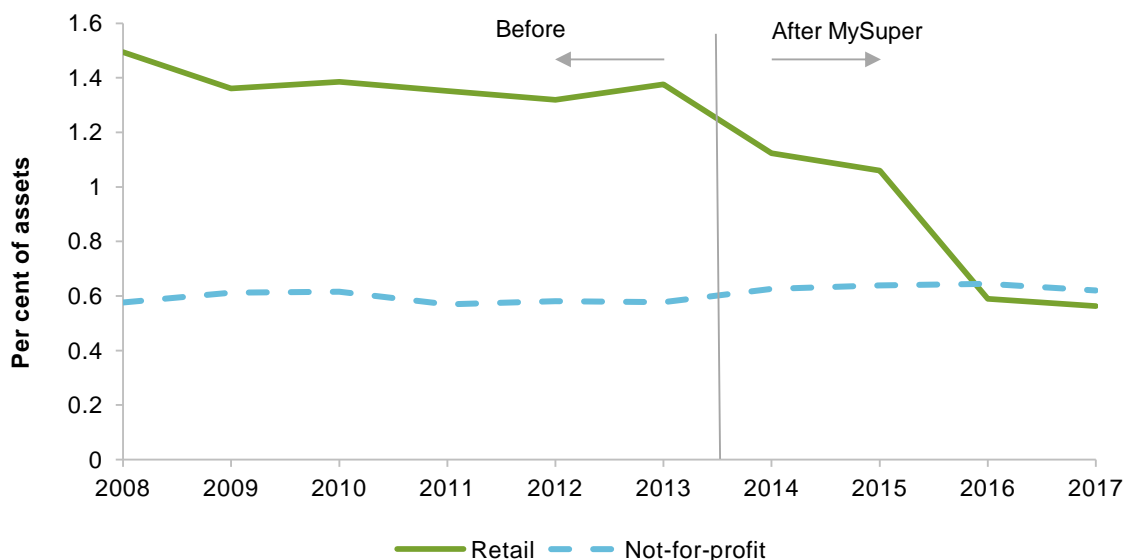


Source	PC analysis of SuperRatings data.		
Coverage	362 products covering 78% of total assets and 76% of member accounts in APRA-regulated funds in 2017.		
Survivor Bias	Yes.	Selection Bias	Yes.

There is a separate question about whether the introduction of MySuper brought about lower fees in the *choice* segment. There appears to be a small decline in fees charged for choice products since 2014, from 1.4 per cent to 1.3 per cent (for a representative member on the basis of SuperRatings data), although fees charged for choice products vary widely. Both investment and administration fees in choice remain above that of MySuper fees. To the extent that MySuper affected broader asset allocations within funds, and subjected the retail funds to heightened competition, it is plausible that there was some positive ‘spillover’ of MySuper to the choice segment.

Aside from the impact of MySuper, the fall in retail administration fees may also reflect the impact of the choice of fund legislation in 2005, which increased competitive pressure as a higher proportion of members changed funds or opened an SMSF (Clare 2006), although the extent of this is not directly quantifiable. Increased competition in the retail choice segment is also reflected in, for example, the emergence of more sophisticated advice models and the introduction of member-directed investment strategies (Rice Warner 2014a).

Figure 3.8 Fees have fallen markedly in retail funds' default options
 Investment fee as percentage of assets in default options, APRA-regulated funds, 2008–2017

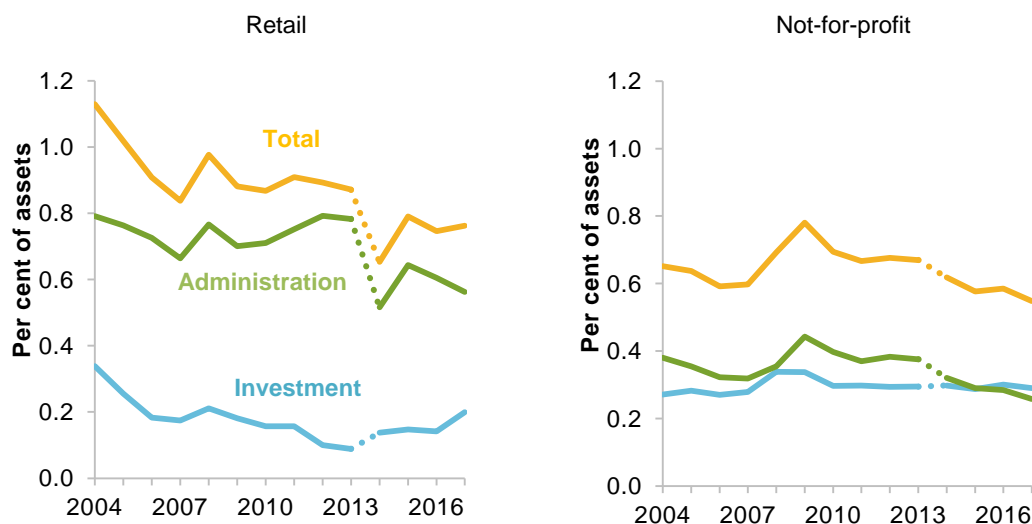


Source	PC analysis of SuperRatings data.
Coverage	The SuperRatings sample comprises the default options that preceded MySuper products together with MySuper products. The data are for APRA-regulated funds with MySuper products. In 2017 the sample comprised 145 products, including 89 MySuper products covering 90 per cent of total MySuper assets in APRA-regulated funds.
Survivor Bias	Yes.
Selection Bias	Yes.

Reported costs relative to assets exhibit broadly similar trends with advertised fees in the not-for-profit segment, but there is little resemblance to advertised fees for retail funds, particularly for investment (figure 3.9). Reported investment costs within the retail segment remain around 0.2 per cent of assets between 2007 and 2017, in contrast with the trend decline in advertised investment fees from 1.5 to 0.8 per cent of assets over that same period. This disconnect again reflects the poor reporting to APRA.

Reported costs can also reflect compliance requirements stemming from regulation, including those associated with reporting obligations. The Association of Superannuation Funds of Australia (ASFA, sub. 47, pp. 21–6) argued that complying with various regulatory obligations and requirements imposes ongoing compliance and trustee support costs on funds. It presented Rice Warner data showing significant increases in estimated compliance costs of almost 70 per cent per member account between 2011 and 2015, from around \$21 to \$36 annually (representing 6.5 per cent of system average fees on a \$50 000 balance).

Figure 3.9 Significant divergence in costs to assets ratios by fund type^a
 Costs as a percentage of assets, APRA-regulated funds, 2004–2017



Source	APRA (2018t, table 3)
Coverage	These data may only account for around 50 per cent of the investment and administration costs of the APRA-regulated system due to significant under-reporting of investment and administration cost data. The Commission has otherwise excluded 50 funds reporting zero investment expenses (predominantly retail funds).
Survivor Bias	No.
Selection Bias	Yes.

^a APRA revised its reporting methodology in 2014, including separating out advice expenses from administration expenses. This resulted in a discontinuity in the series (indicated by dashed lines).

FINDING 3.3

Fees have fallen for retail funds, albeit remaining higher (for choice products) than the (largely unchanged) fees for industry funds.

Among APRA-regulated funds, the MySuper and SuperStream reforms have likely acted to reduce fees (including some possible competitive spillover to choice products), although this is difficult to attribute directly given the impact of other fee drivers.

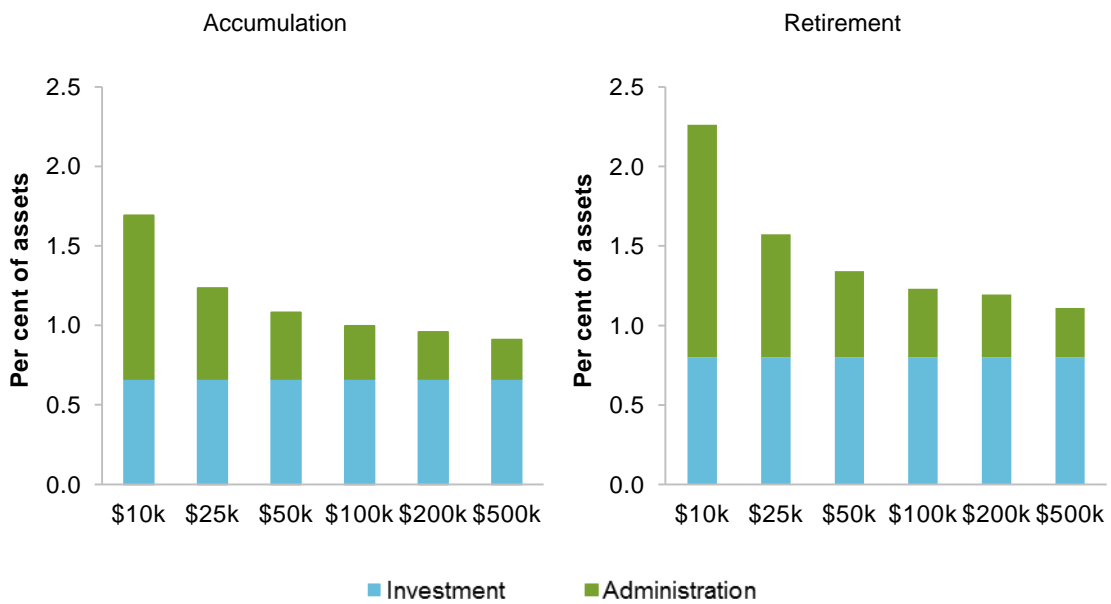
Retirement fees have come down faster than accumulation fees

Fees also differ, on average, across accumulation and retirement members. Members in retirement often pay higher total fees because they have larger balances (and most fees are charged as a percentage of assets). But across the system, members with lower balances tend, on average, to pay more as a percentage of their balances.

Fees in the retirement phase may also reflect, among other things, greater levels of member engagement, and tailored products and advice as members begin to draw down their balances. As such, retirement products generally incur higher administration costs than accumulation products. This is especially so for members with smaller balances (figure 3.10).

Figure 3.10 Low balance accounts are more expensive (as a proportion of assets), particularly in retirement

Fees as a percentage of assets, APRA-regulated funds, 2017

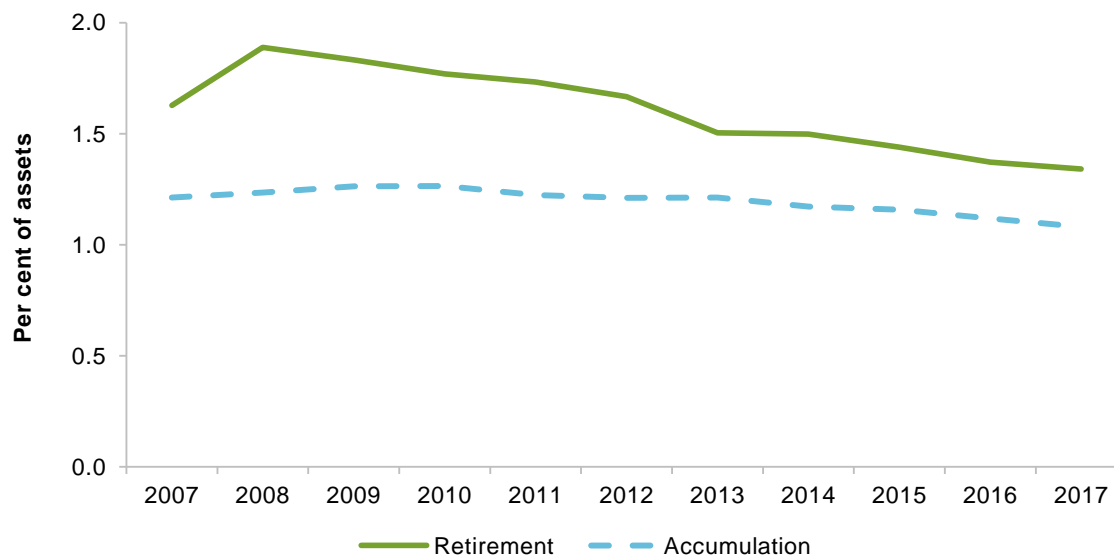


Source	PC analysis of SuperRatings data.		
Coverage	362 products covering 78% of total assets and 76% of member accounts in APRA-regulated funds in 2017.		
Survivor Bias	Yes.	Selection Bias	Yes.

While fees in the retirement phase have been higher (as a percentage of assets) than for accumulation phase products, they have been falling over time (figure 3.11). The relative fall in retirement fees has been driven by reductions in investment management fees, from around 1.2 per cent of assets in 2008 to 0.8 per cent in 2017. This is likely to reflect a competitive response from funds to the emergence of SMSFs, which have grown to represent 52 per cent of assets in the retirement segment.

Figure 3.11 Fees in retirement have been trending down

Total fees as a percentage of assets, APRA-regulated funds, 2007–2017



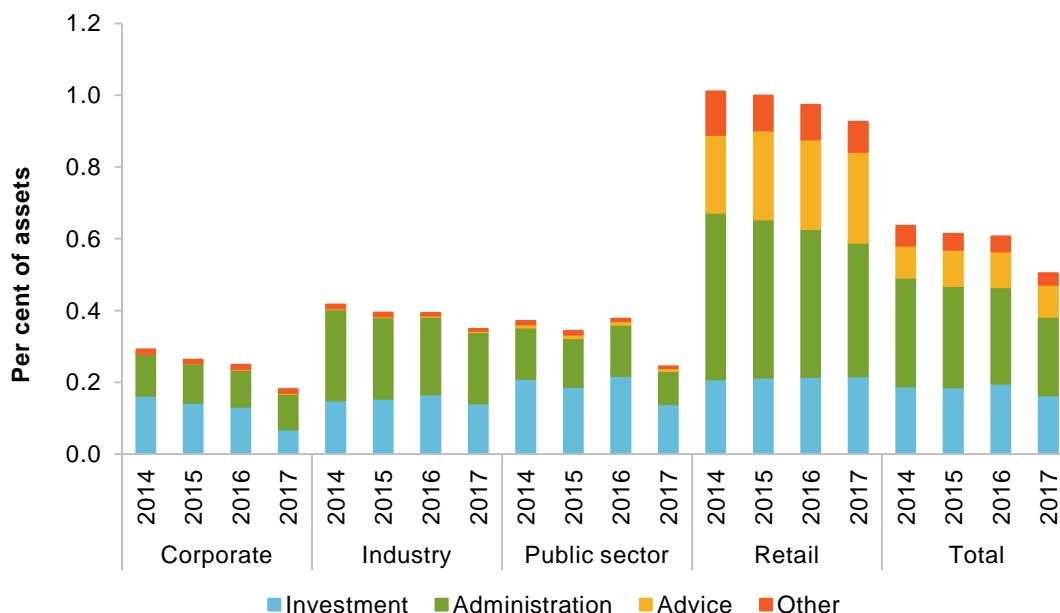
Source	PC analysis of SuperRatings data.		
Coverage	362 products covering 78% of total assets and 76% of member accounts in APRA-regulated funds in 2017.		
Survivor Bias	Yes.	Selection Bias	Yes.

Fees vary by fund type

While fees have fallen in recent years in some parts of the system, there remains significant variation between fund types. Fee revenues among not-for-profit funds — industry, corporate and public sector funds — have historically been (and remain) well below that of the retail funds (figure 3.12). The difference is particularly marked for administration fees and advice fees.

Figure 3.12 **Fee revenue varies markedly between fund types^{a,b,c,d}**

Fees as percentage of assets, APRA-regulated funds, 2014–2017



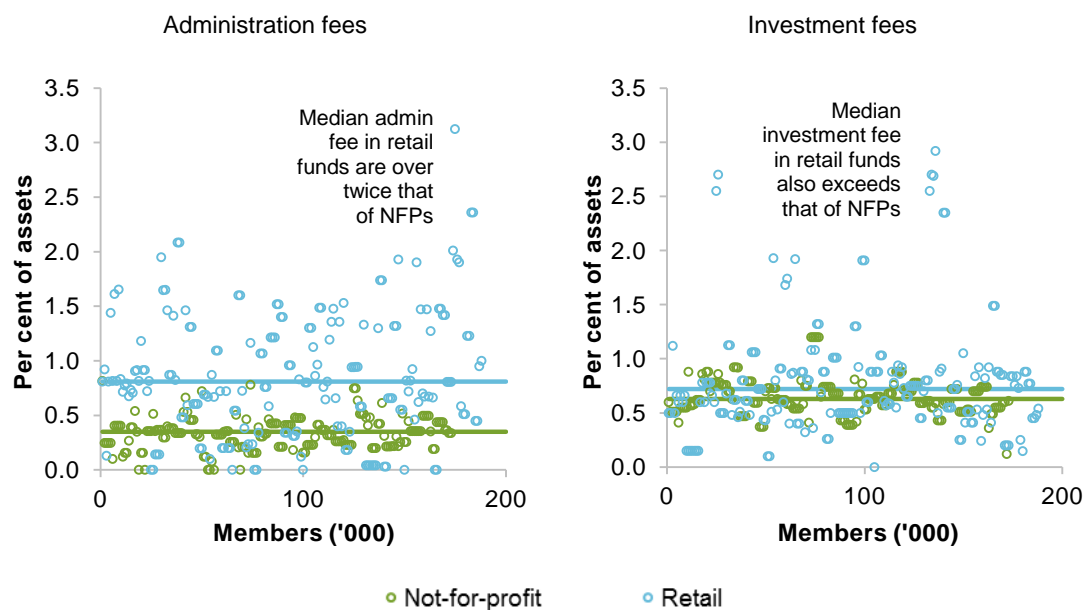
Sources	APRA (2018t, table 7, 2018b, tables 4a, 6b).		
Coverage	These data may only account for around 50 per cent of the fee revenue of the APRA-regulated system due to significant under-reporting of administration and investment fee data.		
Survivor Bias	No.	Selection Bias	Yes.

^a These data include the effect of some funds providing rebates on fees (for example, to certain employers). However, these rebates are small in overall magnitude (at 5.6 per cent of total fees paid). These issues are explored in technical supplement 5. ^b ‘Advice’ fees include ‘activity’ fees received for the purpose of advice. ^c ‘Other’ fees are an amalgam of switching, exit, sundry activity and other fees. ^d Non-reporting of investment fee revenue by some funds distorts the comparison, and may explain why average fee revenue for retail funds (about 1.0 per cent) is below average fees disclosed in SuperRatings data (about 1.6 per cent).

A similar dichotomy in fees by fund type is evident in advertised fee data (figure 3.13). In 2017, the median administration fee in the retail segment was 0.8 per cent, compared with 0.4 per cent in the not-for-profit segment. There is less dispersion among investment fees, with the median fee of 0.7 per cent in the retail segment compared with 0.6 per cent in the not-for-profit segment. There does not appear to be any clear relationship between the number of members in a given product and the fees charged.

Figure 3.13 There is high dispersion of fees across products^{a,b}

Advertised fees as percentage of assets, APRA-regulated funds, 2017



Source	PC analysis of SuperRatings data.
Coverage	362 products covering 78% of total assets and 76% of member accounts in APRA-regulated funds in 2017.
Survivor Bias	Yes.
Selection Bias	Yes.

^a Fees are product-level averages. The lines are medians of product-level fees. ^b Products with zero or negative administration fees have been removed from the sample.

Investment fees

Investment fees are generally higher among retail funds than not-for-profit funds – although the difference is not as stark as for administration and advice fee revenues (figure 3.12 above). In its funds survey, the Commission asked funds to report the costs they incur when investing. While this is not the same as the fees they charge to members, as it includes indirect costs which are generally not captured in APRA data, it can shed light on why retail funds generally charge higher investment fees than not-for-profit funds.

The Commission’s analysis suggests retail funds incur higher investment costs than not-for-profit funds, on average, in all asset classes (figure 3.14). The largest difference was in cash, where retail funds paid 44 basis points on average compared with 5 basis points for not-for-profit funds. However, the underlying reasons for these material cost differences between the segments are not captured by the funds survey data.

Across all types of investment options, investment management fees (in aggregate) have trended down over the past decade as a share of assets (tech. supp. 5). Furthermore, from the GFC, there has been a compositional shift away from high-growth products and towards

balanced options (defined as having 60 to 76 per cent of funds in growth assets) (tech. supp. 5). Because the average fee for a balanced option is less than that of higher-risk growth options, this shift has contributed to the trend decline in average total investment fees. Global experience suggests there may be scope for investment management fees to continue to fall in Australia, particularly as average scale in the industry continues to grow (bfinance 2017; Graseck et al. 2017).

Figure 3.14 **Retail investment costs are higher across all asset classes^a**

Investment costs weighted by assets of a fund invested in the corresponding asset class, 2017



Source	Supplementary funds survey.		
Coverage	In 2017, the funds in this figure represent up to 81% of total assets and 73% of member accounts of APRA-regulated funds.		
Survivor Bias	Yes.	Selection Bias	Yes.

^a Only asset classes with at least 25 observations for both retail and not-for-profit funds are reported. Fund assets are used as weights to calculate an average investment management cost.

Administration fees

There is a marked difference in administration fees between retail funds and not-for-profit funds. While there were more assets (and member accounts) in not-for-profit funds, retail funds collected around \$535 million more in administration fee revenue in 2017-18 (APRA 2018b). The size of this additional revenue may in part reflect the amount of trailing commission revenues (considered below).

There are currently few restrictions on administration fees outside of MySuper. For MySuper products, administration fees must relate to the costs of operating the fund (section 29V(2) of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act)). Not so for choice products. On the one hand, this allows funds to artificially deflate administration fees in

order to appear more competitive. For example, instead of remitting tax benefits directly to members' accounts, Sunsuper contended that some funds use the extra revenue to discount their fees or to offer fee rebates to selected members (sub. DR197, pp. 6–7). This could explain why the dispersion of fees includes a number of products with administration fees around zero (fee dispersion is considered below). Not only would this practice undermine a comparison of funds, it would mislead members.

The lack of restrictions on administration fees in choice products also allows funds to include costs (and margins) in administration fees that do not directly relate to the administration of the fund. For example, some funds charge trailing commissions as a component of their administration fees (IOOF, sub. DR138, p. 4; MLC Wealth, sub. DR174, p. 22).

Indeed, the presence of trailing commissions may explain in part the reliance on percentage based administration fees in the APRA system.¹² Funds may also use percentage-based administration fees to fund additional member services — which members may or may not value. Based on the Commission's analysis of SuperRatings data for 2017, around 84 per cent of products include a percentage-based administration fee — 16 per cent rely only on a percentage-based fee and 68 per cent also include a fixed dollar member fee (tech. supp. 5).

Retail funds rely more on percentage-based fees than do not-for-profit funds. About 27 per cent of retail products rely only on a percentage-based fee compared with 5 per cent of not-for-profit products (and relatively more not-for-profit products charge both a percentage-based fee and a fixed dollar fee). At the same time, retail funds generally charge higher fees whether they be percentage-based fees or fixed dollar fees. On average, a member with a \$50 000 balance would pay \$106 and just over 0.5 per cent of their account balance (a total administration fee of \$374 a year) if they were in a retail fund, or \$66 and just over 0.1 per cent of their account balance (a total administration fee of \$127 a year) if they were in a not-for-profit fund. Because the dollar value of a percentage-based fee rises with the member's balance, the gap in administration fees between retail and not-for-profit funds increases with a member's account balance (figure 3.15).

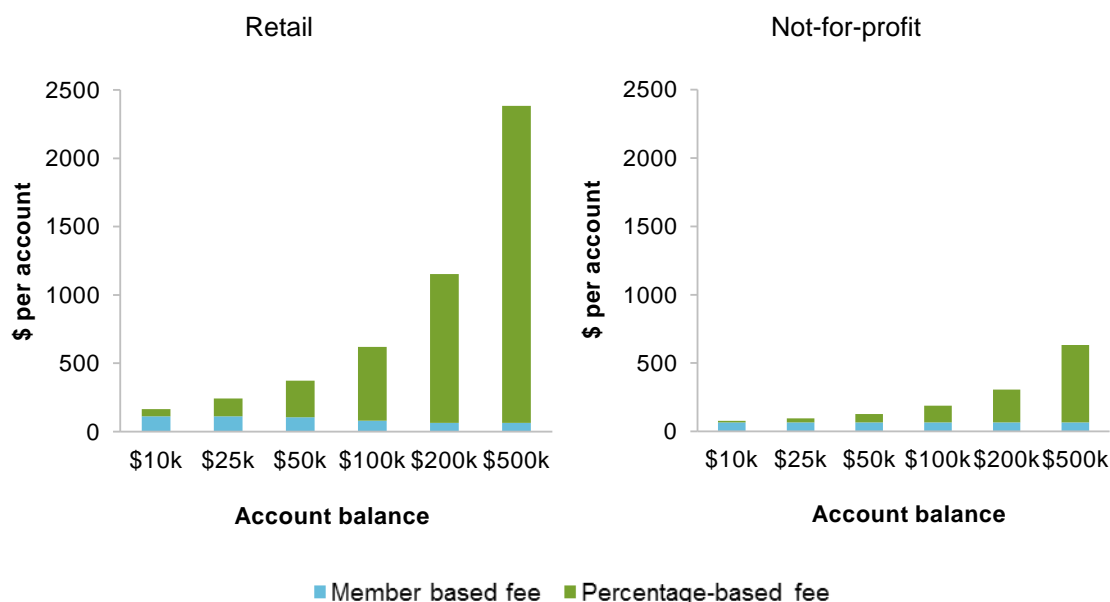
The data in figure 3.15 do not include fee cap data. Ideally, trustees would specify fee caps to avoid percentage-based administration fees rising well in excess of operating costs per account. However, the Commission could find little evidence that fee caps are widely used. According to APRA (2018l), only one retail MySuper product limited its administration fee with a fee cap in June 2017, compared with 26 not-for-profit MySuper products.

While the practice of percentage-based administration fees may be widespread, the Commission considers that there is no obvious basis for variable administration fees levied as a proportion of a member's assets, and that funds should be required to justify percentage-based administration fees to the regulator (chapter 13). Further, where funds do charge percentage-based administration fees, they should be required to have in place a fee cap that reflects the fund's operating costs per member account.

¹² Trailing commissions are classified in APRA's reporting framework as an administration expense.

Figure 3.15 **The gap in administration fees between retail and not-for-profit funds increases with member balances^a**

Advertised fee in dollars, APRA-regulated funds, 2017



Source	PC analysis of SuperRatings data.		
Coverage	362 products covering 78% of total assets and 76% of member accounts in APRA-regulated funds in 2017.		
Survivor Bias	Yes.	Survivor Bias	Yes.

^a These data do not include fee caps.

Advice fees

Advice fees are not included in the earlier discussion of ‘total’ fees. While financial advice can benefit members, advice fees themselves erode member balances. Advice fee revenue totalled at least \$1.6 billion in 2016-17. Almost all of this revenue, 91 per cent, was collected by ten retail funds, which accounted for 24 per cent of assets and 16 per cent of members in the APRA data (table 3.1). The average member in these ten funds was charged \$341 per account for advice in 2016-17. The quantum of this charge reflects the average cost to a member for once-off targeted advice (described as ‘scaled advice’ in the industry).¹³ On the question of how many members in those ten funds benefited from advice in 2016-17, evidence gathered by the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (FSRC) suggested that many members paid a fee for no service (FSRC 2018e).

¹³ SuperRatings (2018) estimated that the average cost to a member for scaled advice was \$550 in 2017 (excluding funds that do not charge an explicit fee for scaled advice).

Table 3.1 Advice fee revenue by fund type
2017

	<i>Value</i>	<i>Share of total APRA</i>	<i>Average per member</i>
	\$m	%	\$ per member
10 retail funds with highest advice fees in data	1 411	91	341
Other retail funds	80	5	15
Not-for-profit funds	60	4	4

Source: PC analysis based on APRA (2018s, tables 3, 6 and 7).

Trailing adviser commissions: a grandfathered and costly problem

Trailing commissions are a further form of fees for advice. Trailing commissions are an ongoing payment (normally a percentage of the account value) from the fund to a financial adviser that begins when a member follows the adviser’s recommendation regarding a particular superannuation product. The Future of Financial Advice laws banned these commissions from 2013, but allowed those already in place to continue under transitional (grandfathered) arrangements (without articulating an end date). Under these transitional arrangements, members of some funds continue to pay high trailing commissions some five years after the ban.

The Commission’s funds survey asked whether funds had any members subject to trailing adviser commissions, and if so, the percentage of their members affected. Around 30 per cent of the 114 responding funds (collectively representing 29 per cent of assets and 26 per cent of member accounts in all APRA-regulated funds) indicated that they have members paying these commissions, but disappointingly (and perhaps not unsurprisingly) less than half of these funds provided the relevant percentage. However, from the information provided, it can be inferred that at least two per cent (636 000) of all accounts in the system (or close to three per cent of accounts for the responding funds) are subject to trailing adviser commissions. Given the data gaps, this is likely to be a significant underestimate.

Data from the FSRC indicate that trailing commissions for eleven of the largest retail funds totalled approximately \$220 million in the six months to July 2017 — which would suggest their members paid over \$400 million in the financial year 2016-17 (equivalent to around 24 per cent of reported administration fee revenue collected by these funds and to around 18 per cent of reported administration fee revenue of all retail funds). Six of these eleven funds are also among the ten funds reporting the highest advice fee revenue in APRA’s public data in 2017 (APRA 2018s).¹⁴

¹⁴ Four other funds in the FSRC data report zero advice fee revenue in the APRA data.

The FSRC has also revealed instances of potential misconduct, where trustees appear to have avoided closing legacy products (or avoided moving members to products that would leave them better off) because this would mean removing commissions flowing to a related party business (FSRC 2018e).

Aside from misconduct, inquiry participants and others have argued that trailing commissions do not represent value for money for members (Kollmorgen 2015; CHOICE, sub. DR184, pp. 18–20). CHOICE pointed out that the Future of Financial Advice reforms were predicated on a similar dim view of trailing commissions. Trailing commissions were banned because they tend to undermine an adviser’s incentives to serve the member’s best interests (Treasury 2018b, pp. 8–9). ASIC likewise supports an end to grandfathered commissions as soon as practicable (ASIC, sub. DR206, p. 14).

Organisations representing financial advisers have called for the retention of trailing commissions (Financial Planning Association of Australia, sub. DR146; the Association of Financial Advisers, sub. DR173). They argued that members would face additional costs if these commissions were removed and instead proposed that trailing commissions be retained while other fees be reduced by the extent of the trailing commissions. It is not clear to the Productivity Commission how extending transitional grandfathered trailing commissions could be in the interests of anyone other than the advisers receiving them.

Trailing commissions have been banned for new products and members since 2013. The time for transition is over. The Commission supports a full ban of all commissions on superannuation products (chapter 13), which will likely have the effect of reducing the fees currently paid by members of some retail products.

FINDING 3.4

While financial advice can benefit members, excessive advice fees in choice products and all trailing commissions erode member balances. Ten retail funds collected about \$1.4 billion of advice fee revenue in 2017, charging their members about \$341 per account in that year alone. Separately, members of 11 retail funds identified in data from the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* are estimated to have paid in excess of \$400 million in (grandfathered) trailing adviser commissions in 2017.

In contrast, advice fees are closely regulated in MySuper products (with funds only permitted to recoup the cost of intrafund advice from fee revenue), thereby protecting members from undue balance erosion. The disparate regulation of fees and costs in the choice and MySuper segments is in part contributing to poor member outcomes in the choice segment.

Exit fees should be at cost recovery ... and enforced

Exit and switching fees can deter members from switching out of high fee or low return products, thereby undermining competition.

While many products do not include a fee for exiting or switching, most do. Around 46 per cent of assets and 60 per cent of member accounts were in products with an exit fee in 2017 (based on the SuperRatings data). For not-for-profit fund members in a product with an exit fee, the average exit fee is around \$25. For retail fund members in a product with an exit fee, average exit fees are double this, at around \$50.

Since 2012, exit fees on all products have been limited by law to a cost recovery level. However, this legislated requirement does not appear to have been enforced. More than half of the products in the SuperRatings database levy a fixed dollar exit fee and these fees range from \$25 to \$180 for each withdrawal. It is difficult to understand how the cost of exit can vary so dramatically between products. This variation indicates that there is considerable scope for some funds to improve their administrative efficiencies, and for the regulator to better ensure that exit fees reflect actual costs.

While exit fees are generally levied as fixed dollar amounts, the Commission found some products in the SuperRatings database that levied exit fees as a proportion of assets. In these products, exit fees range from 3 to 5 per cent of some portion of a member's account balance. For example, some products levy an exit fee of 3.5 per cent on any contribution that is withdrawn within three years. The Commission is not convinced that variable exit fees levied as a proportion of a member's assets reflect the (relatively fixed) administrative cost of processing an account switch or outwards rollover.

The Government has now introduced a Bill to ban exit fees altogether (the Treasury Laws Amendment (Protecting Your Superannuation Package) Bill 2018). The Government Bill would allow regulations to specify exemptions to the ban.

In their submission to this inquiry, the Association of Financial Advisers advocated for keeping exit fees at cost recovery rather than an outright ban, contending that the cost of exit would otherwise be borne by remaining members (sub. DR173). Roll-it Super, a company that guides members in their choice of super fund, contended that the cost of exit is negligible with current technologies (sub. DR113). Others acknowledge that there is some cost of exit, but nonetheless support a ban on exit fees (ASFA, sub. DR148; REST, sub. DR171).

While ASFA (sub. DR148) supported a ban, they contended that fees for partial withdrawals and family law payments should continue at cost recovery. Conversely, the Australian Institute of Superannuation Trustees (AIST, sub. DR130) recommended the Government's ban be extended to include buy-sell spreads and indirect costs.

The Commission supports retaining exit fees at cost recovery. The costs of exit and switching should not be borne by other members. However, the regulator needs to ensure fees do not exceed cost recovery (chapter 13).

The tail of higher fee products

Another perspective on the variation of fees between different fund types is provided by focusing on higher fee products. Understanding where fees are high is pertinent to evaluating whether competition has acted to keep fees in line with costs.

Looking at advertised administration and investment fees, the dispersion of total fees has narrowed over recent years — proportionately more member accounts are observed at lower fee levels, and there are proportionately fewer member accounts in the ‘tail’ of higher fee levels (figure 3.16). In 2012, 35 per cent of member accounts were in products with fees above 1.5 per cent of assets (the ‘tail’ of higher fee products). By 2017, this had fallen to 15 per cent.¹⁵ Nonetheless, over 3 million member accounts have remained stuck in high-fee products. Some may be receiving exceptional investment returns or member services as a result, but most are likely not — and instead their balances are being eroded by excessive fees.

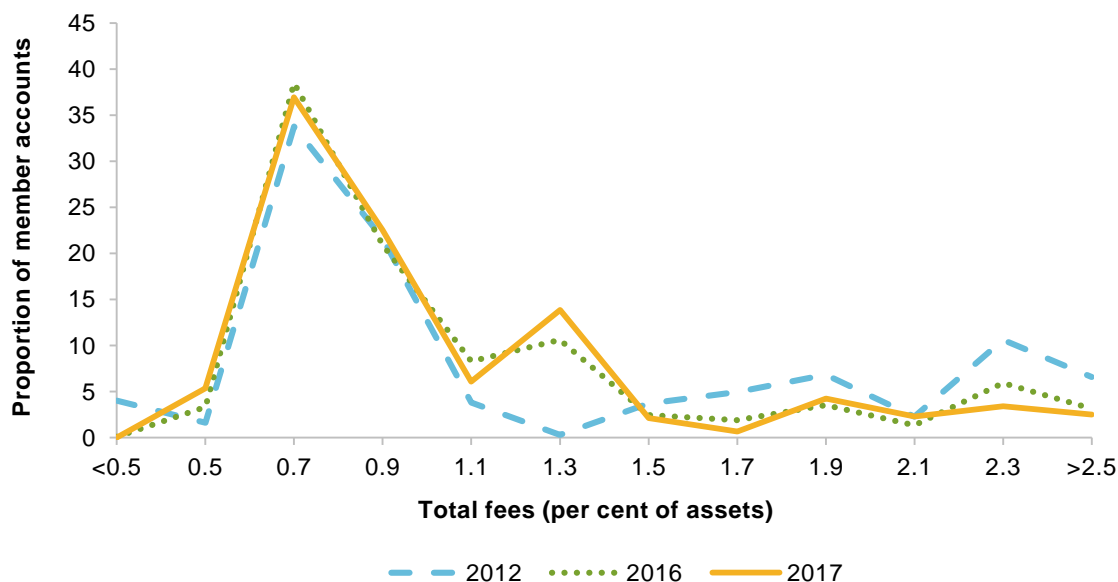
Choice products offered by retail funds account for almost all the ‘tail’ of higher-fee products — those with fees above 1.5 per cent of assets (figure 3.17). Dispersion of fees, in itself, is not necessarily indicative of inefficiency in the system — indeed, price dispersion is a common feature of almost all markets. However the available evidence suggests that the persistent dispersion observed here reflects inefficiencies, including the absence of competition (chapter 7), member disengagement (chapter 5), and higher fees in legacy products (such as trailing commissions).

Products in the higher-fee tail generally have high administration and investment fees relative to other products. That said, the relative difference is greater for administration fees (figure 3.18). For some products, this may reflect the presence of trailing commissions in administration fees. Commissions cannot be paid in respect of MySuper products and, with few exceptions, MySuper products are not in the higher-fee tail. Of those MySuper products that are in the higher-fee tail, two out of three are also found among the worst underperforming default products over the period 2008–2018 in the Commission’s investment performance analysis (chapter 2).

That 15 per cent of member accounts and 17 per cent of assets in the SuperRatings dataset were in products with fees above 1.5 per cent of assets in 2017, implies that about 4 million accounts and \$275 billion in assets were in the tail (if scaled up to the whole APRA-regulated system).

¹⁵ The numbers reported here are based on an expanded dataset relative to the draft report. The Commission changed the source of assets data it used to aggregate fees across products and funds. Instead of using SuperRatings product-level data as weights, the Commission used APRA data. This allowed the Commission to expand the number of products in the dataset for its analysis. For example, there were 327 products for 2016 in the draft report analysis compared with 349 products here. Many of those additional products were high-fee products, resulting in a higher proportion in the tail relative to that published in the draft report.

Figure 3.16 **Dispersion of total fees has narrowed over time^{a,b}**
2012–2017



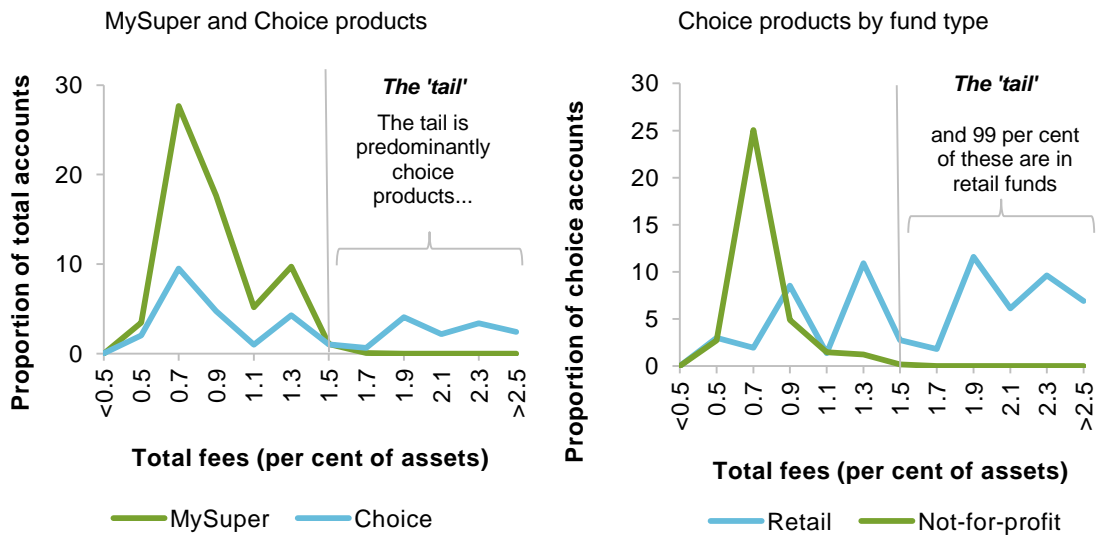
Source	PC analysis of SuperRatings data.
Coverage	362 products covering 78% of total assets and 76% of member accounts in APRA-regulated funds in 2017.
Survivor Bias	Yes.
Selection Bias	Yes.

^a Fee level categories on the horizontal axis are minimums for that category, meaning that, for example, the '1.5' category should be interpreted as above 1.5 and up to 1.7 per cent. ^b Between 2016 and 2017, a few products with a relatively large proportion of members lowered their fees below 2.3, resulting in the observed flattening of the tail at that fee level.

Legacy products (those closed to new members) accounted for just under half of assets in the high-fee tail in 2017 (46 per cent), and these products held almost 2 million member accounts (60 per cent). Retail funds account for all legacy products in the tail. Conversely, almost all retail legacy products in the data are in the tail (there are 50 retail legacy products, 43 of which are in the tail). Legacy products in the tail account for around 8 per cent of total assets in the dataset which, if scaled up to the APRA-regulated system, would represent about \$127 billion. On average, legacy products in the tail charge fees of around 2.2 per cent of assets. The number of retail legacy products in the tail has remained steady over time even as the number of other products and members in the tail has been falling.

Chapter 13 outlines how stronger outcomes tests on trustees can put greater downward pressure on fees and expedite the removal of persistently underperforming choice options from the system.

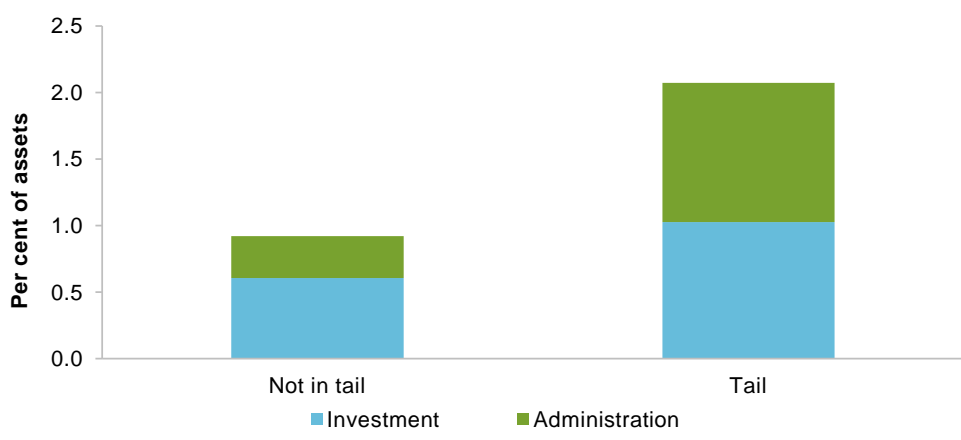
Figure 3.17 Retail choice products account for the ‘tail’ of high-fee products^a
2017



Source	PC analysis of SuperRatings data.
Coverage	362 products covering 78% of total assets and 76% of member accounts in APRA-regulated funds in 2017.
Survivor Bias	Yes.
Selection Bias	Yes.

^a The tail is defined as those products with fees above 1.5 per cent of assets. Fee level categories on the horizontal axis are minimums for that category, meaning that, for example, the ‘1.5’ category should be interpreted as above 1.5 and up to 1.7 per cent.

Figure 3.18 Administration fees especially higher for products in the tail
Fees as percentage of assets, 2017



Source	PC analysis of SuperRatings data.
Coverage	362 products covering 78% of total assets and 76% of member accounts in APRA-regulated funds.
Survivor Bias	Yes.
Selection Bias	Yes.

FINDING 3.5

There is a ‘tail’ of choice products with high fees (exceeding 1.5 per cent of balances), offered by retail funds. This tail accounted for about 17 per cent of assets and 15 per cent of member accounts in APRA-regulated funds in 2017. Retail legacy products account for almost half of all products in the high-fee tail.

The share of member accounts in the high-fee tail has been declining over time, particularly since 2013 and the introduction of MySuper, but today still accounts for an estimated 4 million member accounts holding \$275 billion in assets. Further declines are likely to hinge on the effectiveness of regulator efforts to shift members out of retail legacy products.

3.4 Better disclosure needed to improve comparability across segments

Analysis of trends in fees across segments of the superannuation system and over time is heavily compromised by poor data quality, reporting and disclosure.

Foremost among many issues has been the lack of disclosure by funds to the regulator. Non-reporting appears to characterise a material portion of retail funds of various sizes as well as smaller not-for-profit funds — and overall affects a quarter of funds in the system (table 3.2). Non-reporting has been apparent in APRA data at least since 2004. Given the regulator appears to have enabled this non-reporting, the behaviour is to some extent a function of the regulatory guidance provided (chapter 10).

Table 3.2 Which funds are not reporting?

Funds that did not report any investment expenses to APRA in 2016 or 2017

		<i>Not-for-profit</i>	<i>Retail</i>	<i>Total</i>
Funds	No.	10	40	50
Share of total funds	%	12	34	25
Member accounts	'000	717	6 501	7 218
Share of total member accounts	%	5	56	28

Source: PC analysis of unpublished APRA fund-level data.

Further, indirect investment management costs (that come out of a member’s investment return) appear to be effectively absent from APRA data (figure 3.19). These gaps in data make it nearly impossible to get a true sense of the full costs that funds are incurring and have broader implications for the governance of the superannuation system (chapter 10).

Measurement problems also make it difficult to discern underlying levels of ‘profitability’, and thus the extent of competitive pressure bearing on funds. As noted by APRA, there is a degree of trustee discretion in categorising expenditures, and a lack of consistent information reported on indirect costs paid to related parties,¹⁶ and incomplete collection of information at the trustee level (sub. 89, pp. 1–2). This latter issue impacts the true representativeness of both expense and revenue flows between the trustee and the fund. Indeed, APRA submitted that this limits both their own and external stakeholders’ ability to understand and compare how fund assets are being used in the management of fund operations (APRA, sub. 89, p. 2).

That the regulator is aware of this problem but has not rectified it (as yet) is disappointing to say the least. The inconsistency in how funds comply with disclosure to the regulator warrants Government holding the regulator accountable, such that ongoing monitoring and decisive action by the regulator occurs (chapter 13).

Figure 3.19 **Most administration and investment fees are not reported to APRA^a**

Estimated fee revenue of APRA-regulated funds, 2017



Sources	PC analysis of APRA (2018b, table 6) and SuperRatings data.
Coverage	APRA data are for all APRA-regulated funds with MySuper products. The SuperRatings sample comprised 362 products covering 78% of total assets and 76% of member accounts in APRA-regulated funds in 2017.
Survivor Bias	Yes for SuperRatings.
Selection Bias	Yes for SuperRatings.

^a The estimate of unreported fee revenues is based on the difference between advertised fees in SuperRatings data and fee revenue in APRA data, after allowing for rebates and refunds.

There has also been an issue of incomplete and inconsistent disclosure of fees by superannuation funds to members, especially for investment management. Some progress has been made in this area by the regulator, but poor disclosure practices persist. This erodes

¹⁶ This is partly due to uncertainty about the definition of ‘associate’, and because the collection of expenses is only in respect of arrangements between the RSE licensee and the service provider (APRA, sub. 89, p. 2).

funds' accountability to their members. Funds ought to be required to fully disclose costs that detract from returns.

To address known deficiencies in fee disclosure to members, ASIC recently amended regulations for the disclosure of superannuation fees in its Regulatory Guide 97 (RG97). The efficacy of the recent amendments of RG97 has been long debated within the industry (taking some three years) and the introduction of aspects of the revised guide has been repeatedly delayed. Recently, a further independent review of RG97 released its findings (box 3.3).

FINDING 3.6

Despite regulator awareness, there remain significant gaps and inconsistencies in how funds report data on fees and costs. Funds that misreport or underreport fees and costs appear, at times, to have gone unpunished. This harms members by making fee comparability and decision making difficult at best, and thus renders fee-based competition largely elusive.

Box 3.3 Disclosure of superannuation fees — RG97

The Australian Securities and Investments Commission (ASIC) has been revising Regulatory Guide 97 (RG97). RG97 establishes the rules for how funds are required to disclose superannuation fees in PDSs and periodic statements to members. The revision was to give effect to Stronger Super reforms and has been motivated by concerns that inaccurate, incomplete and inconsistent reporting of fees and costs harms members and makes comparisons across funds and products difficult (if not impossible).

The first draft of the revisions of RG97 was released back in December 2014. After an extended period of industry consultation, the revisions of the disclosure rules came into effect in September 2017. However, ASIC also commissioned a broad review of RG97 by McShane to further consider industry concerns. McShane completed his report in July 2018.

McShane has made a number of recommendations to improve the accuracy of fee disclosure, including:

- improving the consistency and simplicity of fee disclosure to make the information more accessible to consumers
- improving the comparability of cost disclosure of platforms to non-platform products
- proposing a framework for deciding what should be disclosed based on a number of characteristics including the significance of the item, its reliability, consumer expectations and its effect on investment behaviour
- proposing refinements to the reporting of transactional and operational costs and performance fees.

ASIC is now considering McShane's (2018) recommendations.

3.5 How do fees relate to net returns?

Fees matter because they detract from net returns. And when fees are excessive they unnecessarily erode member balances and cause much member harm.

In assessing whether higher fees are excessive, the primary issue for members is whether relatively higher fees generate a higher net return or provide other services they value. The relationship between fees and net returns is critical for what ultimately drives retirement balances, and there is evidence that variation in fees explains a significant amount of variation in net returns and thus member outcomes across the super system (box 3.4).

Using historically linked investment option-level fee and return data, the Commission has examined the relationship between net returns expressed relative to the market average (net of taxes and administration and investment fees), and average total fees at the fund level. This analysis has been conducted for funds in the SuperRatings database that had full data across the years 2006 to 2017 — a sample of 87, on average larger, funds representing around \$1 trillion in assets (the effect of constraining the date range has been mainly to exclude some small retail funds for which data are less consistently observed). The linking process is explained in technical supplement 4.

This analysis reveals a strong negative relationship between net returns and total fees (figure 3.20, top panel), consistent with previous analyses — that is, funds with higher total fees on average deliver lower returns (net of *administration and investment* fees) for their members. A substantial share of assets (as represented by bubble sizes in figure 3.20) are in funds that are performing relatively well compared with the market and are at lower fee levels. However, there are also several funds performing poorly relative to the market and doing so at higher fee levels. This indicates scope for substantial system-wide improvement in member outcomes from mechanisms that ensure members are either actively choosing, or are being defaulted into, lower-fee and better performing products.

Because the analysis in figure 3.20 (top panel) is net of all fees (that is, examining returns net of both investment and administration fees), it provides a measure of the impacts of total fee levels on members' ultimate retirement balances. This is important given that many members do not necessarily value or utilise the additional administrative services offered by some funds and which members are nonetheless charged for. This analysis gives the clearest picture of the net benefits members receive in relation to the fees charged.

Other industry practitioners have analysed the relationship without adjusting for administration fees, namely by looking at the relationship between net investment returns (net of investment fees only) and investment fees in isolation (for example, Chant West (2017b)). Such analyses focus more directly on the investment performance of the funds relative to the investment fees they charge.

Box 3.4 **The relationship between returns and fees**

There is an extensive literature that investigates the relationship between fees and net returns. It is a contentious issue that relates to debates in academia and the financial sector about the effectiveness of ‘active’ versus ‘passive’ management, how the merits of different investment strategies differ across asset classes, and the long-term benefits of investing in higher cost illiquid asset classes.

Overall, there is evidence that fees are a significant predictor of net returns, because on average it is not possible to outperform the market in the long term (Johnson et al. 2015; Jones and Wermers 2011). This does not preclude some fund managers from outperforming the market average by pursuing active management strategies (associated with higher fees), including by investing in alternative asset classes (PC 2016, pp. 126–8). National Australia Bank MLC Wealth (sub. 63, attachment 1, p. 28) argued that in their experience, ‘higher investment costs do translate into higher net return outcomes over the long term’ and that a ‘focus on minimising fees poses a risk of influencing investment decisions’ in ways that ‘might compromise net returns for members in the longer term’.

However, the Grattan Institute found evidence that, on average, Australian funds that charge higher total (investment and administration) fees deliver lower net returns once fees are accounted for (Minifie, Cameron and Savage 2014). In 2015, the Grattan Institute extended this work and found a negative relationship between higher investment fees and lower returns within a range of asset classes (Minifie, Cameron and Savage 2015).

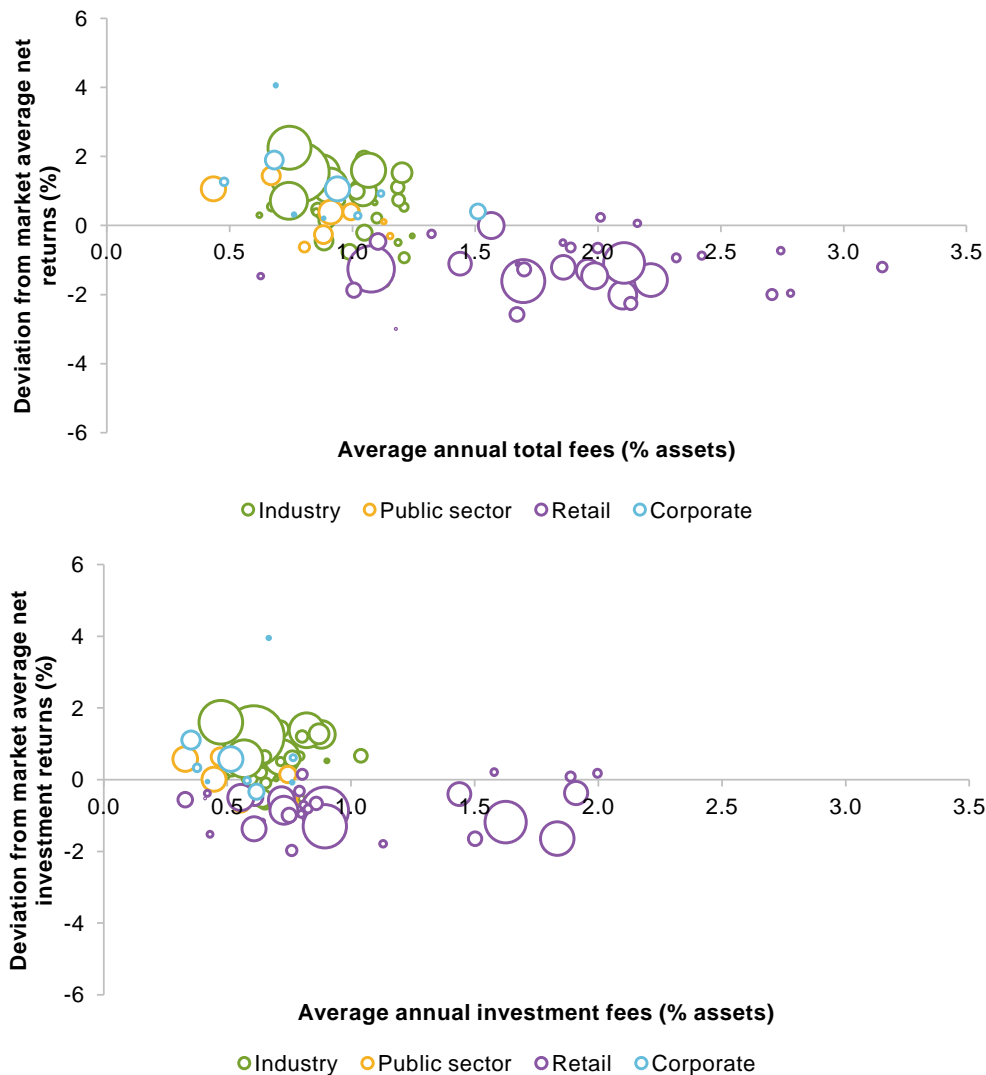
The Grattan Institute’s findings are consistent with other studies. Basu and Andrews (2014) found a (statistically) significant and negative relationship between gross returns from Australian superannuation funds and expense ratios (incorporating investment and administration costs). They found that a 1 per cent decrease in fees is associated with a 0.1 per cent increase in gross returns (and by extension a larger increase in net returns). Drew, Stanford and Veeraraghavan (2002) found that higher investment fees were associated with lower net investment returns across Australian superannuation funds between 1991 and 1999.

Chant West (2014) responded to the Grattan report by arguing that the higher investment fees charged by the ten largest MySuper products are justified by higher investment returns. This conclusion is based on evidence that these ten products, with allocations in unlisted assets of between 10 and 36 per cent, had higher average annual investment returns over the 15 year period to 2014 compared with a passive benchmark portfolio. However, the Chant West measure of returns is not adjusted for administration fees, which ultimately reduce returns received by members.

Other studies have found that while higher fees lead to higher net returns, these higher returns may simply be compensating investors for higher risk. Ainsworth et al. (2016) found that Australian superannuation funds with higher investment fees usually have higher allocations to riskier asset classes, which are more expensive to manage. The study found evidence that funds that charged higher investment fees produced higher net returns than the cheapest funds; however, the most expensive funds did not realise significantly higher net returns once risk was taken into account. A different study, by Cummings and Ellis (2015), found that some Australian superannuation funds realised returns from illiquid investments (net of investment costs) that compensated for the non-diversifiable risk (such as liquidity risk) that the investments contributed to the portfolio.

The bottom panel of figure 3.20 replicates this alternative approach. It shows that most retail funds appear to underperform the market even on this basis. This could reflect some unreported investment costs being netted off returns yet not being disclosed in investment fees, or alternatively a systematic investment in underperforming asset managers — the asset selection effect discussed in chapter 2.

Figure 3.20 Members paying higher fees likely get lower net returns^{a,b,c}
Average annual figures, fund level, 2006–2017. Bubble size represents total assets.



Sources	PC analysis of APRA unpublished data, financial market index data (various providers) and SuperRatings data.
Coverage	All APRA-regulated funds with a MySuper product in the dataset and with returns data for the full period (64% of assets in all APRA-regulated funds in 2017).
Survivor bias	Yes.
Selection bias	Yes.

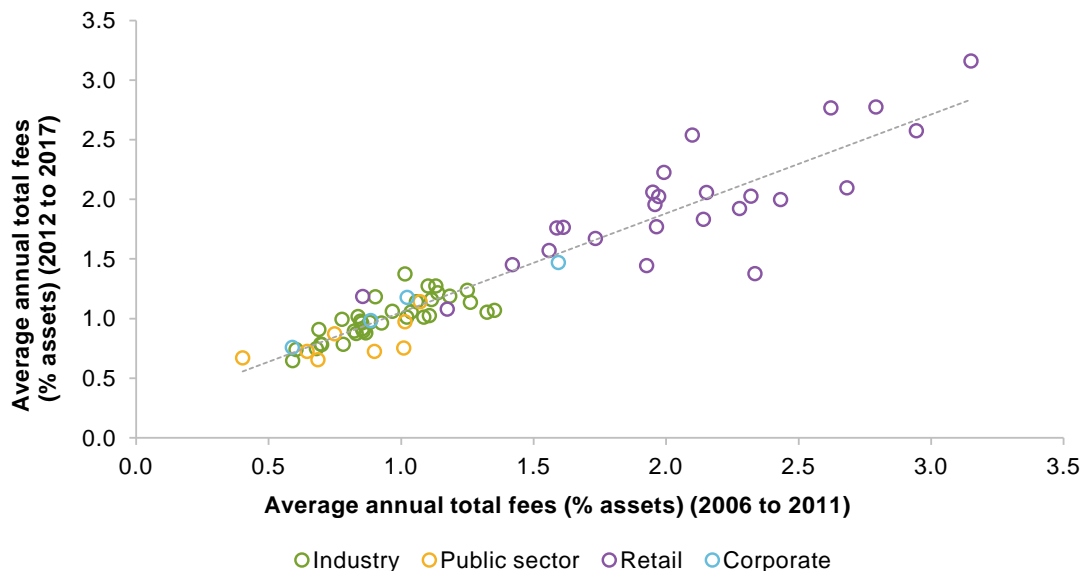
^a Data points are weighted by fund assets using APRA fund-level data. Where asset data are not available from the APRA statistics, total assets have been sourced from SuperRatings. ^b The sample of funds in this figure is the sample in the SuperRatings database that had observable data for the entire 2006 to 2017 period. ^c Market average net returns are a simple average across funds in the sample.

It is also notable that the dispersion in retail funds' performance is large relative to other fund types. Some retail funds deliver above-average net returns. That said, most have below-average net returns, which is *prima facie* evidence of fees driving persistent underperformance in those funds.

Moreover, fee levels persist through time. Figure 3.21 shows that funds' average annual total fees in the five years to 2016 are highly correlated with those observed in the five years to 2011. It also shows that persistence in fees is seen at both high and low fee levels. This means that a member in a high-fee fund could pay those high fees over a long period to the detriment of their retirement balance.

Figure 3.21 Fee levels persist through time

Average annual total (administration plus investment) fees, 2006–2017



Sources	PC analysis of SuperRatings data.
Coverage	72% of total assets in APRA-regulated funds. For retail funds, the sample is 71% of the institutional fund total, while for not-for-profit funds it is 72%.
Survivor bias	Yes.
Selection bias	Yes.

FINDING 3.7

Higher fees are clearly associated with lower net returns over the long term. The material amount of member assets in high-fee funds, coupled with persistence in fee levels through time, suggests there is significant potential to lift retirement balances overall by members moving, or being allocated, to a lower-fee and better-performing fund.

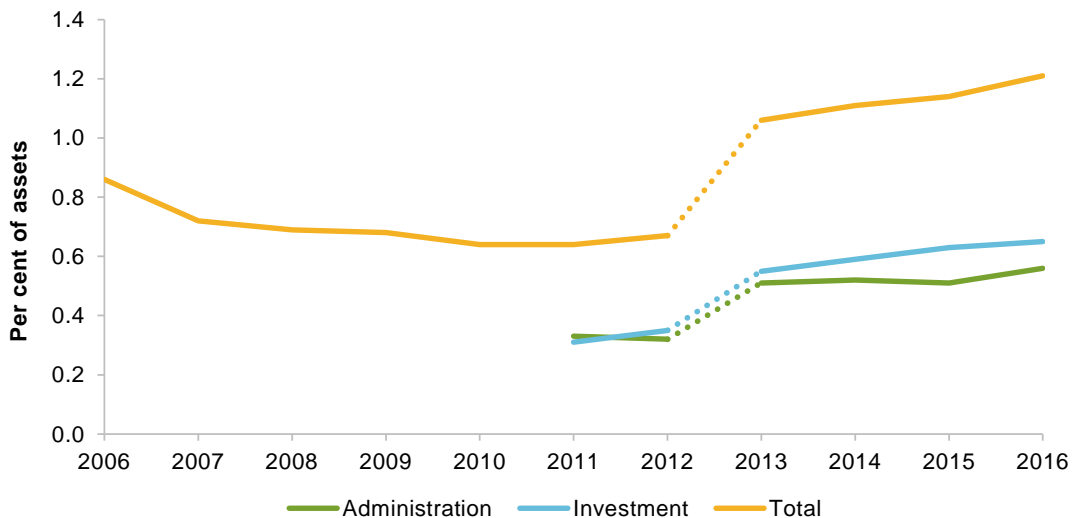
Fees have a significant impact on retirement balances. For example, an increase of just 0.5 per cent a year in fees would reduce the retirement balance of a typical worker (starting work today) by a projected 12 per cent (or \$100 000).

3.6 What about SMSFs?

The SMSF segment — comprising self-managed funds with four or fewer members — has experienced rapid growth in Australia over the past decade, with assets growing at a compound annual rate of 12 per cent in the decade to 2017 (reflecting both net contribution and rollover inflows plus investment returns), compared with 8 per cent for the APRA-regulated funds (APRA 2018b, table 4a).

For the average SMSF member, total annual costs rose from around \$5300 in 2013 to around \$7200 in 2016 (ATO 2017b, tables 1 and 22). This reflects growth in both investment and administration costs for SMSFs, both in total and as a share of assets (figure 3.22).

Figure 3.22 **SMSF reported costs relative to assets^{a,b}**
2006–2016



Sources	ATO (2017b, table 22) and various back editions.
Coverage	The ATO data represent all SMSFs in the system.
Survivor bias	No.
Selection bias	No.

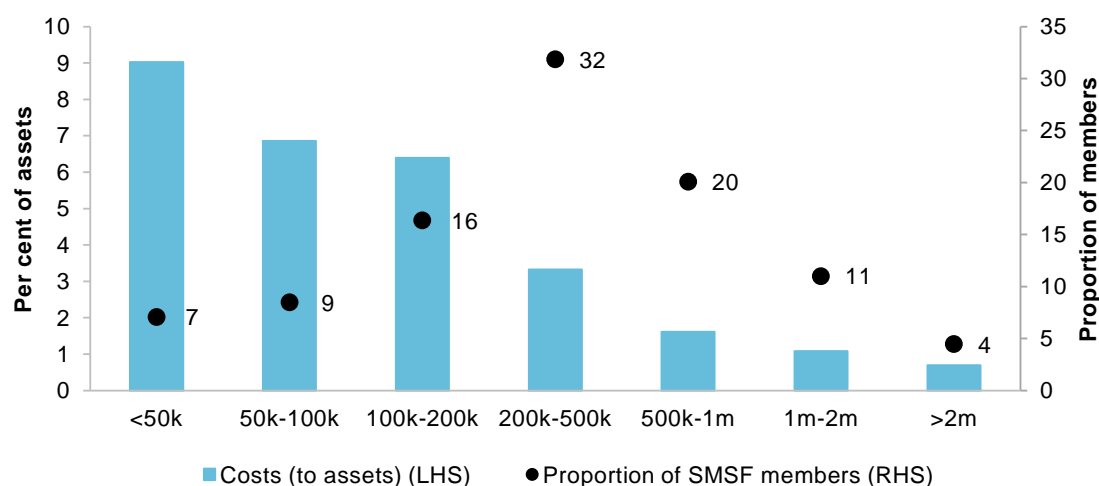
^a The dotted lines represent a break in the series reflecting that the ATO revised its collection methodology in 2013 to collect better information on non-deductible expenses. ^b In this chart, costs in each year are expressed as a ratio of average assets over the year.

Differences in how data are collected by the ATO (for SMSFs) and APRA (for institutional funds) mean that direct comparisons are not possible (tech. supp. 5). For example, cost data for SMSFs do not capture the opportunity costs of the time members spend managing their super — which is likely to be much greater than for members in institutional funds. Further, revisions to the ATO’s data collection methodology in 2013 led to a large increase in reported costs, and made comparisons before and after this date difficult (ATO 2015c). There are also differences in how net returns are calculated by the ATO and APRA (chapter 2).

Data issues notwithstanding, new Commission analysis using updated data provided by the ATO indicates that low-balance SMSFs (assets under \$500 000) report significantly higher costs (relative to assets) per member than APRA-regulated funds (figure 3.23). Among other things, this would explain why the net returns to smaller SMSFs (assets under \$500 000) are negative, on average, even after allowing for different methodologies (see below).¹⁷

Figure 3.23 Smaller SMSFs face high costs^{a,b,c}

Costs as percentage of assets and Proportion of SMSF members, by balance band, 2016



Sources	ATO (2017b) and ATO (pers. comm., 24 September 2018).	
Coverage	The ATO data represent all SMSFs in the system.	
Survivor bias	No.	Selection bias No.

^a ATO data reporting practices mean upfront establishment costs are embedded in operating costs, which raise costs relative to assets more for low balance SMSFs. ^b Costs are estimated on a per member basis, recognising that SMSFs can have up to four members. ^c Costs are expressed as a percentage of assets at the beginning of the period.

To what extent is the presence of small SMSFs in the system a problem? It could be that aggregate cost figures for SMSFs (especially in the smaller size brackets) are inflated by establishment costs for newly created SMSFs, which would not be a driver of ongoing costs for individual SMSFs. It may also be that many of these SMSFs will move into higher balance categories over time. These possibilities are considered below. There may also be other motivations for establishing an SMSF, such as having greater control over investments (chapter 5).

ATO data indicate that expense ratios for SMSFs are much more clearly related to fund size than fund age (tech. supp. 5). When cut by size bracket, the ATO data (for 2016) show that SMSFs under \$500 000 in assets have expense ratios that are well above average irrespective

¹⁷ The figures used in this chapter on SMSF returns and expenses by size category are derived from data obtained from the ATO, which classify SMSFs into size brackets based on the value of assets at the start of a year, rather than the average value of assets during the year (tech. supp. 5).

of age, particularly for those in the smallest size brackets (figure 3.24). Indeed, in most size brackets, SMSFs aged between 2 and years have similar or higher expenses on average compared with those that are under 2 years. The patterns are less clear cut in terms of returns, but SMSF age does not appear to be a strong predictor of investment performance or expense ratios within any size bracket (though SMSFs that have been in existence for five or more years tend to have slightly lower costs than those that are newly established, across most size brackets).

These results may, in part, be explained by the trajectory of newly established SMSFs over time. To the extent that new SMSFs incur high initial costs but quickly grow to over \$500 000 in assets (for example, as members roll in balances from other funds), they may then experience a reduction in expense ratios and an increase in net returns (for example, due to economies of scale). However, those that remain small appear to continue to experience high costs and low returns on average, even well after establishment costs have been paid. Analysis by the Commission reveals that in 2016, about 42 per cent of SMSFs (about 200 000 SMSFs with an estimated 380 000 members) appear to be in this category (older than 2 years and balances less than \$500 000).

Other ATO data analysed by the Commission shine a more direct light on the growth trajectories of individual SMSFs.¹⁸ The data show how the 36 000 SMSFs that first lodged a tax return in 2012 (and were established in either 2011 or 2012) had fared over the following five years (figure 3.25). Overall, about a quarter of funds with less than \$500 000 in 2012 had grown to over \$500 000 in 2016. For the two smallest brackets in 2012 (under \$50 000 and \$50 000 to \$100 000), at least 20 and 15 per cent, respectively, remained in either of these categories by 2016. SMSFs that started large mostly tended to stay large.

These ATO data also indicate how many SMSFs had wound up over the period. Wind-up rates were about 10 per cent for the two smallest size brackets in 2012, and proportionally much lower for larger size brackets. Rates of non-lodgement of 2016 tax returns were also disproportionately higher for the smallest brackets. This could be an indication of financial difficulty in some cases. All in all, the evidence indicates that a significant proportion of small SMSFs remain small, likely at a high cost and with a low or negative return, on average.

¹⁸ Some of these data were previously published by the ATO in infographic format (ATO 2018).

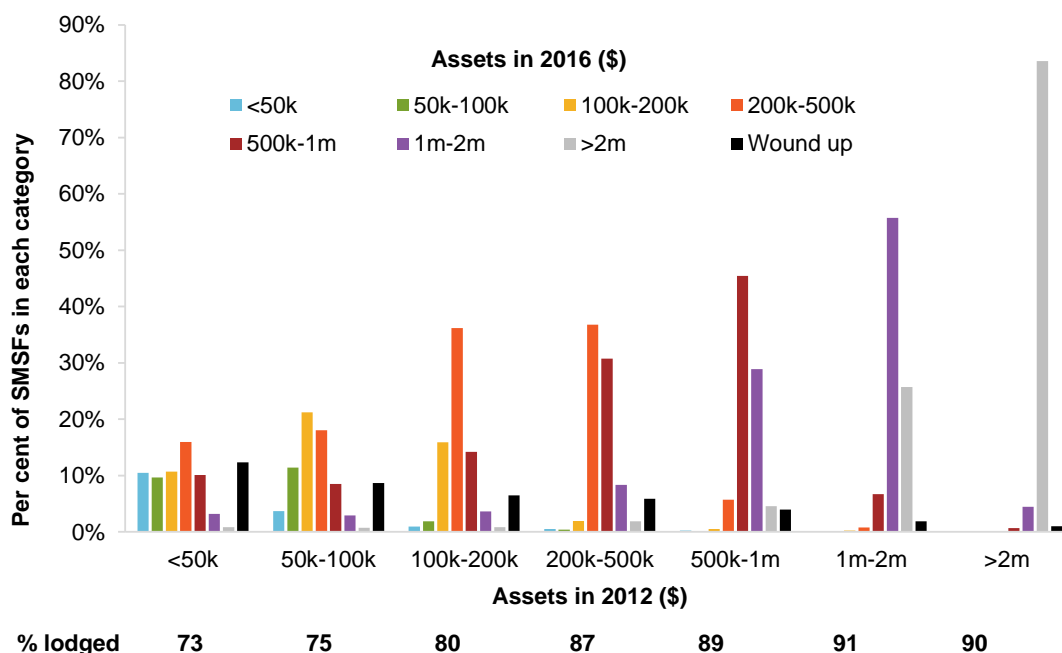
Figure 3.24 **SMSF expenses and net returns by age and size bracket^a**
2016



Sources	ATO (pers. comm., 24 September 2018).	Selection bias	No.
Coverage	The ATO data represent all SMSFs in the system.		
Survivor bias	No.		

^a Adjustments have been applied to SMSF returns data to approximate a 'rate of return' calculation, as per Sy (2009). 'New' SMSFs are defined as those established within the past 2 years. Size brackets are defined using assets at the beginning of the period.

Figure 3.25 SMSF class of 2012: where are they now?^a



Sources	ATO (pers. comm., 24 September 2018).
Coverage	The ATO data represent all SMSFs in the system.
Survivor bias	No.
Selection bias	No.

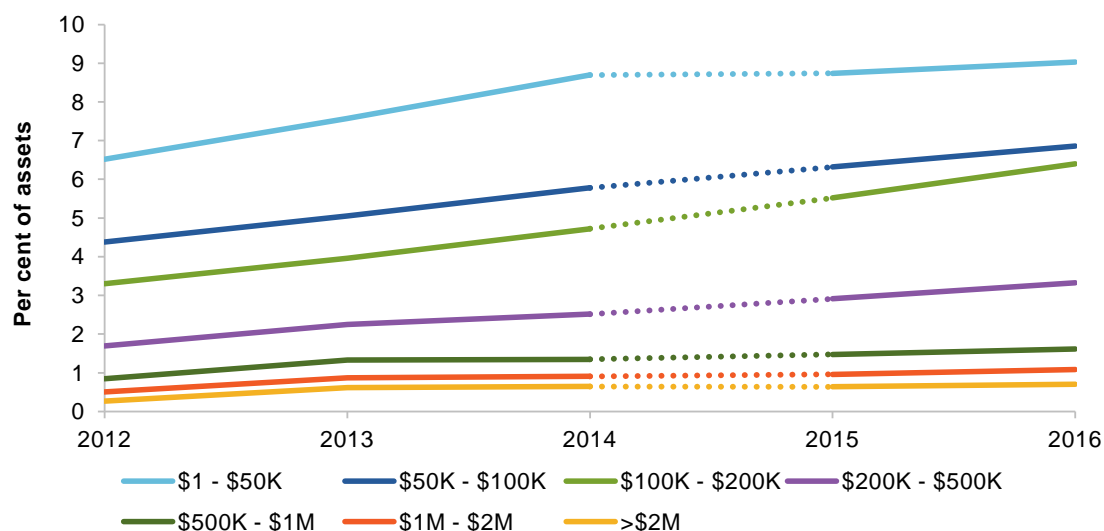
^a The percentage lodged indicates the share of SMSFs within each size bracket that had lodged a tax return in 2016 (and thus are included in the chart).

That said, this need not imply that all SMSFs with balances under \$500 000 are generating poor net investment returns. Averages conceal variation — some SMSFs within this group may well have lean costs and high net returns. A further possibility is that there are tax advantages to members that are not fully reflected in the net returns data (as noted in chapter 6). Hence, the regulatory focus should be on ensuring that members understand the implications of their decision to open an SMSF, including through well-informed financial advice that is in the member’s interests (chapter 5).

Nevertheless, the number of SMSFs in low-balance categories has been falling, partly because average balances have grown. The proportion of SMSFs with balances beneath \$500 000 has fallen by 19 percentage points over the decade to 2016 (ATO 2014b, 2017b, table 14). Further, data on the number of *new* SMSFs indicate that very small SMSFs (those with a starting balance of less than \$100 000) have decreased in both absolute and proportional terms. Such funds represented 31 per cent of new establishments in 2012, but only 22 per cent in 2016 (ATO 2017b, table 14.1).

That fewer small SMSFs are being established could reflect the higher average costs of operating low-balance SMSFs (figure 3.26). This may have countered the benefits of operating an SMSF, such as control over investment decisions.

Figure 3.26 Costs are typically higher for low balance SMSFs^{a,b}
Administration and operating costs as percentage of assets, 2012–2016



Sources	ATO (pers. comm., 24 September 2018).
Coverage	The ATO data represent all SMSFs in the system.
Survivor bias	No.
Selection bias	No.

^a Administration and operating costs are significantly higher than investment costs in general, and have also increased by more over time (across balance bands). ^b The dotted lines represent a break in the series reflecting that the ATO revised its collection methodology in 2013 to collect better information on non-deductible expenses. ^c Costs are expressed as a percentage of assets at the beginning of the period.

FINDING 3.8

Reported costs for SMSFs (relative to assets) have increased over recent years and, for those with over \$1 million in assets, are broadly comparable with APRA-regulated funds. By contrast, costs for SMSFs under \$500 000 in size are particularly high, on average, and significantly more so than for APRA-regulated funds.

About 42 per cent of all SMSFs (some 200 000 in 2016, with an estimated 380 000 members) have been under \$500 000 in size for at least two years, and appear to persist with high average cost ratios and low average returns. Nevertheless, the proportion of new SMSFs with very low balances (under \$100 000) has fallen from 35 per cent of new establishments in 2010 to 23 per cent in 2016.

4 Are members' needs being met?

Key points

- Much of the superannuation system is failing to deliver the right products and services to its members. Given a maturing system, the financial stakes involved and the need to give more weight to the drawdown (decumulation) phase, this failure is likely to be accentuated over time.
- In the accumulation phase, the greatest need for members is relatively clear-cut — high average net returns, appropriate asset allocations to manage risk, and efficient fees.
- Yet products to manage risk and post-retirement incomes are often crude, or worse, produce poor outcomes, and the system is overly complex in areas that are largely irrelevant to members' needs:
 - *Well-designed* life-cycle products can achieve good retirement incomes while reducing the adverse effects of large asset price downturns for older members, but many existing products de-risk too early in a person's working life, with adverse impacts on retirement incomes.
 - The facts belie the belief of many that (on average) greater control of assets and more options increase net returns. The proliferation of little-used and complex investment options (tens of thousands in 2016) in the choice segment of the market collectively appear to increase fees and reduce net returns (by about one percentage point), consequently eroding members' retirement balances (potentially by up to \$230 000 for an affected member). And it is a sign of unhealthy competition.
- Excess variety (as distinct from 'virtuous' variety) also obscures people's capacity to find the products and funds that deliver good returns in the choice segment.
- The decumulation phase is more complex than the accumulation phase. Retirees often have multiple and conflicting objectives that change as they age, and depend on their own and any partner's characteristics. Interactions with the Age Pension, health and aged care, and assets held outside of superannuation add a further layer of complexity. Given that many retirement product decisions are largely irreversible, the need for good quality advice and member protection is essential.
- There is little evidence that the product range in the retirement phase is deficient per se. The bigger question is whether people act with discernment in this phase.
- There has been low take up of annuity-based retirement income products, despite their potential advantages in insuring against longevity, market and other risks. Account-based pensions (ABPs), which are used by the bulk of retirees, suit many because they provide maximum flexibility. People can still manage longevity and other risks by varying bequests, taking up the Pension Loans Scheme and using the Age Pension. Nevertheless, there is the potential for some growth of hybrids of ABPs and annuities.
- The Australian Government should further assess the design and desirability of the Retirement Income Covenant given its risks and implementation challenges. There are risks that the Covenant may nudge people into annuity products ill-suited to them, will not deliver the intended goal of greater consumption in retirement, and could, in the current underdeveloped annuity market, lead to poorly priced products. Many funds do not want to offer them.
- While 'data is the new black', the industry's use of data to design better products and services has progressed slowly, while policy uncertainty has stifled broader innovation.

Good markets meet consumers' needs.

A well-functioning and efficient superannuation system should ensure that it has a product range sufficient to meet people's sometimes varying needs ('virtuous variety') and that across this range, it matches products to people's needs as they age ('efficient matching'). It should do so at a price that is efficient.

Failures in these dimensions can adversely affect member outcomes through lower net returns or unwanted risks. A good system should provide a suite of products that are relevant to people's different needs over the life cycle and as the nature of work evolves. The goals would be to:

- provide high average net returns that allow members to maximise long-term net returns for most of the accumulation phase, with some mitigation of the market risks that can affect retirement balances and subsequent income. High-income members for whom tax and related matters are relevant might choose different accumulation strategies, but such members are in the minority
- cater for people's varying circumstances (including access to social welfare benefits), preferences and risks during retirement. A key issue is the extent to which there are affordable options for risk pooling for those who want to insure against variance in market returns, inflation, idiosyncratic and systematic longevity risk, and other risky events that can lead to uncertain or unstable retirement incomes
- take account of the potential changes to working patterns associated with the gig economy, reduced demands for automatable skills, interruptions to job continuity, and the risk of continuing wage growth inequality
- avoid products and system characteristics that lead to balance erosion. Unequivocally, deficiencies in insurance offerings, the potential for people to still hold multiple accounts, and high fees without commensurate returns do not meet members' needs. As critical as these concerns are, the Commission addresses them in other chapters in this report (chapters 3, 6 and 8).

A good suite of products (especially in the retirement phase) does not by itself meet members' needs, but requires a complementary product — disinterested advice — to achieve the goal of efficient matching. There have been some reforms to the provision of financial advice in superannuation. However, evidence from the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (FSRC 2018e, pp. 134–5, 141, 155) has highlighted examples where advice has not met members' needs. This is one of the concerns of the next chapter.

The irony of the superannuation system is that when it should be sophisticated — particularly in managing risk and in catering for member variety — it is crudest, while being overly complex in areas that are largely irrelevant to members' needs.

In the transition and retirement phases, products may often still be elaborate, but are insufficiently-tailored to individuals' often distinct preferences (sections 4.4 and 4.5). A person's circumstances and cognitive capacities determine the drawdown rates, the riskiness of assets held in ABPs, and strategies to manage their retirement incomes (such as the Pension Loan Scheme and 'two-bucket' approaches) that best suits their needs.

To a lesser degree, the lack of tailoring reflects the legacy of constraints posed by the tax and transfer system on the development of new types of products, such as deferred lifetime annuities and group self-annuitisation. Few superannuation funds are active in producing such products, notwithstanding relaxation of some of the key policy constraints.

Unlike many other goods and services, whose capacity to meet people's needs are quickly assessable either before or soon after purchase (a haircut, a meal and most physical products), the extent to which a super product meets a person's needs is only discoverable at certain junctures in a person's life, sometimes many decades into the future. There is evidence that people often cannot distinguish good superannuation advice from poor (ASIC 2006; chapter 5). Therefore, a person needs a product whose design appears likely to deliver the preferred outcomes in retirement, but also some reassurance that in the long period before maturation, the member is satisfied with the credibility of a super fund's claims about the characteristics of the product, its ongoing performance and its suitability for the person's circumstances. The intangible concepts of 'satisfaction' and trust are therefore an easily overlooked dimension of members' needs (section 4.1). Consumers' needs are not being met if they are not satisfied with, or do not trust, the business that manages a fair share of their mandatorily appropriated lifetime savings.

The extent to which businesses meet peoples' needs is often dependent on engaged, informed and footloose consumers. Unfortunately, members are mostly not engaged, and while they may be bombarded *with* information (and marketing), it can hardly be said that they are generally able to make informed decisions (chapter 5). Even some sophisticated people making tailor-made choices among thousands of investment options can overplay their real ability to beat the market. Behavioural biases abound.

Information is a two way street. The data age has demonstrated the value to businesses of mining customer data to add value, yet the degree to which funds use this strategy appears nascent (section 4.6). More generally, this raises the question of the extent to which the sector is innovative in areas that best meet members' needs, and any inhibitors to innovation.

The gap between needs and products is a symptom of the interplay between fund conduct, product complexity, and cognitive biases (and knowledge) of members. Regulation, market structure and limited competition play a decisive role behind this interplay. Many of the policy improvements proposed elsewhere in this report will play a role in narrowing the gap. For example, policies to improve engagement and information provision (chapters 5 and 13), the re-design of default allocation to encourage high performance (chapter 12), and an effective regulatory regime (chapter 13) will increase the alignment of need and product offerings. However, some policies can directly target the tension between members' needs and the products delivered by the funds.

Overall, the key questions of this chapter are captured by the following three criteria identified in the stage 1 study.

- Do funds compete on member relevant non-price dimensions? (C8)
- Is there innovation and quality improvement in the system? (C9)
- Is the system providing products to help members manage risks over the life cycle and optimally consume their retirement incomes? (E7)

4.1 Do members *believe* they are being well served?

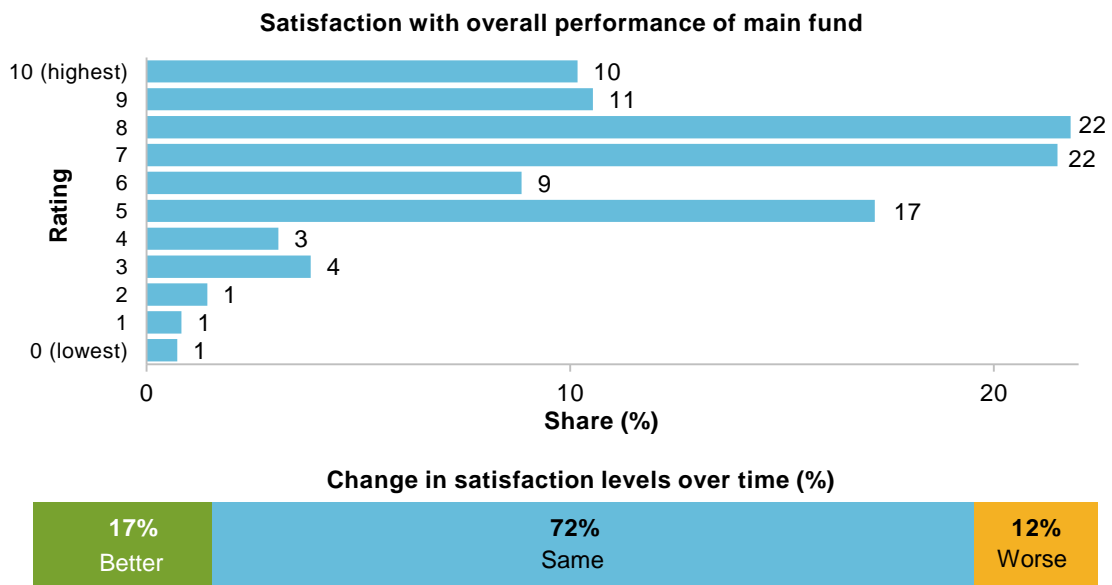
While not necessarily well-based, members' subjective assessments about the degree to which the system is working for them is an important indicator. Many aspects of a member's experience — such as trust or satisfaction with the various dimensions of products — can only be gauged this way.

Members had relatively high levels of satisfaction with the overall performance of their funds, with a small minority (about 10 per cent) expressing some degree of dissatisfaction (figure 4.1). While most considered their fund's performance had not changed much over the few previous years, where they did, it was normally for the better. There is evidence of greater diversity in members' satisfaction with specific dimensions of their fund's performance, though the overwhelming share of members were still positive (figure 4.2). Fees charged were a conspicuous source of dissatisfaction (an issue placed under the microscope in chapter 3 of this report).

Analysis at the member level found that there was close to a one to one relationship between a member's trust that their superannuation funds would act in their best interests and their overall rating of the performance of the fund. The strong relationship also suggests that trust is a fickle aspect of people's subjective judgments because mere chance events affecting the returns on assets can result in poor (bad) performance without that implying that trustees are failing in their obligations.

In the retirement phase, there is a tendency for poorer ratings for annuities compared with account-based pensions and self-managed superannuation funds (SMSFs), but this may reflect low sample numbers for members using annuities, which reduces confidence in the result (figure 4.3). The most revealing aspects of people's perspective on retirement products was that when they were deciding the product to choose, a significant minority of members expressed equivocal or negative views about the degree to which funds met their specific product needs. This judgment resonates with the Commission's findings about the retirement phase (section 4.5).

Figure 4.1 **Overall satisfaction with superannuation funds^{a,b}**
Including SMSFs



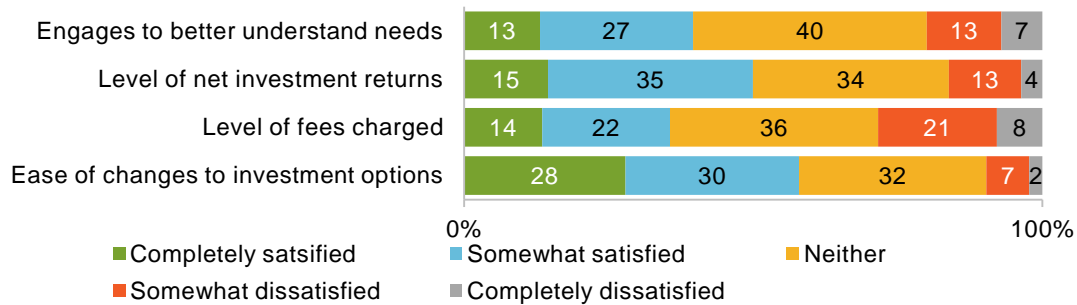
^a Responses are weighted using Commission weights. ^b The top panel (question Q6b) is based on 2069 observations and the bottom panel (question Q6c) is based on 1738 observations.
Source: Members survey.

The broadly positive views of members about superannuation has been repeated in other survey evidence. For example, results from a recent CHOICE survey of about 2500 people also suggested about 70 per cent considered that the system was ‘working for them’ (figure 4.4). The greater share of people with negative views than the more structured Commission members survey is likely to reflect differences in design and implementation.

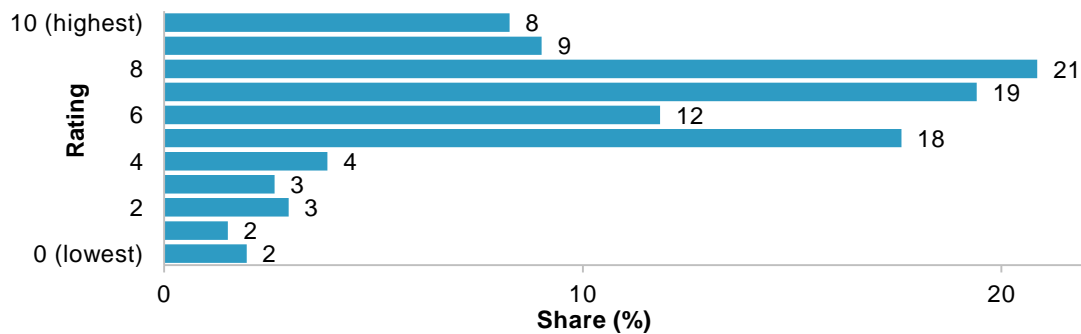
Subjective assessments have some deficiencies regardless of how they are collected. There is evidence that poor understanding of, or interest in, superannuation translates to lower levels of satisfaction and trust (tech. supp. 6). Notwithstanding the aphorism, familiarity does not breed contempt. To that extent, subjective measures of performance may partly reflect the difficulties people face in making assessments when they do not understand the performance of a fund objectively. In that case, less weight should be given to such assessments.

Figure 4.2 Satisfaction with, and trust of, funds^{a,b}
Excluding SMSFs

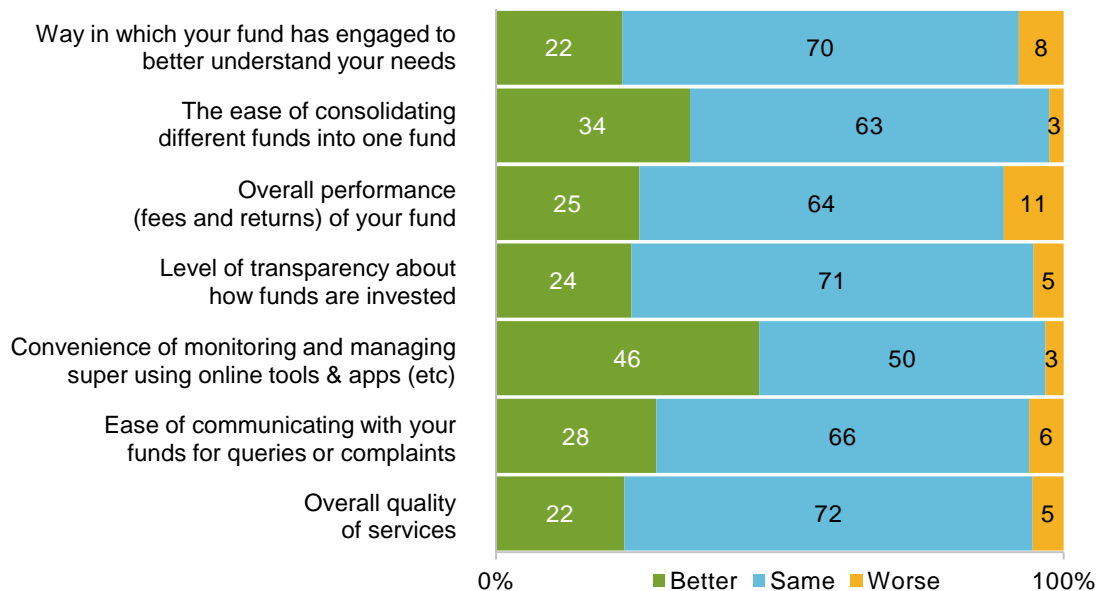
(A) Satisfaction with specific performance metrics, *excluding* SMSFs (% in each rating group)



(B) Trust main fund to make decisions in best interests *excluding* SMSFs (% in each group)



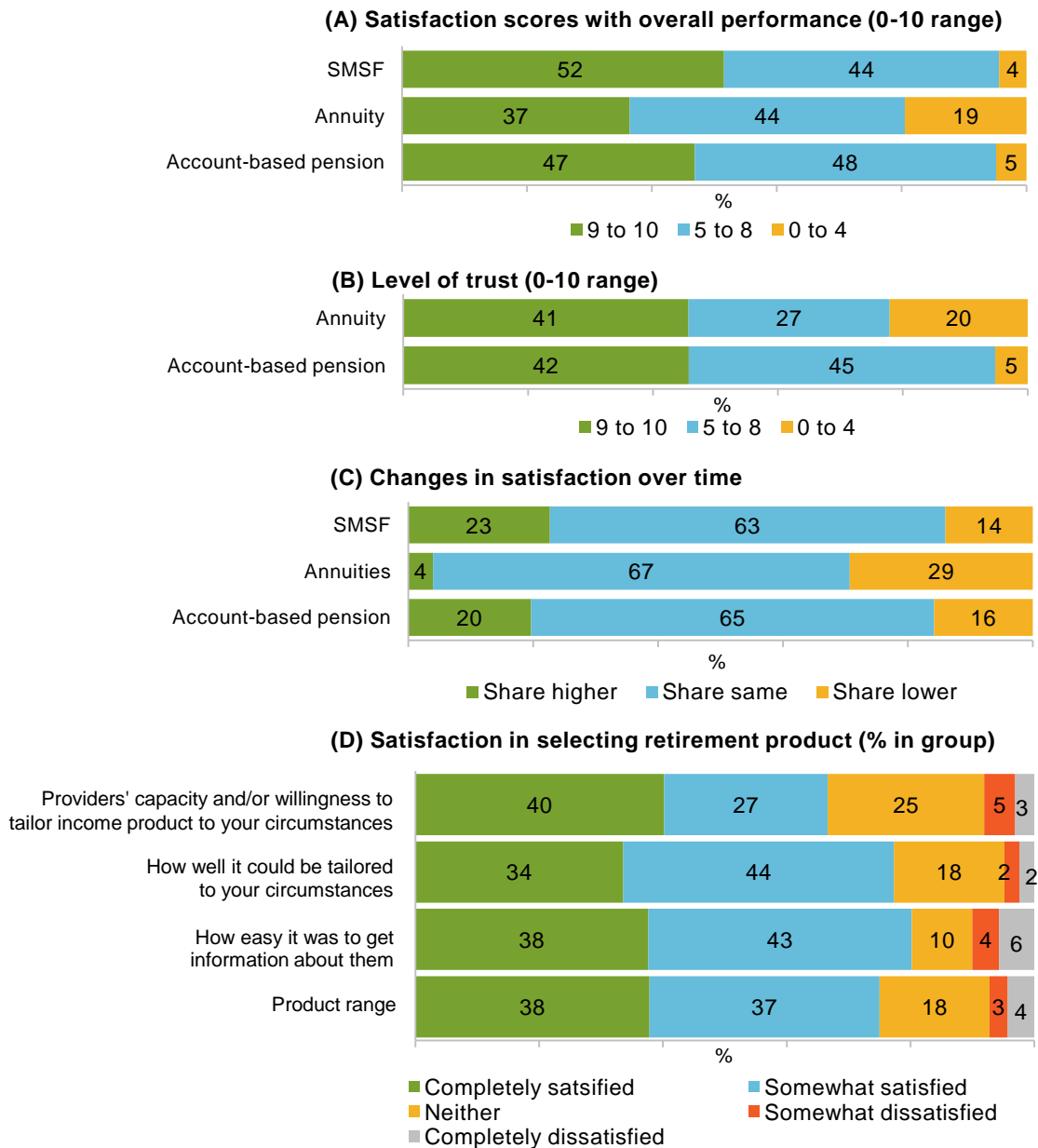
(C) Change over time in rating of funds, *excluding* SMSFs (% in each rating group)



^a Responses are weighted using Commission weights. ^b Panel (A) (question Q8) is based on respondent numbers that vary from 1676 to 1945. Panel (B) (question Q7a) is based on 1908 respondents and panel (C) (question Q7b) is based on respondent numbers that vary from 1088 to 1304. 'Don't knows' and missing values are excluded.

Source: Members survey.

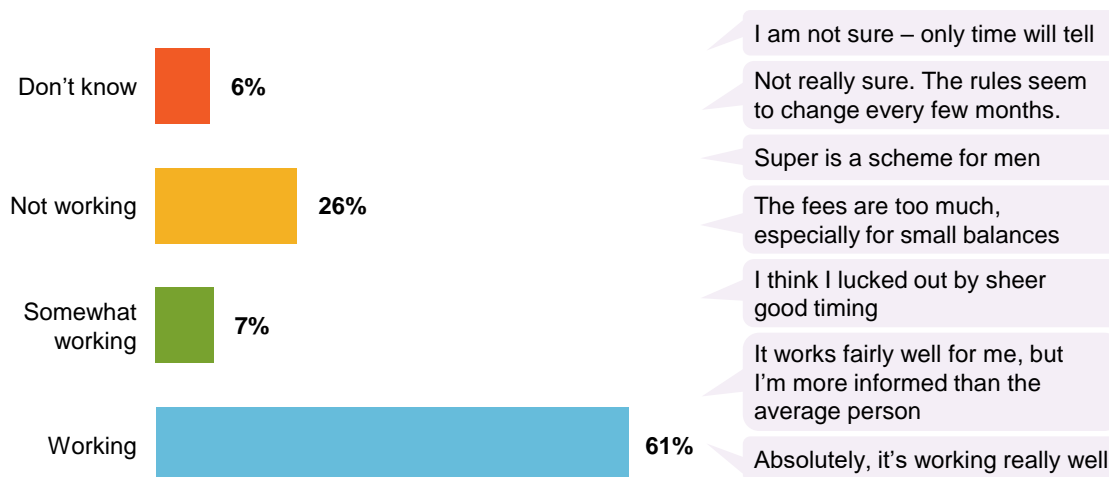
Figure 4.3 Subjective assessments about retirement products^{a,b}



^a Responses are weighted using Commission weights. ^b Panel (A) (questions R6a to R6c) is based on respondent numbers of 72 for account-based pensions, 18 for annuities and 23 for SMSFs. Sample sizes are sufficiently small that results need to avoid over-interpretation. Panel (B) (questions R7a and R7b) relates to trust that the fund will act in the member's best interest. It is based on respondent numbers of 69 for account-based pensions and 18 for annuities. Panel (C) (questions R6d, R6c and R6d) have respondent numbers of 51 for account-based pensions, 15 for annuities and 20 for SMSFs. Panel (D) (question R5) is based on 90 respondents and relates to the time when people were selecting their product.

Source: Members survey.

Figure 4.4 An overarching view of whether the system is working for members, 2017^a



^a Survey of 2498 CHOICE members, of which there were 2376 valid responses for the question of: 'Overall, do you think the superannuation system is working well for you?'

Source: Survey data provided to the Commission by CHOICE.

FINDING 4.1

Qualitative judgments by members of superannuation funds suggest that a small share are dissatisfied with the overall performance of their fund. Members who have a poor understanding of the system and less capacity for accurately gauging the performance of their funds tend to report being much less satisfied. Many more members indicate that the performance of funds, including their service quality, has improved over time than those who feel that performance has flagged.

A sizable minority of members selecting a retirement product express equivocal or negative views about the degree to which funds meet their specific product needs.

4.2 Is there product proliferation and does it matter?

In many markets, product proliferation is desirable as it meets the diverging preferences and needs of consumers, fosters further innovation and creates downward price pressures on existing differentiated products protected by patents. The dynamism and variety of the smartphone sector is an exemplar. While less dynamic, the supermarket industry demonstrates even greater product variety, with the average full service supermarket stocking between 20 000 and 25 000 different products (Mitchell 2016) — a variety that most consumers would see as beneficial.

There appears to be a similarly large number of options in superannuation with concerns that unlike typical markets, the variety adds little value for consumers, while increasing costs,

fees and confusion, an issue relevant to the financial sector more broadly (PC 2018a). The concern applies to all stages of people’s involvement with superannuation. However, it is most critical during the accumulation phase because this comprises peoples’ most protracted involvement in the superannuation system. Accordingly, it is where the potential adverse effects of poor product choice or high fees will have the greatest effect.

The blunt assessment of Industry Super Australia (sub. 59) was that product variety is an indicator of how for-profit funds extract value from the system as part of their business, including through distribution channels such as sales and marketing, product bundling and advisers. The Deputy Chair of the Australian Prudential Authority (APRA) was not much less critical:

I have previously expressed the view that there are too many investment options within super ... Under APRA’s proposed member outcomes assessment, and as part of sound strategic and business planning, we would expect trustees to seriously consider the optimal number of investment options they should be providing to efficiently deliver quality outcomes for members. (Rowell 2017b, p. 9)

A starting point for testing the validity of this grim diagnosis is the nature of product variety in the superannuation industry.

How many products are there?

About half of member accounts are in default products, where, by design, there is no product proliferation at the fund level (though the number of funds offering MySuper products has grown). However, an open question is whether product proliferation in the choice segment might contribute to the dominance of the default market as product complexity may lead to member inertia (an issue explored below).

For industry fund members, there are a relatively small number of options (a median of 16 among the funds in 2016).¹⁹ Most members chose one of four pre-mixed options — high growth, growth, balanced or conservative (Rice Warner 2017d). The story for retail funds is quite different. The tail of funds with a large number of options is long (tech. supp. 6), and the median number of options are nearly double that of industry funds. In 2016, 18 APRA-regulated funds offered more than 1000 investment options and a further 24 offered between 100 and 1000 options. All were retail funds. Such options give individual members the scope to develop highly customisable portfolios (for example, specific listed companies, and multiple managed funds with varying asset mixes). The consequence of the large number of options offered by some funds is that there *appear* to be about 40 000 options across all APRA-regulated funds (covering the accumulation and decumulation phases). The numbers exaggerate the real extent of proliferation because the

¹⁹ Based on unpublished APRA data. Medians provide a more meaningful indicator of central tendency than averages when the data are heavily skewed, as they are for option numbers. Note that APRA indicates that industry funds tend to group investment options in reporting. This contributes to their lower count compared with retail funds, which report them individually.

concept of an option is woolly (box 4.1) and because 30 of all the investment options accounted for three quarters of all assets in the retail segment (Rice Warner 2017d).

Box 4.1 Quibbles about funds, products, categories and options

Measuring product proliferation is not straightforward given the esoteric framework for categorising the outputs of superannuation entities. Super products somewhat resemble the financial equivalent to Matryoshka dolls in that they are packages of packages of packages of investment options. Registrable superannuation entities (RSEs) are umbrellas for one or more funds, which offer one or more 'products' (typically for different client groups — retirees, individuals in the accumulation phase, and employers, though there are sometimes a few more variants). Each fund offers one or more investment options — and it is in the latter that the choices seem extravagant. In 2016, there were over 40 000 such options among the 220 APRA-regulated funds. On face value, the number of options has trended up over the longer run, with APRA data revealing a startling increase of about 100 per cent between 2013 and 2014. However, before a rushed judgment about the significance of these numbers, several important caveats bear emphasis.

First, APRA changed its reporting standards in 2014, which seems likely to have affected the reported numbers, and thereby the meaningfulness of the trend data. In advice to the Commission, APRA does not regard the reported option numbers as a precise measure of product range.

Second, the reporting framework is complex, as even a peremptory examination of the relevant instructions attest (APRA 2015a). Options are only non-MySuper options if they meet certain asset thresholds, after taking into account the degree to which MySuper assets are held in that option. Options with very similar features can be identified as separate options for the same fund, and some options can be shared across funds, but are counted as different options when fund statistics are compiled. For instance, across the 43 000 open options identified in the Rainmaker data, there are more than 1100 cash products, which by construction provide very similar returns. Similarly, there are more than 6100 fixed income products — again where the heterogeneity of assets is relatively low. Lying behind many of these assets, the same fund manager may manage an asset for more than one superannuation entity.

Third, many of the options are only available for certain types of investors. Confusion in choice for any one group can only relate to the options available to them. For instance, in the Rainmaker data, there are about 19 000 open options that are only available in the retirement phase to individuals and about 20 000 open options for individuals in the accumulation phase. There are several thousand more options only available to corporates and employers. As noted by the Financial Services Council (sub. DR186, pp. 8–10), there is double counting of options across funds or accumulation and retirement. The FSC indicated that most funds have less than 10 investment options and many options are only available through financial advisers.

Finally, it is important to note that the key issue is not the option numbers themselves, but who selection among them. A member who defaults into a MySuper product is by definition, not party to the numerous choices among investment options made on their behalf by fund managers. In the choice segment, members themselves can — if they wish — play a bigger role in asset selection, albeit with the vulnerabilities they bring in doing so.

Nevertheless, no matter how the data are measured, aggregated or interpreted, it appears that the degree of product proliferation is an undesirable feature for members of the choice segment of the superannuation system.

Nevertheless, there is little doubt that some funds offer a large array of investment possibilities, and that they still account for a sizable share of member numbers and asset values. The 2016 APRA financial data on registrable superannuation entities show that funds offering more than 100 options accounted for about one third of member accounts and total assets.²⁰ Moreover, although SMSFs are not retail funds, they provide their members with options equivalent to the most complex retail funds and they now account for a large share of total superannuation assets (chapter 1).

While retail funds tend to offer more investment options than other fund types, only some offer a very large number, suggesting that variety itself is a source of differentiation between funds, but not a requirement for fund success. There is no significant divergence in average member balances or member accounts between funds with different option numbers once the numbers are above ten. Furthermore, membership growth rates between funds with varying numbers of investment options are not systematically different.

While the data are poor, the evidence suggests that the number of options have been increasing over time (figure 4.5), with qualitative evidence from stakeholders also supporting this contention. The rapid growth in SMSFs also represents a widening of the investment options available to members.

Does product proliferation matter?

In contrast to many other industries, the high degree of product diversity is perplexing because many people's ultimate goal from superannuation is relatively simple — the maximum return (and thus balance) at retirement for a given level of risk appetite. A wide array of investment options may assist members in achieving that outcome, but a key question is whether members wish (and are competently able) to make those technical decisions compared with super funds.

The more important issue for many members is the relative weighting given to defensive versus risky growth assets. By their early 20s, about 80 per cent of Australians hold superannuation accounts (ABS 2017b, table 15.1) and will therefore have about 40-45 years in the accumulation phase. Members' balances at retirement are a function of any fees and the gross returns from the portfolio of assets held on their behalf. In general, holding a portfolio weighted towards growth assets accompanied by a modest share of low risk assets (bonds and cash) will meet many members' needs, though there is debate about how this risk allocation should change as a member ages (section 4.3). Safer investments in cash and fixed income assets provide a lower variance in returns, but at the cost of a lower rate of return (tech. supp. 6). Indeed, over the long run, all but the very worst outcomes for portfolios exposed to risky assets outperform conservative portfolios as would be expected given the equity premium (KPMG 2017; tech. supp. 6). So even if the downsides occur, the average growth in riskier portfolios over a working life will mostly beat safer strategies.

²⁰ Unfortunately, the available data do not provide comprehensive information about the value of assets in each product option. As noted by Rice Warner, some options are little used (2017d).

The Commission’s members survey included a ‘choice experiment’, which sought members’ willingness to pay for various features of superannuation products (appendix C and tech. supp. 1). The results suggested that the capacity to control investment options was valued by older and more financially literate members (though note the evidence below about SMSF investors). This is consistent with the general desire by people to control their lives. It also accords with people’s varying appetites for risk at different stages of their life or for other aspects of investments (such as ethical investments). However, these preferences do not explain the extreme range between funds of the number of options they provide. The critical point is that the number of investment options needed to cater for any such variation in preferences is not great, a point emphasised by Rice Warner (2017d). Given the high levels of variance in returns across asset classes, it is not tenable that members can construct bespoke portfolios that are *likely* to produce better long-run returns than choosing among a relatively small set of off-the-shelf portfolios that span different asset mixes.

Figure 4.5 Option numbers appear to have grown over time, 2004–2016^a



^a The data include options that are not reported in public data. Although coverage has improved in recent years, some funds do not report the number of investment options offered.

Sources: APRA data for funds and Australian Taxation Office data for SMSFs from [https://www.ato.gov.au/About ATO/Research and-statistics/In-detail/Super-statistics/SMSF](https://www.ato.gov.au/About%20ATO/Research%20and%20statistics/In%20detail/Super%20statistics/SMSF).

If people believe that, on average, greater control over assets and more options increases their net returns, the facts belie this.²¹ Based on analysis of APRA fund-level data, Industry Super Australia (sub. 59) found that choice proliferation in superannuation was strongly

²¹ While the Commission draws on the Australian evidence, similar results have been found in the United States (Keim and Mitchell 2016).

associated with *poorer* financial outcomes for members (ISA 2017, p. 3).²² In its own analysis of APRA data, the Commission found that, as measured by the 10 year compound rate, the *net* long-run returns are lower on average for funds that offer more options (after controlling for asset class allocation, fund status, and average benefits per member, which also affect returns).²³ The annual net rate of return for funds with 300 or more options is about one percentage point lower than funds with a modest range of options (about 10-15).

Commission analysis of APRA data shows a positive relationship between the number of options and the ratio to assets of fees paid. Conservatively, the average ratio of fees to net assets (excluding costs relating to insurance) is about 0.5 percentage points higher for funds offering 300 or more options compared with those offering 11–15 options. Such higher fees may reflect a fund’s capacity to charge a premium for access to variety, higher costs, or a combination of the two. APRA data for 2016 reveal no systematic relationship between the total operating costs of funds and the number of investment options. However, this is probably more a reflection of the difficulty of isolating the drivers of costs, than proof that no such relationship exists.

The divergence in net rates of return between funds offering many as compared with few options (as set out above) has major implications for retirement balances. For example, a full-time male employee commencing work at age 21 years and retiring at 67 could readily forgo between \$140 000 and \$230 000 in their retirement balance — a substantial penalty for access to a fund with numerous options. If the person was to make additional contributions to the fund, then the balance erosion could readily be greater than this.

The existence of a group of funds offering large numbers of options (while others do not) suggests that they cater for a subgroup of members for whom control and choice are especially important (for example, FSC, stage 1, sub. 29, pp. 18, 23; MLC, stage 1, sub. DR115). Some industry experts told the Commission that the expansion in the total number of options in the super industry reflects the competitive response of retail funds to the burgeoning growth in SMSFs, a view underpinned by the public statements of some funds (ASFA, stage 1, sub. 42, p. 17; Dixon Advisory, stage 1, sub. DR103, p. 12). Examination of the PDSs of typical super funds offering large numbers of options (funds typically characterised as wraps and master trusts) shows that they are intended for people who want to implement individualised investment strategies similar to those obtainable through SMSFs. For example, one superannuation fund indicated that its product ‘has been designed to deliver the same flexibility as a SMSF, without the administrative burden’ (AMG Super 2017).

²² An important caveat to Industry Super Australia’s (2017) analysis is that only those funds with 10 year average returns were included in the analysis. This reduced the number of investment options in 2015-16 to 28 000.

²³ A note of caution: these findings are at the fund level, not at the member level. It is possible that members who construct their own portfolios from funds offering multiple options obtain higher net returns. However, that is only reconcilable with the aggregate performance of such funds if other members obtain poor outcomes in funds that offer large numbers of options, which is not desirable either. Additionally, the results are averages across funds. Some funds with many options will have better returns than some funds with fewer options.

Given the similarity between an SMSF and a retail fund offering hundreds or more options, it is likely that the same motivations are at play in members' decision making. The Commission's members survey found that the main reason for creating an SMSF was control over assets and investments, which complex retail products also do through creating many options and a 24-7 capacity to recalibrate asset choice. While the capacity to choose from a wider array of investment options was rarely the *main* reason for setting up an SMSF, it was the equal second most important motivation — again suggesting that this is salient for the complex end of the retail market.

These findings present a paradox. Control is valuable when it provides higher net returns or some other clear benefit that could not be otherwise obtained through access to a simpler product. Some people may simply enjoy managing their superannuation investment — but only a very few suggested this in the Commission's members survey. For others, complex products and SMSFs may also offer advantages over typical institutional funds in that tax (and to the extent that they choose it, insurance) are calculated at the member level, not pooled across all fund members (Anne Street Partners 2015).²⁴

Cognitive vulnerabilities may also be at play in understanding the attractiveness of complex products to people, and why a fund is able to extract higher fees by offering them, even if on average, the gross return is not high enough to fund that premium. The literature on behavioural insights in finance highlights that people often believe that they have good skills in discerning optimal asset allocations, even when that belief is not well founded. One intriguing finding in behavioural literature is that 'speeding tickets (a proxy for sensation seeking) and perceiving one's intellect to be above actual intellect (a proxy for overconfidence) are associated with higher trading frequency', accompanied by the high transactions costs and lower returns that this strategy involves (Frydman and Camerer 2016, p. 666).

Moreover, high levels of engagement does not *necessarily* equate with high levels of financial literacy (chapter 5). One survey of SMSF investors found that they had no better financial literacy than other superannuation members, but that 85 per cent self-rated their skill as at or above average (Bird et al. 2016a, 2016b). The Commission's members survey found that SMSF investors had lower average financial literacy than other choice members because a smaller share got all the answers right.²⁵ In general, the evidence about their literacy is mixed (chapter 5).

Overconfidence implies ironically that a share of those people who are highly engaged in superannuation may not be well served by the system. In contrast, the disengaged often end up in the default segment with a net return that is likely to be superior (albeit accompanied

²⁴ Nonetheless, tax benefits were rarely given as the major motivation for establishing an SMSF — with the likelihood that the same would apply to those who take advantage of complex retail products.

²⁵ However, the share of SMSF members getting at least *two out of the three* questions on financial literacy correct was the same as other choice members, where a choice member is defined as a member not in a default fund *plus* members who made an active decision to stay in (or join) their current default fund (chapter 5).

by the risk that they could be allocated to a poorly performing fund that falls well short of the average performance of default funds). The implication is that engagement is most valuable when matched by readily accessible, salient and comparable information about the best choices (chapter 5).

Other concerns about excess variety

There may be other grounds for concern about product proliferation.

At the more banal level, one is simply the administrative and compliance costs of a system with so many options. APRA (stage 1, sub. 32) argued that numerous investment options generated substantial operational complexities and cumbersome and inefficient processes that ultimately disadvantage members. The costs of variety were not apparent in the fund-level statistics, but given all the other factors affecting costs, this is not surprising. Any acquaintance with APRA's reporting framework indicates that the large amount of variety must at least add to compliance and administrative costs, even if these are hard to discover at the aggregate level.

A further concern is that the large number of superannuation options makes it hard for people to make informed decisions (for example, AIST, sub. 39, p. 59). It is clear that product variety confuses many people. Industry Super Australia and UMR Strategic Research (2017, p. 4) found that 63 per cent of survey respondents either strongly agreed or agreed with the statement that 'the wide variety of superannuation products available in Australia means that it is hard to get a clear idea of which products are right for you'. (These results probably have little to do with the large number of options as defined in box 4.1 because these only become visible to people who have already selected a wrap or similar product.)

Other than the effects of overconfidence, other behavioural biases may be at play in determining the sources of product variety and its impacts.

The burgeoning demand for ethical investment products may sometimes reflect behavioural biases that give prominence to an emotional framing of an issue rather than a careful consideration of the actual products (Kahneman 2003). Two concerns arise. First, funds offering such products may be able to extract higher fees and make lower returns without that necessarily reflecting the costs of their investment management (CHOICE sub. 71; Farr 2017) For instance:

CHOICE holds significant concern that a consumer switching out of a safe default option into some heavily-marketed 'ethical options' in the 'choice market' may be unknowingly putting a comfortable retirement at risk. (CHOICE sub. 71, p. 12)

However, ethical investments are not boutique products — the bulk of large funds now adopt some type of ethical investment strategy (RIAA, sub. DR143. p. 4). And notwithstanding specific instances where returns and fees are out of kilter with well-performing funds, the long-run Australian empirical evidence suggests a *positive* (but small) impact on returns for funds that negatively screen investments in parts of the economy often perceived as unethical (Foo 2017, p. 20). In any case, it can be rational for an informed member to base investment

decisions on their ethical preferences as well as net returns. This is borne out by the consumer research of the Responsible Investment Association of Australasia (sub. DR143).

A potentially bigger concern is that the definition and disclosure of ethical investments is not always transparent. A fund may say it has no investments in fossil fuels, but the fine print definition may disclose that it holds no companies with fossil fuel revenues above 10 per cent (Verway 2018). RIAA has developed a certification system that provides some clarity, while some superannuation funds provide comprehensive disclosure. Nevertheless, it appears that such disclosure is not universal (Frost 2016a; Kollmorgen 2016). APRA (2013, p. 8) has indicated that it expects a fund trustee would be able to demonstrate to members the basis for its ethical investment strategy and would be mindful of the risks to members, for example, from suboptimal diversification. It is unclear whether all of these expectations have been met.

There is also some evidence from the behavioural economics literature that excessive choice can lead consumers to experience frustration or use faulty heuristics for decision making. The evidence for choice overload is generally strong (Chernev, Böckenholt and Goodman 2015). However, the concept is more nuanced than in its original formulation and some of the seminal studies have not been replicated (Scheibehenne, Greifeneder and Todd 2010). Regardless, one does not have to turn to behavioural economics to be concerned about the potential effects of product variety on consumer decision making. For people who are not well-informed about the relevant product characteristics, lack financial literacy or who find the terminology of finance bewildering, there are simply high transaction costs in making comparisons. Those costs will be most relevant for those people for whom the benefits of superannuation are most distant — the young. The evidence bears that out. Two thirds of millennials (18–34 year olds) either strongly agreed or agreed with the statement about excessive variety cited above, compared with 58 per cent of baby boomers (those aged 55 years and over).

The Australian Institute of Superannuation Trustees (sub. 39, p. 15, p. 60) was concerned that the number of investment options outside the default market was ‘primarily supply-driven and not member driven’, with financial planners apparently a major driver of greater product variety. This is probably over-simplistic in that clearly members are not required to choose complex products, and the fact that the market seemed to be responding to the consumer-initiated growth in SMSFs. Nevertheless, funds may sometimes be seen as accomplices to the behavioural vulnerabilities of some investors.

Regardless, the number of accumulation products and investment options appears to be a symptom of unhealthy competition in the system. Excessive variety can lead to choices that do not lead to best outcomes for members, or make them susceptible to poor advice. The potential under the current system that these costs may prompt people to choose default products with their typically higher returns may be a silver lining. However, a market in which widespread confusion is present does not meet people’s needs adequately.

In this respect, one of the key advantages of raising the bar in the default market is that it could create a better performance benchmark for the choice segment — which would make

it easier for people to make decisions and to compare products. A reputable default product — where the features that are most valuable to consumers are signposted by a trusted intermediary (the Government and its agents in this case) — would provide consumers with an independently-based framework for making good choices.

Changes that improve the capacity for members to make informed judgments (chapter 5) would reinforce the flow-on effects of policy improvements in the default product market to the choice segment.

But take care to avoid regulatory over-reach

Beyond these policy measures to contain the risks posed by product variety, it would be hard to justify prescriptive regulations that limit options and products, and given the ambiguities about the definition of an option (box 4.1), effective restrictions would not be easy to accomplish.

Indeed, some suggest that certain types of accumulation products are missing.

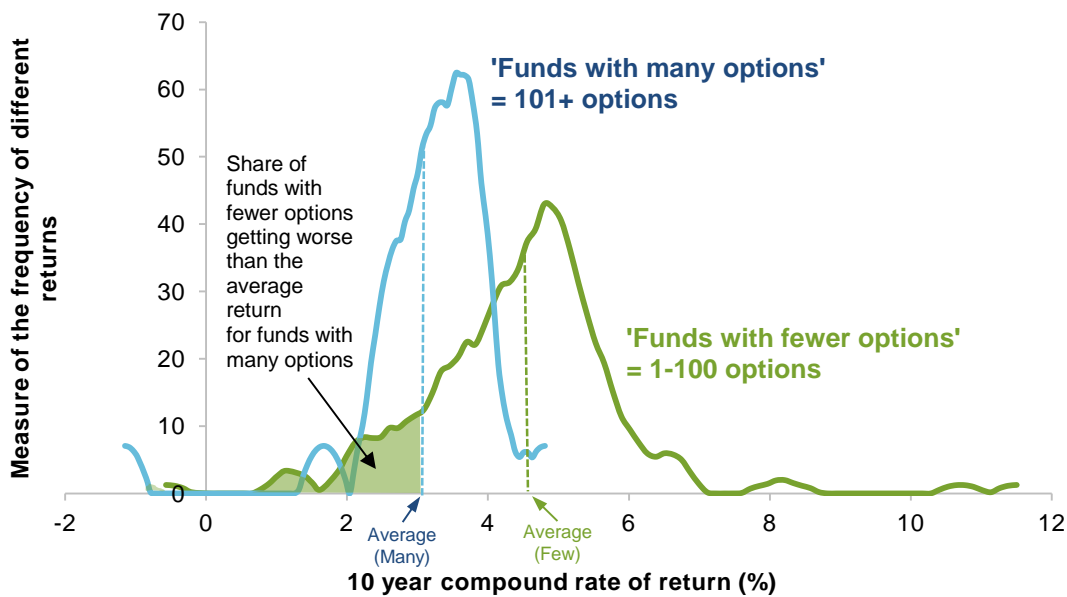
- Smart life-cycle products have a strong in-principle justification, but none are so far available. (The complex issues surrounding life-cycle products are discussed further in section 4.3 and in tech. supp. 6.)
- There are no examples of pooling across members in the accumulation phase beyond legacy defined benefits (DB) schemes. While DB schemes are headed for extinction, in principle, *some* form of pooling has benefits (Ganegoda and Evans 2015). This is already recognised in retirement products, such as standard annuities and group self-annuitisation, which are being encouraged through Australian Government policy. Internationally, there is increasing penetration of products that combine elements of defined benefit and defined contribution systems, such as ‘defined ambition schemes’ (Stanko 2015; Xu, Sherris and Shao 2015). The United Kingdom Department of Work and Pensions (2014) has advocated their use in that country and they are already in wide use in the Netherlands, Canada and Denmark . In responding to the Commission’s draft report, Bell (sub. DR201, p. 10) raised their potential value in an Australian setting, noting that they can lead to higher and smoother retirement outcomes across cohorts. However, implementing risk-pooled accumulation super products (non-guaranteed defined benefits) would be a major change to Australia’s system and would be complex for regulators and members to assess. The Commission has not closely examined such complex products in this report given all of the problems affecting the current suite of products and the funds that provide them. As one participant quipped, it is better to learn to crawl before walking. Nevertheless, regulators should be open to the development of risk-pooling accumulation products over the longer run, subject to stringent scrutiny.

Above all, a consistent message from the Commission’s analysis of the superannuation system is that ‘good’ or ‘bad’ *average* outcomes do not necessarily justify regulation. It is critical to assess the variation in outcomes across funds and members. For example, while funds with more than 100 options have lower average returns, many still outperform funds

with few options (figure 4.6). The number of options does not explain much of the variation in return rates. That fact should not preclude APRA and the Australian Investments and Securities Commission (ASIC) to work together to monitor the effect of option numbers on costs and fees, as trustees have an obligation to their members.

Figure 4.6 Why averages can mislead

Some funds with many options beat some funds with few options^a



^a Densities were estimated using an Epanechnikov kernel.

Source: Unpublished APRA data for 2016.

FINDING 4.2

Many members find it hard to make comparisons between the large numbers of superannuation products available. The proliferation of tens of thousands of investment options in the choice segment complicates decision making and increases member fees, without boosting net returns.

A low fee product that, over a person’s working life, exposes them to a mix of defensive and growth assets is likely to meet the needs of most Australians during the accumulation phase. A better designed and modernised default allocation mechanism could act as a trusted benchmark for better member decision making across the entire system.

Are product features a problem?

Superannuation products offer access to a range of different features, which are sometimes seen as problematic. However, apart from the inclusion of insurance as an opt-out feature

(chapter 8), it is not clear that the large variety of features does much harm, and in many cases, they are likely to meet members' needs.

Many of the features are just the usual part of running a business that has an ongoing relationship with customers, and where product choice and communication is relevant to consumers — call centres, websites, online account access, investment choice, and consolidation services. Funds offered these member services for nearly 100 per cent of products (based on Rainmaker and SuperRatings data). Mobile apps and social media had much lower prevalence rates (about 50 per cent of products). The Commission's choice experiment indicated that members valued features where they could communicate with funds — like call centres — so their almost universal presence is a good feature of the system. Similarly, the choice experiment showed that the ways in which funds engaged with members were valued (for example, newsletters, education seminars and webinars), albeit to a lesser extent than the features that allowed members to engage with funds.

The offer of financial advice was frequently included in products (to about 85 per cent of individual members) and in some instances, such as wraps, was a mandatory feature of the products. The value of this feature depends on the quality and cost of the advice — an issue that has been raised in evidence to the Financial Services Royal Commission (FSRC 2018, pp. 121–43, pp. 329–40).

Products included a range of promotional features — computer deals, shopping discounts and travel discounts — which are of dubious value and could act as a potential distraction from informed choice about superannuation. Nevertheless, few products included these features (only 5 per cent based on Rainmaker data). While various financial services — health, car and home insurance, credit cards — were more common, most super products did not include them. Depending on the financial service, between 8 and 33 per cent of funds offered these services.

Overall, it would be deeply problematic if there were intense competition based on product features with little relevance to the key objectives of superannuation. However, the Commission's choice experiment suggests that people do not much value such features, and it seems therefore unlikely that they have much capacity to distort people's decision making. While funds do not publicly reveal take-up rates of such features, the Commission also understands that the take-up rates of some features (for example, discounts on health insurance) are unlikely to be material — again consistent with their likely irrelevance to the decision making of most members.

In a broader context, even those features that members do find valuable (as discussed above) are not *that* valuable to them. The choice experiment suggests that in 70 per cent of cases, respondents chose the cheapest package in the menu of product and service characteristics, and were therefore looking for a no-frills, low-fee, high-returning product above all else. Another recent survey found that fees and investment performance were more important than technology credentials or ethical/green investments (ISA 2017) . While people have trouble understanding superannuation products, the ancillary features do not appear to transfix them.

Legacy products — is there a problem?

Product variety is partly a consequence of old products held by some members, but no longer on offer (legacy products).

There are two broad categories of legacy products in the accumulation phase.

Successor fund transfers (SFTs)

The first relate to circumstances where members are transferred to another fund — a successor fund — without a requirement for the consent of the members involved, as occurs in any merger. Several participants noted that the legally enforceable requirement on successor transfer funds to protect the ‘equivalent rights’ of members has led trustees to replicate investment options in their own funds (for example, MLC, stage 1, sub. DR115, p. 37).²⁶ It appears that the problem may be resolving. APRA (2017c) released updated guidance on successor fund transfers in July 2017 that clarifies how trustees should interpret the equivalent rights assessment of product features and particular investment options. APRA noted that a ‘line by line’ comparison of every feature is unlikely to be necessary so that the product features of the proposed receiving fund would not generally be expected to be identical to that of the legacy product. Instead, a fund would consider equivalence in terms of a so-called ‘bundle of rights’, in which trade-offs are acceptable.

APRA indicated that a fund could generally expect to be able to transfer a MySuper member from an extinct fund to their own MySuper product (2017c, section 25). This is important because one of the benefits of the Commission’s policy proposals is that they not only pull new members into the highest performing funds, but also encourage the transfer of existing MySuper members to such funds.

APRA’s clarification of equivalent rights also has relevance to the non-default market because an outcome of the Commission’s improvements to default allocation is that they should create stronger pressures for poorer-performing funds of all kinds to exit or merge.

Own-fund legacy products — intrafund transfers (IFTs)

The second type of legacy products are those developed by an existing fund and no longer offered.

Some suggest that some funds preserve poor value legacy products for their own self-interest (AustralianSuper, sub. 43; AIST 2018a, p. 13; Clark 2018). It is unclear whether this practice

²⁶ Trustees of the transferring RSE licensee also have an obligation to meet the equivalence requirement, which may add to the cost of a merger or exit. Equivalence is a somewhat murky concept and does not relate to discretionary features of a transferring fund’s products that it could unilaterally change were the fund to have continued.

is widespread, but it would leave the fund trustees at risk of breaching their duty to look after their members' interests. There is also a concern that legacy products can be carved out from disclosure requirements, which can make it hard to include them in product comparisons, notwithstanding evidence that they apparently have higher fees and costs (AIST, sub. 39, p. 34; Long and Cohen 2018).²⁷ The Commission has proposed that all products should be included in product comparison dashboards (chapter 5).

Others perceive regulation, not non-regulation, as the issue, claiming that regulations concerning IFTs inhibit product consolidation, raising costs to the disadvantage of members and also discouraging innovation if a fund is obliged to keep members in a novel product that is ultimately unsuccessful (ASFA, sub. 47, p. 20; PwC, sub. 62, p. 3; MLC Wealth, sub. 63). However, the obstacles to IFTs do not seem so significant that they would have much effect on innovation in comparison with other factors, including previous regulatory barriers to annuity products (section 4.4). Indeed, in making the case for rationalisation of legacy financial products generally, the Financial Services Council (FSC 2017, p. 9) argued that the 'current rationalisation regime in superannuation works well from a consumer and producer issuer perspective' and urged it as a model for other financial services.

Overall, the case for immediate regulatory change is not strong, especially as many legacy products will disappear following initiatives to increase account consolidation, the pending ban on exit fees, the closure of old defined benefits schemes and greater member awareness of poor value products through dashboards (chapter 5). Nevertheless, some funds still express concerns, and there has been no systematic appraisal of the costs associated with legacy products, nor of the potential for these to increase as funds develop new products and then close them. APRA should consider undertaking such an appraisal. If evidence emerges that legacy products represent a significant compliance cost for super funds (and therefore an impost on the incumbents of such funds), APRA should revisit the conditions for member transfers, clarifying further the trade-offs implicit in the 'bundle of rights' underpinning the equivalence test. In the case of SFTs — the area of greatest concern to the Commission — careful oversight and good governance arrangements will remain essential, as emphasised by APRA.

What about the retirement phase?

Legacy products can also arise in the retirement phase, most particularly for products that offer some form of longevity insurance. As noted by the Financial Planning Association of Australia (2017b, p. 4):

There is a history of longevity risk type products being developed with little consumer uptake, resulting in significant cost for product providers and creating a string of legacy products with few consumers invested. Examples ... include: Asteron longevity income stream (14 people in product when closed) — provided a longevity solution with lifetime guarantees but failed to

²⁷ Notably, in its current form, the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 carves out legacy products.

qualify for the exemption on pension assets due to the methodology to share profits among the members of the fund ... [and] ANZ money for life — closed due to insufficient scale.

Such legacy products appear to be rare.

However, product innovation and recent policy developments suggest that various forms of annuities and pooled investments will grow in prominence (section 4.5). At any given time, the form of those products will reflect tax and social security policy settings and the state of market development. As this context changes, or if innovative products fail to get a sustainable foothold in the market, some products may become obsolete, and be closed to new members (ASFA 2017b).

There is, accordingly, a strong risk that the incidence of legacy retirement products will rise. That could be accompanied by complex arrangements for transferring members from legacy to new products²⁸ and confusion for people — many of whom will be very old — about any new terms and conditions (for example, in relation to the payouts on withdrawal from the product, and any benefits that, on death, are transferred to a member's estate). The Actuaries Institute (2017) has sounded an alarm over legacy products in comprehensive income products for retirement in particular, such as those that arise from product failures.

There is no obvious problem yet, but the push for retirement income products (section 4.5) will require well-designed disclosure arrangements and monitoring by regulators to reduce the risks for members, especially those with poor financial literacy or impaired cognitive capacity. As in many other areas of superannuation, good outcomes for members requires access to high quality, impartial financial advice (chapter 5).

4.3 Are products meeting people's needs over their working life?

The underlying volatility in asset returns as people accumulate their superannuation exposes them to increasing risk as their retirement approaches (tech. supp. 6). The key driver of this is that earnings and thereby contributions rise over time. A large fall in asset prices in the years close to retirement can lead to significant losses in the total retirement balance and subsequent retirement incomes.

Consequently, some funds have developed 'life-cycle' products that *automatically* re-orient members' portfolios from growth assets early in their working life to defensive assets, such as cash and bonds, as they get closer to the normal retirement age.²⁹ In the vast majority of

²⁸ Indeed, Macquarie Group (2018) is concerned that it may be very costly or impossible to terminate the longevity portion of a retirement product.

²⁹ Life-cycle products are often referred to as target-date products in the United States and are also marketed as such in the United Kingdom and other countries. High uptakes of target-date products has been reported for the United States, accounting for 25 per cent of 401(k) plans in 2015 (RRI 2016, p. 87). Their growing role appears to be a consequence of quasi-government endorsement (Cooper 2011).

cases, life-cycle products have been calibrated purely to the age of the member (Chant, Mohankumar and Warren 2014). One super fund (QSuper) offers a more sophisticated default life-cycle product that takes age *and* account balances into account (though no other member characteristics). People with low balances are allocated to higher returning assets at any given age.

The Australian Government approved, at the discretion of trustees, the inclusion of life-cycle products in MySuper from its commencement in 2013 (Australian Government 2011), while APRA (2013a, pp. 10–12) developed guidelines for their design. (Many non-MySuper funds also offer life-cycle products as a choice among other investment options). In June 2018, 31 per cent of MySuper products had a life-cycle strategy, and these accounted for 36 per cent of MySuper assets (APRA 2018p, p. 9). In June 2017, life-cycle products accounted for 34 per cent of MySuper member *accounts*, though there is no information of the number of members enrolled in such products (APRA 2018a table 15).

Consumer representative bodies have given in-principle support to such products given their potential capacity to manage risk better than single-strategy products (for example, CHOICE, stage 2, sub. 31, p. 13). However, others have questioned the benefits, including the Commission in its draft report. For example, one study found that life-cycle products offer expected returns of about one per cent less per year (after investment fees and taxes) compared with a balanced fund (Chant, Mohankumar and Warren 2014, p. 2). That study concluded that it is an open question whether such products are beneficial for members. Similarly, another experimental assessment concluded that life-cycle strategies only slightly improve results in the lower tail of simulated wealth returns, suggesting that life-cycle products are only suited to very risk averse investors (Trueck 2016).³⁰ Some super funds argue that life-cycle funds are (currently) ill-suited to their members because the Age Pension already acts as an effective risk buffer.

In considering their value, it is important to distinguish between investment performance relative to a benchmark and desirable asset allocations. There appear to be a significant number of life-cycle funds whose investment performance at the asset class level is relatively poor (chapter 2) — a problem best addressed through the same process as that applying to poorly performing single-strategy funds. Underperformance by some does not repudiate the principle of varying the management of risk as a person ages.

The costs and benefits of life-cycle products depend on their design and on the characteristics of fund members (for example, the size of their balance). Using a variety of assumptions about the investment performance of growth and defensive assets, the average retirement balances between different life-cycle products can vary by some hundreds of thousands of dollars (tech. supp. 6). As noted by several participants (for example Warren, sub. DR118; Dimensional Fund Advisors, sub. DR135), retirement balances per se are not the goal of the

³⁰ There is also some question about whether such products necessarily de-risk, as outcomes and expectations for apparent low risk assets can vary significantly. Funds that were heavily invested in (apparently low risk) pooled debt products in the United States prior to the global financial crisis suffered double digit percentage losses (Matterson 2013).

superannuation system, though they are more readily assessable by trustees than post-retirement outcomes. Once the sum of retirement income, bequests (which often have value to members) and access to the Age Pension are taken into account, the divergence between different life-cycle products falls, though remaining significant.

The determinant of the variation between life-cycle products is the glide path from growth to defensive assets as the member ages (figure 4.7). The lowest average retirement balances occur for life-cycle products with accelerated transitions to defensive assets as the member ages. Rice Warner (2016b) noted that most life-cycle products are offered by the retail funds, and that these tend to dial down risk many years before retirement — some commencing at age 30 years. The Commission’s analysis of contemporary APRA data confirms this picture (tech. supp. 6).

The view that life-cycle products *necessarily* produce worse average outcomes than standard single-strategy products is not true if they are sufficiently growth-oriented in the earlier part of a person’s working life (Qsuper, trans. pp. 335–41; Minney, sub. DR131; Mercer, sub. DR175, p. 24; and tech. supp. 6). Moreover, such higher-performing products have the additional benefit that when there is a market downturn, they produce less poor outcomes than a standard single-strategy product.

Notwithstanding that different funds vary somewhat in their membership characteristics, it is hard to understand why the diversity of life-cycle product designs shown in figure 4.7 can be justified. Indeed, as represented in APRA data, some life-cycle products would be very unlikely to meet many members’ needs. Some in the industry that *advocate* life-cycle products echoed this perspective:

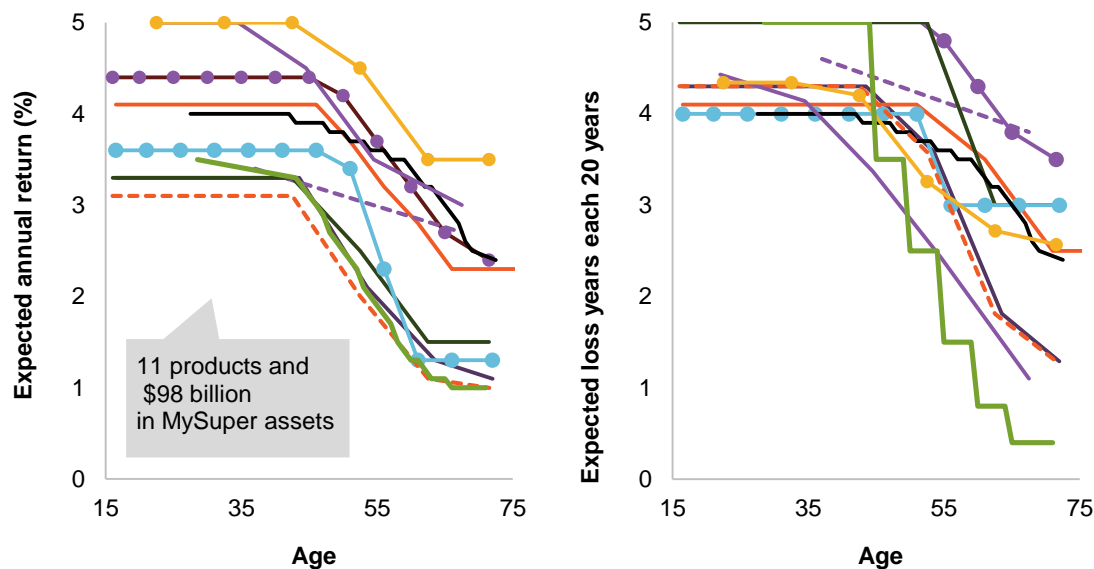
... lifecycle designs and performance vary significantly and therefore we do not suggest that all existing lifecycle strategies are suitable default funds for MySuper. (Mercer, sub. DR175, p. 20)

A dilemma facing existing life-cycle *and* single-strategy MySuper products is that as members are enrolled by default, the extent to which their preferred risk-return trade-off is met is a lottery dependent on the MySuper product their employer chooses for them. The consequences of those employer decisions are fundamental to their employees’ retirement balances, incomes and risk management.

Among the multitude of products, how can the wheat be separated from the chaff? Recognising that no super product can meet every member’s needs, one approach to is to identify the locus of asset allocations during accumulation and retirement that are likely to meet *many* account members’ appetite for risk (as in Vanguard sub. DR155 and Bell, Liu and Shao 2017). Vanguard’s ‘utility scoring’ approach suggests that the most promising single design is akin to what has been described above as a growth-oriented life-cycle product. In particular, their analysis suggests that life-cycle funds that de-risk by too much or too early are unlikely to be in the average member’s interest (regardless of whether they obtain good asset returns within any asset class).

Figure 4.7 'Life-cycle' products come in many forms^a

Expected returns and number of loss years across selected life-cycle products



^a Each line represents funds' expected outcomes (in returns and loss-making years) for people of different ages holding a given life-cycle product. While not covering all MySuper life-cycle products, the results are representative of the glide paths in life-cycle products generally. The funds usually give an age range for any given asset allocation, but for clarity of presentation, the midpoint of the age range has been used in the chart. The data relate to MySuper life-cycle products in the June quarter 2018.

Source: APRA (2018b table 1b).

Super funds with poorly configured products can readily change asset allocation (and clearly have a significant capacity to do so given the wide margins they are permitted outside the target asset allocations). The mandated rationalisation of poorly designed life-cycle products involves some challenges, but not markedly different from those that affect any other problematic product. Legislation is currently before the Senate that, if enacted, would give ASIC product intervention powers to ensure that financial products are appropriately designed for the consumers for whom they are intended (ASIC 2018c). More broadly, the Productivity Commission's elevated outcomes tests for funds (chapter 13) would apply to those offering underperforming life-cycle products. Where the application of the test precipitated a fund merger, the key issue would be whether a member's 'bundle of rights' (as discussed earlier) could be met if they were to be involuntarily ported to a successor fund that did not offer a life-cycle product. Given the findings in tech. supp. 6, balanced growth products may not outperform a well-designed life-cycle product, but they certainly do so for a poorly designed one. Nevertheless, members shifted involuntarily from a life-cycle to a balanced growth product should be made aware of this, so they can review their investment options.

The short-run need to scrutinise and rationalise existing life-cycle products should not preclude the development of more innovative products. There is significant scope for more personalised MySuper products, extending the design currently used by QSuper. Some have proposed smart life-cycle default products whose underlying investment strategy is

customised to the needs of each member, going beyond age and balances as the criterion for asset allocation (CIFR, stage 2, sub. 7; FFPL, stage 1, sub. 7; FSC and TTS 2017; LCC 2010; TTS, stage 1, sub. DR66). For instance, Bell (sub. DR201, p. 7) observed that:

... data and technology provide the opportunity for giant advancements in the design of personalised lifecycle strategies. Such strategies could account for: age, balance, contribution rate (which entails non-contribution due to career breaks etc), gender, expected returns, [and] risk.

Ultimately, individualised product design could also take into account other member characteristics, such as household assets, income from any partner and the potential capacity to extend a working life if there are adverse asset price shocks. However, most funds do not currently collect such evidence at an individual level — lifting the need for the greater collection and use of data (section 4.6).

Smart products would present some challenges to the regulator because of their greater complexity and the need for technical analysis to understand their impacts on diverse members. The algorithm underpinning the investment strategy for enrolled members would need to be tested to verify that its actual design benefited fund members. Some have argued that proposed smart options have not verified their benefits (as cited in Stewart 2017), although equally, given member heterogeneity, many existing MySuper products have not done so either. Benchmarking relative fund performance also becomes more difficult the greater the diversity of products, but it is possible to control for asset allocation (chapter 2).

Against that background (and unlike its view in the draft report), the Commission now recognises the value of well-designed MySuper life-cycle products, and the potentially significant gains that could arise from further personalisation. However, the detritus of poorer products requires some cleaning.

FINDING 4.3

Well-designed life-cycle products can produce benefits greater than or equivalent to single-strategy balanced products, while better addressing sequencing risk for members. There are also good prospects for further personalisation of life-cycle products that will better match them to diverse member needs, which would require funds to collect and use more information on their members.

Some current MySuper life-cycle products shift members into lower-risk assets too early in their working lives, which will not be in the interests of most members.

4.4 Variety is needed in the drawdown phase

A superannuation system exists to contribute to funding consumption for members at the stage in life when the capacity to meet ongoing consumption through regular income from work is diminished. Given a maturing system, there is a growing need to give more weight to the decumulation phase as any failures in this phase will be accentuated over time (chapter 1). The considerations relevant to the retirement phase are multifaceted and complicated (figure 4.8). As noted by Barr and Diamond (sub. 74, p. 9) ‘... concern with consumption over a lifetime of unknown length is more complicated than accumulating wealth up to retirement’.

Superannuation is not the exclusive, or for many people, the most important, way to meet consumption needs and post-retirement risks (Daley, Coates and Parsonage 2016).³¹ Home ownership can either act as another direct funder of consumption through equity withdrawal or downsizing, or provide a stream of rental equivalents. Refundable accommodation deposits were about \$22 billion in mid-June 2016 — an indication of the role of the home as a source of funding of consumption of aged care accommodation close to the end of life (ACFA 2017, p. xiv). The extension of the Australian Government’s Pension Loans Scheme by 2019 to all people of Age Pension age (regardless of whether in receipt of that income support) has provided another way of flexibly accessing the equity in any dwelling assets (including investment property). Other assets, intra-family transfers, and the safety net played by the Age Pension and in-kind services to the old (housing, health and aged care), all contribute to the capacity of a person to meet their consumption preferences and act as shock absorbers for longevity risk, unplanned expenses, inflation, and market risk for any exposed assets.

For example, about one third of people receiving regular income from superannuation receive more than 50 per cent of their total income from government pensions and allowances (ABS 2017b, table 15.6). More than half of those in receipt of term annuities were similarly reliant. However, while Age Pension dependency rates will remain high over the next 40 years, they are projected to fall significantly from current levels.³²

³¹ Across the population, superannuation assets accounted for about 50 per cent of financial assets, but only 17 per cent of total assets (ABS 2017c, table 2.4).

³² This reflects the longer contribution periods associated with a maturing system, asset and income tests that are only indexed to inflation, rising eligibility ages, increased labour force participation by older Australians and the mooted increase in the mandatory contribution rate to 12 per cent. Modelling suggests that while the share of eligible people on the full age (or DVA) pension will decline from about 51 per cent to 29 per cent from 2017 to 2038, part pension rates will climb from about 18 to 27 per cent over the same period (Rice 2018, p. 31). The Parliamentary Budget Office similarly projects an increase in the importance of part-rate pension recipients to 2028-29 (PBO 2018, p. 27). ASFA forecasts that dependence on the full Age Pension will decline to about 25 per cent by 2055 (ASFA 2018a, p. 9).

Figure 4.8 The balancing act of retirement



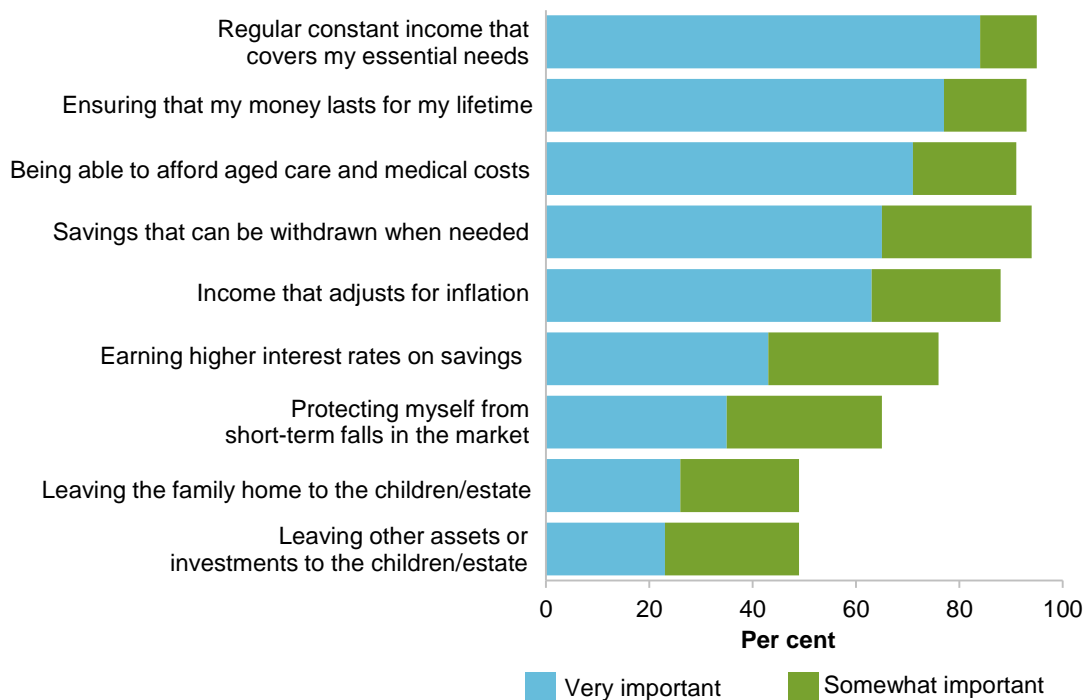
INCOME TOOLS	RISKS	GOALS	PROCESS
<ul style="list-style-type: none"> • Age Pension and other transfers • Business holdings • Part-time work • Corporate pensions • Bond portfolio management • Smoothing consumption shocks through savings • Returns from investment accounts including dividends • Rental income • Support and risk sharing within family • ‘Vanilla’ lifetime annuities • Insurance (general, health, long-term care) • Deferred lifetime annuities • Equity indexed annuities • Imputed rental income and home equity extraction • Variable annuities with guaranteed living benefit riders • Group self-annuitisation 	<ul style="list-style-type: none"> • Changes in government retirement, tax & social policy • Longevity • Poor financial advice • Asset return volatility • Fraud and theft • Bad sequence of returns at retirement start • Inflation risk • Poor health • Reduced cognitive capacities • Rising health costs • Behavioral vulnerabilities • Need to help family members • Unexpected expenses • Death of, or separation from partner 	<ul style="list-style-type: none"> • Maximise spending power • Build an estate • Manage preferences for risk • Capacity to meet varying consumption needs over lifetime 	<p>Combine income tools to balance household goals and risks</p>

Source: A variation on Pfau and Cooper (2014).

Varying tax exposure, state of health, consumption preferences over time, behavioural norms, inter-generational altruism and risk aversion increase the desirability for people to determine their own choices for managing superannuation balances among the many other assets they hold.

The empirical evidence substantiates that while retirees share some goals, they give considerably different weight to others (figure 4.9).

Figure 4.9 Things that matter most about retirement finances
2017



Source: National Seniors Australia and Challenger (2017, p. 9).

The Commission found similar results in its survey of older Australians. Having enough money to live comfortably throughout retirement was a major consideration in retirement decisions, particularly for the younger old, but other factors, such as a capacity to access the Age Pension and provide bequests also mattered (PC 2015a).

Consistent with other data on people’s risk preferences, people *typically* reduce their exposure to riskier growth assets as they age. But ‘typical’ outcomes hide significant heterogeneity in risk preferences within any age group. About 25 per cent of superannuation members in the choice segment aged 65 or more years have exposure to growth assets of about 25 per cent or *less*, while about 25 per cent have exposure of about 80 per cent or *more* (Rice Warner 2017a). People with the highest balances (of \$500 000 or more) tend to adopt less risky strategies than others, perhaps because the Age Pension is less likely to act as a

feasible form of insurance.

Participants in the inquiry highlighted different strategies and concerns during the retirement phase:

Most people, as retirement approaches, realise they will need some cash as well as a pension. This is to buy that last car after a few years in to retirement, undertake inevitable home maintenance (painting, plumbing etc), funeral expenses, unexpected emergencies, and so on. They are very conscious of not having that hefty weekly salary coming in to sustain their living standards. This saved money they put in the bank and use the interest it generates to buy clothes or go on the occasional holiday etc. (Gegan, sub. 84, p. 5)

At some stage as my SMSF balance runs down, it will be no longer sensible or efficient to pay the costs of SMSF administration and the technicalities of transferring the balances to some simpler superannuation vehicle may be more than I want to have to deal with in my 80's. (Williamson, sub. 19, p. 1)

The implication of the above discussion is that the drawdown phase of the superannuation system should be re-conceptualised as the drawdown phase of *all* savings present at retirement. To that extent, a reflection on the performance of the superannuation system in meeting the drawdown phase is really an assessment of how people and the broader financial system manage retirement savings. In recognition of this, when a person's superannuation assets held captive by the system are finally released, people will often re-organise their asset holdings. The most common use of lump-sum payments is to clear outstanding household debts and to purchase durables — which is simply the re-allocation of assets (ABS 2017b, table 15.7). In recent years, the incentives for asset re-allocation has been accentuated by rising mortgages among the old. In 2000, about 4 per cent of people aged 65 years or more had a mortgage, while by 2015-16, this had trebled to 12 per cent, and with higher values for people aged 65–74 years old (ABS 2017a, table 10.2; Ong et al. 2017). The average housing costs of a homeowner aged 65 years or more was \$12 428 annually for a mortgage holder and \$2400 for an outright owner, implying that extinguishing all mortgage debt would be equivalent to a sizable additional disposable annual income (ABS 2017d).

Simple is wrong

The conclusion, as observed by the Commission in 2015, is that in the drawdown stage, one size never fits all (PC 2015b). The implication is straightforward, if not necessarily easy to achieve: we should stock the retirement options supermarket with a large range, accompanied by disinterested and sophisticated advice to help elicit preferences and to match these to the available options. Given that many retirement product decisions are largely irreversible, the need for good quality advice and member protection is essential.

In that case, the key policy issue is whether the options and the advice are available. Chapter 5 examines the defects in information provision and financial advice, and the solutions to these. That leaves product variety.

4.5 Is the product range in retirement wide enough?

There is little evidence that the product *range* in the retirement phase is deficient per se, especially in light of the very flexible ways in which people can structure their income streams using SMSFs and the availability, if not the widespread use, of annuities. Moreover, new hybrid annuity products are on the market that offer the capacity for deferred annuities, greater flexibility in payments, and the preservation of some bequests if people value this (for instance, Challenger 2017).

The bigger question is whether people act with discernment in the decumulation phase.

In gauging whether people are making the right choices among the suite of products, it is worth looking at revealed preferences, starting with people's propensity to make regular withdrawals from an account, convert to an annuity or take lump sums.

People allocate the overwhelming bulk of their assets to account-based (or allocated) pensions, which they draw down over time (Rice Warner 2017a; Treasury 2016b). Among those who receive ongoing income from superannuation, more than 70 per cent do so through account-based pensions (ABS 2017b, table 15.6).

There is little to suggest that most people's behaviour in respect of lump sums reflects a failing in the system. Notwithstanding popular impressions, few people convert all of their retirement benefits into a single lump sum (chapter 1), though many will convert *some* of their pension accounts into lump sums as they age. In 2015-16, about 18.3 per cent of people with superannuation coverage who were aged 65–69 years took a lump sum in the previous two years, with lump-sum extractions falling rapidly in prevalence for older groups. The overall share of people taking some lump sum was 13 per cent for those aged 65 years or more. One quarter of lump sums were between \$500 and \$10 000 (ABS 2017b, tables 15.2 and 15.7). Of the people who did take lump sums in the previous two years, 80 per cent still had positive superannuation balances afterwards. This is a sign of a maturing system because in 2003-04, the figure was only 55 per cent. Those who tended to take most of their superannuation as lump sums had low initial balances (PC 2015b, p. 84). Given immediate consumption needs and debt obligations, and the transaction costs of maintaining a small balance, a tendency to convert small balances into lump sums is a rational strategy for lower-wealth households.

Is there an annuity gap?

A key policy question is whether the dominance of account-based pensions (ABPs) reflects rational behaviour given personal preferences and the inherent problems of alternatives, or is a symptom of system flaws. Such flaws could arise through inertia by funds in offering alternative retirement products, policy obstacles to their adoption, or behavioural anomalies.

There is widespread concern that once in retirement, people's financial prudence is inimical to their self-interest — and that ABPs place no constraint on this behaviour. By drawing

down an ABP at the regulated rate, a retiree will receive less lifetime annual superannuation income than a person who had purchased a well-priced annuity with the initial capital. In particular, retirees will also be very likely to leave a bequest, which for some, may be unintended. In the Commission's stochastic modelling of a standard single-strategy accumulation product, the average bequest associated with minimum drawdown rates comprised about 16 per cent of the total net present value of retirement benefits (including welfare payments).³³

The Financial System Inquiry (Murray et al. 2014) was unequivocal in its judgment that it was desirable to move away from ABPs and promote the use of guaranteed income products. It claimed that this would address longevity risk, enable higher consumption during retirement and reduce the use of the Age Pension. It also suggested that some form of a comprehensive income product for retirement (CIPR) should be the default retirement product (MyRetirement). A CIPR is a hybrid retirement income product that would combine a stream of broadly constant real income for life (an annuity of some kind) with some flexible access to capital through an ABP. (It would therefore include lifetime annuities, but only when combined with an ABP.) A CIPR is intended to deal with uncertainty about longevity, among other risks, while by reducing bequests, also providing greater income throughout retirement than an ABP (Treasury 2018e, p. 6). The OECD (2017b) similarly urged policies that would promote annuities. The Australian Government has proposed a Retirement Income Covenant (Treasury 2018e), which would attempt to nudge people into CIPRs — a specific policy proposal that is briefly assessed later.

There is some evidence in favour of a shift away from ABPs. Most retirees say they want to avoid longevity risk, obtain a regular income and protect themselves from asset fluctuations through safer portfolios while maintaining ownership of the family home (figure 4.9 and Spicer, Stavrunova and Thorp 2016). ABPs are by themselves imperfectly constructed to achieve a predictable real income flow given a multiple set of risks — particularly market, inflation and longevity risk.

In addition, regulated minimal withdrawal rates from ABPs may affect the capacity for people to achieve predictable income flows because they appear to serve incidentally as a behavioural anchor for many people. Longitudinal evidence reveals that 48 per cent of retirees withdraw at the regulated minimum drawdown rate (Balnozan 2018, p. 87). This means that — other than by drawing down on other assets — people whose behaviour is anchored in this way cannot achieve a certain income flow. For a pre-committed drawdown rate and any given starting retirement balance, the variance of people's retirement income tends to grow as the person ages.³⁴

³³ These results are based on the cameo model settings described in chapter 1, and assume a 3 per cent return on defensive assets (standard deviation of 2.5 per cent), and an 8 per cent return on growth assets (and a standard deviation of 10.8 per cent), which is consistent with a 5 per cent real expected return for a balanced single-strategy product.

³⁴ Reflecting the lower risk and commensurately lower anticipated real rate of return on assets in the decumulation versus accumulation phase.

People's claimed preference for certainty has not been translated into any popularity of annuity products or CIPRs more generally *yet*. While the market for such products has been growing (box 4.2), estimates suggest that they represent only a small fraction of the overall superannuation retirement incomes market, with Challenger remaining the dominant provider (PC 2016a, p. 225).

Box 4.2 How important is the market for products that address longevity risk?

The Commission's funds survey asked about the number of retirement products with longevity risk management (LRM) and other features offered in 2012-13, and the number of new products offered between 2013-14 and 2016-17.

The results suggest that in 2012-13 a limited number of funds offered LRM products compared with retirement income products with other features. Five funds offered LRM products. In terms of products on offer, most offerings were in the retail segment; 28 LRM retirement income products were offered by retail funds (with 23 of them offered by just one fund), while industry funds offered a total of four products.

Since that time, the number of funds offering LRM products has grown, as has the number of LRM products on offer. Between 2013-14 and 2016-17, 19 funds indicated they offered new LRM products and 47 new LRM products were offered, three quarters of which were offered by retail funds. Twenty such products were offered by one retail fund, with the remaining LRM products offered by industry and public sector funds.

Source: Funds survey.

There is no unanimity on annuity retirement policy, with the small size of the annuity market often referred to as the annuity puzzle. That there is a puzzle at all is not a reflection of a lack of explanations. On the contrary, like murder mysteries, the problem is that the population of perpetrators is very large. Just one review found 19 rational reasons for the unpopularity of annuities and 17 irrational ones (O'Meara, Sharma and Bruhn 2015).

There are also questions about the desirability and form of any policy that encourages annuities, whose answers depend on:

- whether policies concerning annuities can overcome the limitations of ABPs
- the advantages of ABPs, and not just their limitations
- their impacts on access to social security.

Amenability to policy action

Some of the reasons for a weak annuity market are not amenable to direct policy action.

Unless CIPRs are mandated (which no one suggests the policy merit of in an Australian context), adverse selection of those who have a better knowledge of their longevity than the provider will raise the price of CIPRs, decreasing their overall attractiveness.

People overestimate the probability of dying at ages up to 85–90 years — ‘survival pessimism’ — thereby underestimating the longevity risk they face. To the extent that people understand the concept of actuarial fairness,³⁵ this means that the market cost of annuities is higher than the price people would consider actuarially fair, making annuities appear to be poor value (Gazzale and Walker 2009; OECD 2017b, p. 61; PC 2015b; SoA 2012; Sturrock 2018, pp. 23–4). Indeed, the very term annuity has such a poor reputation for value that even using its name for a retirement product reduces its uptake. Absent some form of mandated annuitisation, the best antidote for survival pessimism is likely to be access to independent high-quality financial advice that advises people on optimal drawdowns (chapter 5; Barr and Diamond, sub. 74; Rice Warner 2018a) and marketing of the products that take account of people’s ignorance of longevity risk and biases against the word annuity (a responsibility of the providers).

The lack of sufficiently long-term financial instruments to mitigate providers’ risks, and investment strategies that favour lower-returning assets (O’Meara, Sharma and Bruhn 2015, p. 54) may also put upward pressure on annuity prices, but it is not clear that the Australian Government has much scope to address this.

The overall perception that immediate lifetime annuities represent poor value has some validity, though this may change. Estimates of the present value of annuity payments to their current price are well below one in Australia — and sometimes even below 0.7. Commission analysis of the annuity stream offered by some contemporary products found instances where the average present value of the annuity stream was about 0.8 (though the realised value would be greater for those lucky enough to live longer and lower for those who die prematurely). People therefore have to weigh up the price of insurance (20 cents or more in the dollar of any investment) for the reduction in longevity risk. An additional constraint on the value of annuities is that retirees appear willing to invest a relatively higher share of their super accounts in growth assets than annuity providers (Rice Warner 2018d, p. 2). Deferred annuities — (one of a variety of CIPR options) — seem more likely to be attractive, though that market is in a fledgling state. Deferred annuities allow people the flexibility of an ABP in their younger years, and provides a guaranteed income stream from an age close to mean (or median) life expectancy, thus providing longevity insurance.

One red herring argument for policy action on CIPRs should be given short shrift. Commentators sometimes point to the divergence between the Association of Superannuation Funds of Australia (ASFA) standard of comfortable retirement incomes and actual incomes as further supporting the need for adding unintended bequests to an annuity risk pool. On the latter score, the ASFA standard is more than many people spend before retirement (Daley 2017, p. 17). It is no more than an arbitrary benchmark that should be ignored in policymaking.

³⁵ It is unlikely that poor judgment about longevity is the only factor underpinning impressions of poor value. That would assume that people were otherwise able to make actuarial assessments, which flies in the face of the generally low levels of financial literacy (chapter 5).

ABPs have some advantages and there are remedies for their problems that do not require CIPRs

ABPs provide considerable flexibility compared with traditional annuities because people can readily vary the drawdown rates and take lump sums when larger than expected consumption needs arise (PC 2016a, p. 228).

While people prefer regular income — and according to the data, typically obtain it from their ABPs — they do not require it to be constant over time, risk-free, or exclusively drawn from their superannuation assets. It is notable that a significant number of retirees withdraw a constant *nominal* dollar amount from their accounts up to a certain age, and then lower their withdrawals (Balnozan 2018). Given inflation, such behaviour would engender a significant reduction in potential consumption, and yet is clearly a deliberate strategy. In that vein, utility analysis suggests that consumption should optimally fall for many people as they age, regardless of the savings vehicle used to fund retirement (Bell, Liu and Shao 2017).³⁶ Slow decumulation appears to be a stylised fact around the world, despite the large variations in financial instruments to fund retirement income (Wu et al. 2015).

While not addressing all uncertainty, alternative drawdown strategies can also provide more predictable income flows. A two bucket approach — a safe bucket of assets for essential spending and a risky one for extras and long-run returns, with sporadic replenishment of the safe bucket as it is drawn down — might be a reasonable heuristic for many. As Rice Warner (2017c, p. 1) suggested:

One of the advantages of the Australian superannuation system is that many retirees retain significant exposure to growth assets. Those who use a cash bucket for their pension payments can leave the rest of their benefit in a typical MySuper product. Generally, they are immune from short-term capital fluctuations as they are not taking money out when markets are down. If they top up their cash in good years and draw the minimum required pension payment each year, they will end up with more money ten years into retirement than they had at the time of retirement. The exposure to growth assets will take the sting out of their longevity risk and they can then plan the balance of their retirement years with more security. This is a much smarter strategy than holding assets in lifecycle products or low-income products such as bonds or annuities.

Several super funds offer such retirement products (for example, Australian Catholic Super). However, this approach would still need calibration to individual circumstances, and there are other options that could achieve the same outcomes.³⁷ Using the Pension Loans Scheme as a means of both augmenting retirement income and smoothing any erratic cash flows from

³⁶ This has been contested for Australia. Longitudinal data from the *Household, Income and Labour Dynamics in Australia* (HILDA) survey appear to show relatively constant levels of consumption over time (AIST and ACFS 2016), but HILDA has some deficiencies for looking at consumption and savings behaviour. More reliable data from the ABS' *Household Expenditure Survey* show systematic downward trends in consumption with age — for multiple cohorts — as does data drawn from bank transactions (Daley and Coates 2018, pp. 28–31).

³⁷ For example, an automatically re-balanced portfolio with the shares in safe and risky asset classes can achieve the same outcomes as a formal segregated investments strategy.

an ABP may also be another mechanism for securing greater certainty (though the new scheme will not commence until mid-2019).

In addition, the empirical evidence for excessively conservative drawdown rates from ABPs is unclear because of defects in the drawdown data, but what evidence there is suggests that many people still make considered choices about running down their accounts (PC 2015b, p. 95). Recent data from Rice Warner (2017c) show that about 40 per cent of pensioners draw down *above* the minimum rate, close to findings from longitudinal evidence (Balnozan 2018). In any case, to the extent that people do not withdraw ‘enough’ from ABPs, it may be better to guide them about the impacts of different withdrawal rates as has recently been done by Rice Warner (2018b). A higher drawdown rate through retirement makes a large difference to the relative importance of consumption and bequests for retirees.³⁸ Tailored information would leave people with the option to choose their desired rates on an informed basis, which would be preferable to a default annuity product that would often not match people’s preferences. (And *if* there is compelling evidence that behavioural biases remain intractable, which is not clear, then higher regulated minimum withdrawal rates may be a better option than CIPRs.)

To a significant degree, CIPRs achieve higher retirement consumption by reducing bequests, which, in the case of pure group self-annuitisation decreases them to zero. Given a crude death rate of 0.65 per cent, an annual bequest rate of 1.5 per cent and an average bequest value of \$85 000 (ABS 2018e; AHURI 2015), it is clear that, whether intended or not, bequests are both common among those who die, and relatively generous. Assets at death suggest even higher values (Temple, McDonald and Rice 2017). Whether bequests represent a problem that CIPRs need to solve is not straightforward. Bequests are undoubtedly not the major goal for retirees (figure 4.9 and Alonso-Garcia et al. 2018). However, that few retirees wish to pass on *all* of their savings to the next generation does not mean that the bequest motive is unimportant. Leaving a bequest remains ‘very important’ to ‘somewhat important’ for about half of Australian seniors (figure 4.9), extends to more than passing on their dwelling, and increases as people age (chartpack 19 of PC 2015a). Only about 10 per cent of older Australians wish to leave no bequest (NSA and Challenger 2017, p. 8). To the extent that a bequest leaves the donor with ‘a warm glow’, a bequest is a consumption good for the donor similar to other goods consumed by the elderly (Andreoni 1990). Experimental work has also found that 55.8 per cent of individuals without children were willing to select a CIPR, compared with 50.3 per cent of those with children (Hiscox et al. 2017), consistent with the value of funding bequests from retirement assets. While the rules may be justifiable, the deeming provisions for asset transfers made prior to Age Pension claims will have the effect of encouraging bequests as the vehicle for intergenerational transfers.

³⁸ In an illustration of this, the Commission adapted the cameo model described earlier, with a drawdown rate that increased slowly from 11 per cent to 35 per cent. This gave relatively smooth real income over the retirement years and meant that bequests were on average only 1 per cent of the total net present value of all retirement benefits (with a 0.6 to 1.4 per cent 90 per cent confidence interval).

For people reliant on income from accounts, bequests also act as a risk buffer for longer than expected lifespans or poor asset returns. People want to give them, but if longevity risk materialises, are willing to cut into their value (Bray 2013).

The implication of the above is that modelling that portrays bequests as wholly a welfare loss for retirees is misplaced. That bequests can be valuable does not rule out CIPRs, but it does affect their design (such as the degree to which they offer reversionary benefits and the relative weighting given to their ABP component).

An associated issue is whether, even if there were a problem, CIPRs would effectively resolve any biases people have in consuming during retirement. An annuity does not fully resolve any behavioural bias toward excessive frugality as a person can receive an income stream and still save a portion of it. (Consumption and income are not the same thing, as is sometimes assumed.) Commission analysis of the 2015-16 Australian Bureau of Statistics' (ABS) *Household Expenditure Survey* found high saving rates for retirees drawing income from annuities, and to a lesser extent, even the Age Pension.

Some might reasonably argue that ABPs dominate because they are what funds are accustomed to providing and what retirees are accustomed to receiving.³⁹ Ignorance and inertia are often the enemy of innovation. There is at least some doubt about whether CIPRs are afflicted by this. In the United Kingdom, annuities were once mandated, and so were therefore a familiar product. However, there has been liberalisation of once restricted access to pension accounts, which has led to a much weaker role for annuities, and to retirement choices that are similar to Australia (FCA 2017b). When given a choice, people graduated towards pension accounts in the UK, notwithstanding their familiarity with annuities.

A final observation is whether the kinds of CIPRs that the Australian Government are seeking to promote are designed to achieve the outcomes that are being claimed for them. While a fund could offer a guaranteed retirement income product, they are not required to do so:

There is no requirement for products to be fully or even partly guaranteed. ... It would be at the discretion of the trustee to decide whether the expected income should be broadly constant in real or nominal terms (or in between). (Treasury 2018e, p. 6)

Accordingly, retirees could potentially be exposed to several major risks — particularly market and inflation risk. For instance, someone receiving a nominal annuity of \$60 000 per annum from age 68 years in 1997-98, would be receiving a pension worth just over \$35 000 in real terms when they died at age 88 years in 2017-18 — a reduction in real income of over 40 per cent (ABS 2018c). It is not evident why management of longevity risk should be given pre-eminence over inflation and market risk.

³⁹ The Commission's members survey suggests that funds were not very active in providing information about retirement options. Only 20 per cent of members recalled that their super fund provided information on retirement income products when they retired. 17 per cent said they did not, and the rest could not remember.

Access to the Age Pension — are CIPRs really ‘better’?

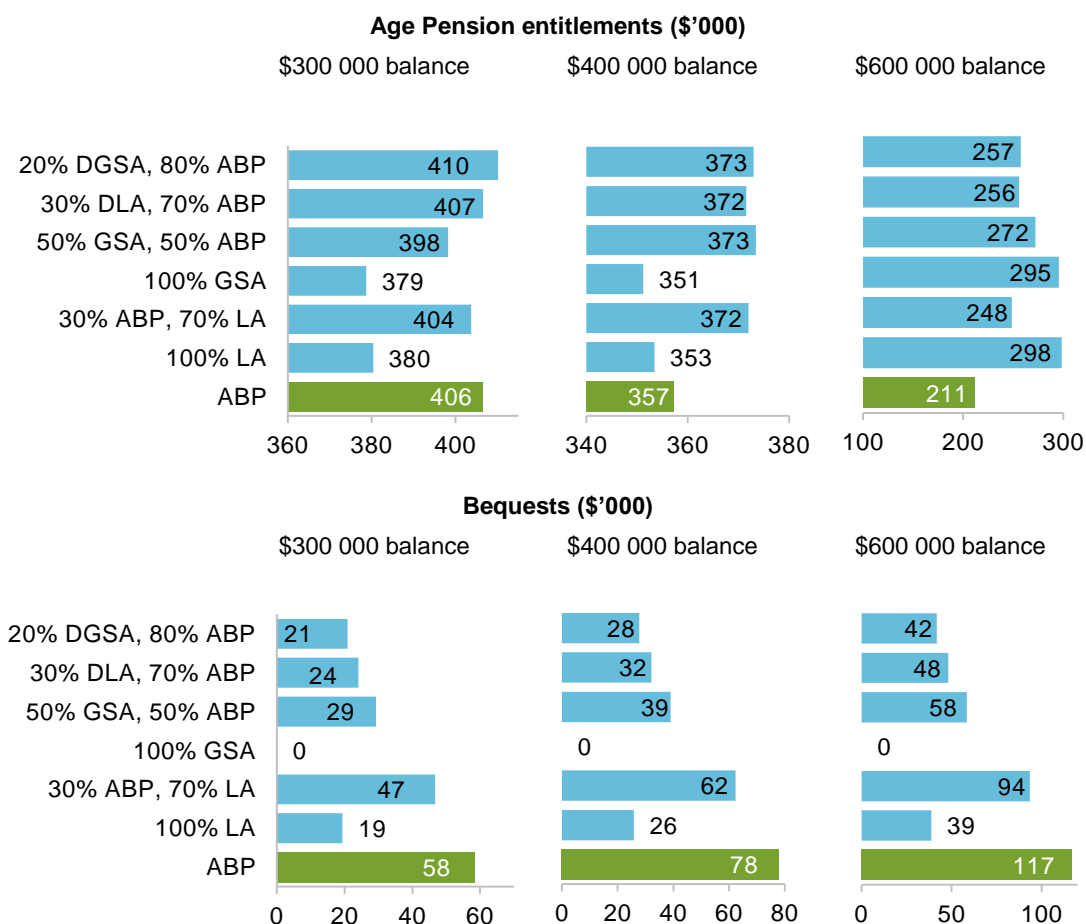
As well as its direct role in providing support for older Australians with lower income, the Age Pension acts like a deferred annuity for many people, providing insurance against longevity and other risks. Given its funding is mandated through taxation, it does this without the problem of adverse selection noted above. Since CIPRs are, in function, a substitute for the Age Pension, it could be expected that they would reduce social security obligations.

In fact, modelling by the Australian Government Actuary finds that following changes to the means test rules for pooled lifetime retirement income streams, Age Pension entitlements would be greater for higher-income households using CIPRs rather than an ABP (figure 4.10). For example, a person with a \$600 000 retirement balance would get \$211 000 of Age Pension entitlements if they took an ABP (at the minimum drawdown rate), but \$272 000 if they took out a 50/50 per cent ABP and group self-annuitisation (GSA) product.

The opposite pattern applies to lower-income households, where most annuity types reduce total benefits and decrease access to the Age Pension compared with an ABP. These contrasting outcomes appear inconsistent with any income distributional function of the Age Pension, and imply that choosing an annuity may not be favourable for households with lower net superannuation assets. Given that lower educational qualifications tend to reduce earnings and ultimately retirement balances, low-balance households will have fewer sophisticated investors able to make an informed decision about the desirability of CIPRs — especially given their complex variants (as shown in figure 4.10). This would become more problematic if the proposed Retirement Income Covenant nudges people into such products. The same equity concern would arise for groups with systematically lower life expectancy for whom longevity insurance is less valuable.

Nonetheless, given no retirement product is optimal in a world of complex taxes, transfers, and heterogeneous preferences, the damage done by the disadvantages above are not decisive in ruling out the potential benefits of CIPRs for *some* people. The changes to the social security treatment of pooled lifetime retirement income streams is likely to encourage the development of such products. Retirees may be receptive to their uptake under current policy settings, especially if the product is carefully explained to them. A recent large-scale survey suggested about 50 per cent were willing to accept a CIPR if it were offered to them in the future (Hiscox et al. 2017, p. 6), though it is hard to see that anything like that penetration would occur in real world settings (Rice Warner 2017b).

Figure 4.10 **CIPRs obtain more generous Age Pensions than account-based pensions for wealthier households and reduce retirement income bequests for all^a**



^a The outcomes relate to a single homeowner with varying retirement balances. The different retirement income products are account-based pensions (ABP), life annuities (LA), group self-annuities (GSA), deferred lifetime annuities (DLA) and deferred group self-annuities (DGSA). Their definitions are provided in the relevant paper cited below.

Source: DSS (2018).

The potential role of an Retirement Income Covenant

The 2018-19 Budget announced a Covenant that would be inserted into the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act), which would require trustees to develop a retirement income ‘strategy’. In practice, this would require a fund to offer a flagship CIPR or CIPRs — and not just an ABP — drawing on a suite of principles, such as effective management of longevity risk. The Covenant would also be accompanied by regulation that would require providers to report simplified, standardised information on retirement income products (akin to MySuper dashboards). A central aspect of the proposal is the way in which it is to be presented to members as the *first offering*:

Trustees may choose to offer additional products at the time of offering the CIPR, but it should be clear that the flagship CIPR offering is the starting point for members. (Treasury 2018e, p. 7)

This approach is not a MyRetirement default in that a person would only be enrolled in a CIPR following consent. However, the behavioural insights literature suggests that a first offer choice architecture would be likely to increase the uptake of CIPRs because it:

- acts as an anchor to the retirement decision (in the same way that minimum drawdown rates affect annual withdrawals from ABPs)
- has an endorsement effect because it has the appearance of a recommendation from both the sponsoring fund and the Government (Beshears et al. 2018, p. 232)
- reduces the effort of making a choice, especially if it is offered as a ‘solution for life’ and postpones or avoids subsequent irksome and complex decision-making.

Some winners, some losers, some practical issues

Putting aside the practical issues of implementing the Covenant, government-sponsored nudging should demonstrably be for people’s good. As discussed in the previous section, CIPRs almost certainly suit some people, especially those who do not value bequests or will benefit from the more favourable access to the Age Pension.

On the other hand, there would be likely losers too from a Covenant, a view supported by financial modelling undertaken by various submitters to the Treasury’s position paper on the Covenant (First State Super 2018; Legal & General 2018; Mine Super 2018). There is a tension between trustees’ obligations to members and a legislative requirement to make a first offer to members who will not benefit from that offer. For example, Cbus (2018, pp. 1–2) said:

The use of the term ‘flagship’ CIPR (the ‘soft nudge’ approach) may infer that this product is being offered by the trustee as their best retirement solution. A CIPR containing a longevity income product would not be the most suitable product for a large proportion of our members. Building and construction employees have a shorter life expectancy than the general population. Pooling building and construction members with members from other occupational groups would put them at a comparative disadvantage as they would essentially be funding others’ retirement. In offering a CIPR, the trustee may not be acting in the best interests of members.

On the practical front, there are also several concerns.

- Requiring funds that are unable to develop pooled products in-house to still offer a third party product may provide some degree of market power to the few current incumbent providers.
- A nudge will probably make a difference, but, given uncertainty about the behavioural responses of retirees, its materiality is unknown. A lot of effort might be spent on an initiative that achieves CIPR penetration rates not much different from those that might naturally evolve. Experimental evidence is often now used to assess people’s likely actual behaviour. Some initial analysis has already occurred in relation to the role of information provision and CIPRs (Hiscox et al. 2017), but further research analysing the

behavioural outcomes from the proposed nudge would be worth collecting prior to any finalisation of the Covenant.

- While funds could offer more tailored pooled products, pre-eminence would be given to the standardised flagship product, though the former by design is intended to match the preferences and characteristics of members better than vanilla products. First State Super (2018, p. 5) pointed out that the notion of a flagship product ‘runs counter to the whole philosophy of developing a suitable retirement income strategy for members’.
- Funds would — subject to the existing regulations — be allowed to provide various forms of advice and information to members, but the only mandated obligation would be to provide ‘guidance’ in the selection of any flagship product. This is unlikely to be sufficient for good decisions by many. While retirees *could* voluntarily use more personalised services, they tend not to do so due to cost, or if they do so, are subject to advice whose quality is mixed and/or conflicted, an area where policy should move quickly (chapter 5).
- The Covenant includes provision for a safe harbour that would shelter a provider from litigation if a product fails, so long as in other respects the trustees or advisers meet their obligations to act in the best interests of a particular member in relation to personal financial advice. The inclusion of this sanctuary has puzzled some stakeholders, in part because as described, it already exists under s. 961B of the *Corporations Act 2001* (Cth). It has left some to suppose that what it really means is that if a trustee is compelled by statute to offer a CIPR that might not be in the interests of their members, they are by dint of this compulsion given immunity. This is crucial for those compelled to offer a CIPR, but equally a signal that consumers may not be better off (AIST 2018b; Colonial First State 2018; FPAA 2018; NSA 2018).
- By design, pooled products are long-term contracts with limited reversibility or reversibility that comes at a necessarily significant price (AIST 2018b, pp. 13–16). If nothing else, this accentuates the need for careful matching of members to products, but also engagement earlier than retirement — an imperative that may be hard to meet.
- One of the advantages of annuities is that they transfer risk from members to providers, but, in turn, this means that funds must efficiently manage those risks. Where an annuity leaves retirees subject to inflation and market risk, the residual risks borne by the product provider are low. However, the Covenant does not preclude guaranteed income products, where the risks borne by the provider are significantly greater. In that instance, regulators must seek a balance between prudential oversight and the avoidance of excessive annuity capital charges. The bigger the market for guaranteed products, the greater the need for oversight. Globally, the International Monetary Fund (IMF 2017) has pointed to the solvency risks posed for life insurers (which usually issue annuities) by low yields on safe assets.

Nuancing of the existing proposal, including a re-consideration of the form of the offer and the obligation for all funds to offer flagships, may go a long way to resolving some of these problems and risks. For instance, offering CIPRs alongside various ABPs (such as ones with higher drawdown rates) would give members a more neutral choice than the first offer

variant currently being entertained. Following a decision by the Australian Government to extend by two years the commencement date of the Covenant to 1 July 2022 (Robert 2018b), there should be ample time to test any new designs with the industry and other stakeholders, assess alternatives and undertake more elaborate modelling of impacts. However, the process for adapting the proposal should not rule out relinquishing the Covenant altogether if key imperfections remain.

FINDING 4.4

In the retirement phase, risk-pooled lifetime income products may meet some members' preferences for a predictable income stream and for managing longevity risk. However, the proposed Retirement Income Covenant may nudge many others into products ill-suited to their long-term needs, may not achieve its desired goal of increasing retirement consumption, and fails to take sufficient account of the diversity in household preferences, incomes and other assets.

The requirement that all funds must offer a 'flagship' risk pooled product would oblige any fund without a capacity to create such a product to purchase it from a third party — where there are few choices currently on the market. The requirement for a standardised risk-pooled product may conflict with trustees' obligations to act in members' best interests, and many funds do not want to offer them. Their complexity, limited scope for reversibility and major deficiencies in the credibility, independence and affordability of financial advice for retirement products leaves significant scope for member detriment arising from the requirement to supply risk-pooled products.

4.6 Innovation and quality improvement in the system

'Data is the new black'

The above statement from a super fund encapsulates the growing understanding of the role of data in product innovation (BNPP and AIST 2015, p. 16).

Suppose that the decisions about the sale of clothes between customers and retailers were made with no information about age, sex, size, and colour preferences. Some impractical and amusing outcomes would ensue. The importance of data to the determination of the best products applies with even greater force to superannuation because the financial stakes are so much higher. That and the bewildering complexity of the products, disengagement, and behavioural anomalies, means that superannuation funds should be active in collecting data and using it to design and price products that meet member needs. This is particularly relevant to the transition to retirement and decumulation phases, where member needs are so diverse.

The degree to which funds collect and use data is contested. For instance, Tailored Superannuation Solutions (sub. 16, p. 6) was critical of many funds' approach to using member information:

Trustees' Investment Strategy Committees rarely even consider member demographics, let alone members own projected retirement outcomes. They typically concern themselves with 'which investment' and 'by whom' decisions. There is a void in considering long-term outcomes for members.

A survey of 10 large superannuation funds suggested that contemporary methods for using data were lacking:

As the industry transitions to a customer-centric approach, many funds are recognising that their existing operating models are not designed to capture and leverage data. Funds have traditionally encouraged low transaction, low engagement relationships, with few opportunities to collect new analytical insights or monitor member behaviour in depth. (MetLife 2016, p. 4)

In contrast, AIST (sub. 39, p. 109) said:

AIST member funds report that they consistently use member data such as age cohorts, account balances and the current investment patterns of members to develop their key investment and insurance strategies. For example, one fund has an over-representation of female members of child-bearing age who take time out of the workforce, and so is particularly mindful of downside protection. Other funds provide varying insurance defaults tailored to the needs of members who are self-employed, or those likely to be in casual or contract employment who do not receive employment benefits like paid sick leave.

Some funds also suggested that the funds were engaging more with members to provide better products — though sometimes this appeared to be more about educating members and eliciting their general preferences, rather than using data to develop new products (MLC Wealth, sub. 63).

While such subjective views are useful, there are some more objective measures of the industry's use of data, which suggest a less rosy picture.

In 2013, APRA expressed strong reservations about data integrity in the industry, indicating that 'RSE licensees' attention to the issue of data integrity and to the key drivers of data integrity risk has tended to be quite poor' (Ellis and Brown 2013, p. 33). For example, they found that 22 per cent of member records had an error in one or more audited fields (p. 35) — hardly conducive to good analysis of member needs or more general risk management.

The Commission's funds survey showed that funds often failed to collect data on their members (table 4.1; figure 4.11). Of the 10 member traits examined by the Commission, the most common outcome was that funds collected just one item. Even where funds did collect data on member characteristics, they often did not use it to design or price products. Funds

with higher member numbers were much more likely to collect information, an overlooked economy of scale relevant to the desirability of efficient processes for fund mergers.⁴⁰

Table 4.1 What data do funds collect?

Share of responding funds^a

<i>Type of information</i>	<i>Directly collected</i>	<i>Indirectly collected</i>	<i>Not collected</i>	<i>Correlates</i>
Age	73.2	15.2	11.6	Higher for industry funds
Personal income	24.1	17.0	58.9	Higher with greater fund size
Personal wealth	9.8	16.1	74.1	Higher with greater fund size
Household income	7.1	13.4	79.5	Higher with greater fund size
Household wealth	7.1	6.25	86.6	None
Education	3.6	6.3	90.2	Higher with greater fund size
Profession	26.8	15.2	58.0	Higher with greater fund size
Marital status	15.2	8.9	75.9	None
Dependents	14.3	6.3	79.5	None
Smoker	21.4	2.7	75.9	Higher for size and zero association for public

^a 112 valid responses from funds for shares and 108 valid responses for logistic regressions of each of the dichotomous version of the member variables (1 = collected in any way, 0 not collected) against dummies for retail funds, industry funds, corporate funds and the log of member numbers..

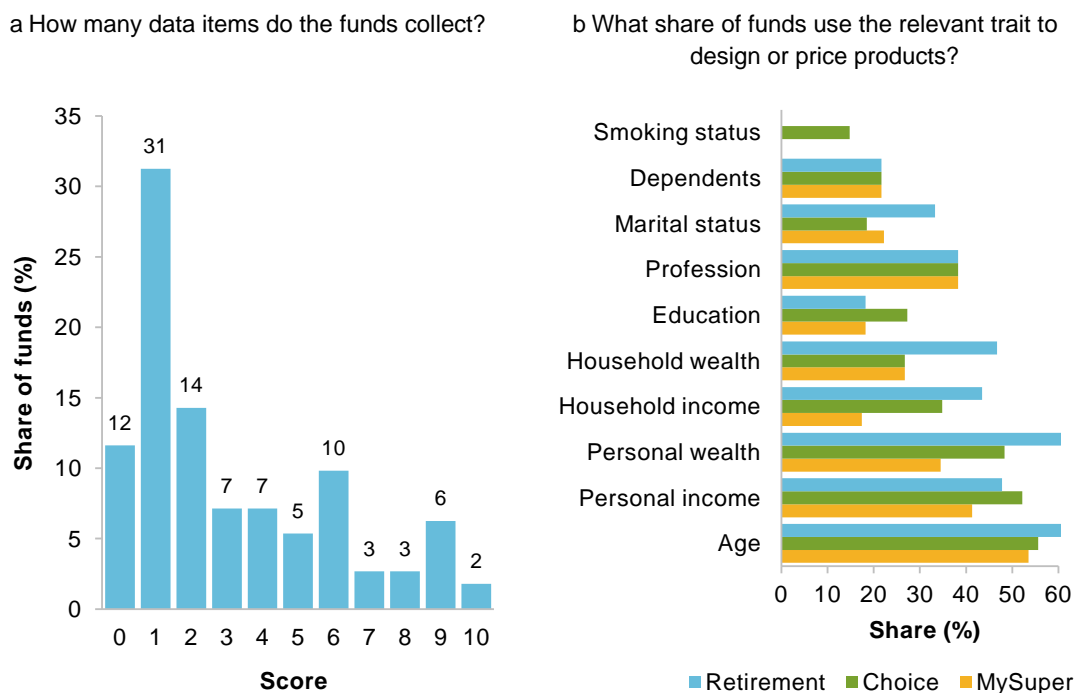
Source: Funds survey.

There are some signs that data management and use is improving. APRA indicated that the industry's quality and consistency of reporting was better than five years ago (sub. DR204, p. 18). Some formal indicators verify this. By December 2016, the data integrity error rate described above had fallen to less than 8 per cent (ASFA and Equifax 2016, p. 8). That still meant that 240 000 member records had issues with core data such as tax file numbers, date of birth and address (p. 3). Some smaller funds had error rates of about 35 per cent (p. 4).

APRA's review of the industry's approach to stress testing their liquidity also has precipitated further advancement in data collection about members (APRA 2016b; BNPP and AIST 2015, p. 16). Other data initiatives by government also appear to have been influential. SuperStream — a package of proposals developed by the Australian Government for electronically lodging employee superannuation guarantee contributions to super funds in a standard form — has been seen by the FSC as the 'most significant technology project undertaken by the superannuation industry since its inception' (FSC and TTS 2017, p. 18).

⁴⁰ Funds indicated several obstacles to gathering high quality data including various regulatory impediments (such as the *Privacy Act 1988* (Cth), sole purpose test), the limited (and sometimes inaccurate) data provided by employers via SuperStream, the costs of collecting and protecting the data, the presence of disengaged members, and members from a non-English speaking background.

Figure 4.11 **Most funds have little information about their members^a**



^a In panel a, the Score relates to the number of traits that a fund collects across the 10 categories. A score of 10 means that a fund collects data on all of the 10 traits and zero means none are collected. In panel b, the results reflect the share of funds in each product category that use the information collected on the various traits to design or price products. The results exclude those funds that collected no information on a given trait or gave a null response. For example, information on personal wealth is used by about 60 per cent of those funds that collect such data to design or price retirement products.

Source: Funds survey.

Tools for data analytics *are* being developed and used by the industry. For example, Empirics (2018) developed a superannuation model that integrated data from employers, transactions, call centre information, seminar information and emails, and then used it for product tailoring and consumer engagement (among other uses). For example,

Predictive tools are also used to identify when is the right time to talk to a member about particular products, for example, a fund’s pension product. “Funds used to put a finger in the air and say, ‘Let’s talk to them after their 53rd birthday, or when their balance is \$X.’ Now we take a lot more granular and scientific approach to predicting when a member is ripe for that conversation, based on all of their activity across various touchpoints. (Dunn 2018, p. 1)

However, the market penetration of data analytics is not known. A recent survey found that the industry expected exploitation of data to be a key technical focus over the next decade (BNPP and AIST 2015, pp. 15, 19, 30). Robust data management was seen by the industry as the second most important thing that could improve the future of the superannuation industry. The AIST indicated that it is championing a data framework that would include an assessment of the information needed for benchmarking performance and the potential value of Australian Taxation Office (ATO) data (AIST, sub. DR130, p. 28).

It would be a mistake to see each fund's own data as the exclusive vehicle for product development. Data available across funds can provide insights into product design. For example, the Rice Warner data used by the Commission is useful at revealing the drawdown behaviour of different cohorts and income groups. Similarly, datasets that have not been collected for the superannuation industry — like HILDA — provide insights into retirement and savings behaviour. The industry is now tapping such resources (AIST and ACFS 2016). Low-cost imputed data are also being used for the design of the insurance products that often accompany superannuation products (chapter 8). However, the extent to which funds exploit such data approaches is patchy.

Actuarial analysis based on the underlying distribution of asset returns, the tax treatment and social security treatment of assets and income, and demographic data can be used to determine the types of products that are suited to different member groups. The recent debates about CIPRs have often drawn on such analysis. Combined with data on any given fund's members, this allows better matching of products to people (or strategies for attracting different customer groups to a choice fund).

Finally, members need an easier way to share their data. The Australian Government is implementing a Consumer Data Right across all sectors of the economy, starting with banking ('open banking') in 2019, followed by energy and telecommunications (Treasury 2018a, p. 4). Open banking will provide consumers with access to information from a diverse range of financial accounts (including pensioner deeming accounts and retirement savings accounts — but not otherwise superannuation), which they can then share with authorised deposit-taking institutions (ADIs), and if accredited, other parties. Open banking will, if consumers give consent, provide useful information to superannuation funds to tailor products to members. However, to access the data, superannuation funds will require accreditation, which given their regulation by ASIC and APRA, should be automatically granted. In addition, individual superannuation funds will increasingly collect valuable information about their members. When the Consumer Data Right includes superannuation, this will give a member the right to pass information from their superannuation fund to any other fund when they switch, which is likely to be particularly beneficial at retirement. Currently, there is no indication of when the Consumer Data Right will apply to superannuation despite the fact that superannuation data have many attributes similar to data held by ADIs. There are strong grounds for the Australian Government to roll out the Consumer Data Right to the superannuation industry, with timing to coincide with the implementation of the major structural and governance changes recommended in this report, and particularly the elevated outcomes tests.

FINDING 4.5

Superannuation funds make insufficient use of their own (or imputed) data to develop and price products (including insurance). This is particularly problematic for designing products for the retirement and transition to retirement stages, because this is when different strategies can have the biggest payoffs for members.

Data aside — where else is the innovation?

The FSC has characterised innovation in the industry in bleak terms:

The world is changing fast, driven by rapid technological advances. However, the \$2.1 trillion superannuation industry in Australia looks much the same as it did when universal super was legislated 25 years ago — it has simply increased in size. (FSC and TTS 2017, p. 4)

This is an overly pessimistic perspective. It may be imperfect, but data management has improved. Processes that allow easier engagement with members, such as mobile apps and online access, are relatively common (chapter 5), and yet did not exist at all in 1993. ASFA (sub. 47) provided examples of innovations across the retail and wholesale markets, including: digital delivery of disclosure material; member self-service; robo advice; more targeted bespoke products; cloud computing; and electronic binding nominations. While still in a fledgling state, tax and regulatory changes have encouraged the development of new annuity products, and new entry into an area almost entirely the preserve of one fund. There is a greater awareness of the importance of member engagement and of dashboards that might better enable people to understand funds' performance (chapter 5). Some novel experiments using behavioural insights have suggested better ways of presenting information to change member behaviour (Hiscox et al. 2017). The industry has generally highlighted areas where innovation has, or is, occurring (box 4.3).

There are some gaps. The translation from member and financial data to informed decisions is haphazard and primitive. For example, empirical studies identify multiple medical factors influencing expected longevity (Sijbrands, Tornij and Homsma 2009), yet other than standard life tables by gender and age, few (if any) financial advisers have access to more sophisticated data or the statistical expertise to use it for considering personalised longevity risk. Innovation that exploits new forms of data analysis with new software tools could make a significant difference to the development of tailored longevity insurance products (without relinquishing the capacity for risk sharing among subgroups with similar predicted risks). The Consumer Policy Research Centre (CPRC, sub. DR196, attachment, p. 44) suggested that there may be scope for automating the process of consumer searching and switching, with software assessing whether it would be profitable for a member to move. Given the Commission's proposed best-in-show model, this would probably be most relevant to the choice market and to relatively simple product offerings only.

Box 4.3 **Participants' views on innovation and quality improvement in the system**

AIST said:

Funds which market on 'bells and whistles' and large funds will have capacity and desire to develop 'innovative service delivery mechanisms', even if this entails higher cost to members. (sub. 39, p. 61)

AustralianSuper submitted an example of an innovative tool (to help members make informed decisions) based on member information to inform its design.

Our key innovation tool is one of the largest member listening programs in Australia. In the 2016/17 financial year, we heard directly from more than 100,000 members. To incubate innovations, we perform 'test & learn' experiments to create primary data, we test member offers to see if they're viable and listen to the voice of current and future members. These experiments allow for decision making and innovation of new products that creates, or avoids the destruction of, value for members.

Based on changing member needs and preferences, AustralianSuper has introduced new channels to assist members including:

- A mobile app that allows members (accumulation and draw down) to check their balance, transactions, insurance cover as well as change investments and update details
- Click to chat, which allows members to conveniently communicate with a service agent in real time from the website, and
- Webcasts, which allow us to conduct education sessions that can reach more remote parts of Australia that we otherwise could not have reached in person. (sub. 43, p. 15)

The Australian Council of Trade Unions argued that while competition may not have driven innovation, collaborative benchmarking processes across industry funds had helped to drive efficiency:

These approaches have driven issues like cost reduction in investment fees and custodian fees and are now driving administration approaches which adopt best in the world approaches to drive cost efficiency. (sub. 50, p. 10)

MLC Wealth said:

In terms of accessing distribution channels, rapid technological developments and extensive adoption of innovative digital tools has enabled newer entrants to move into the superannuation system. (sub. 63, attachment, p. 9)

Some are more sceptical that the industry involves much innovation:

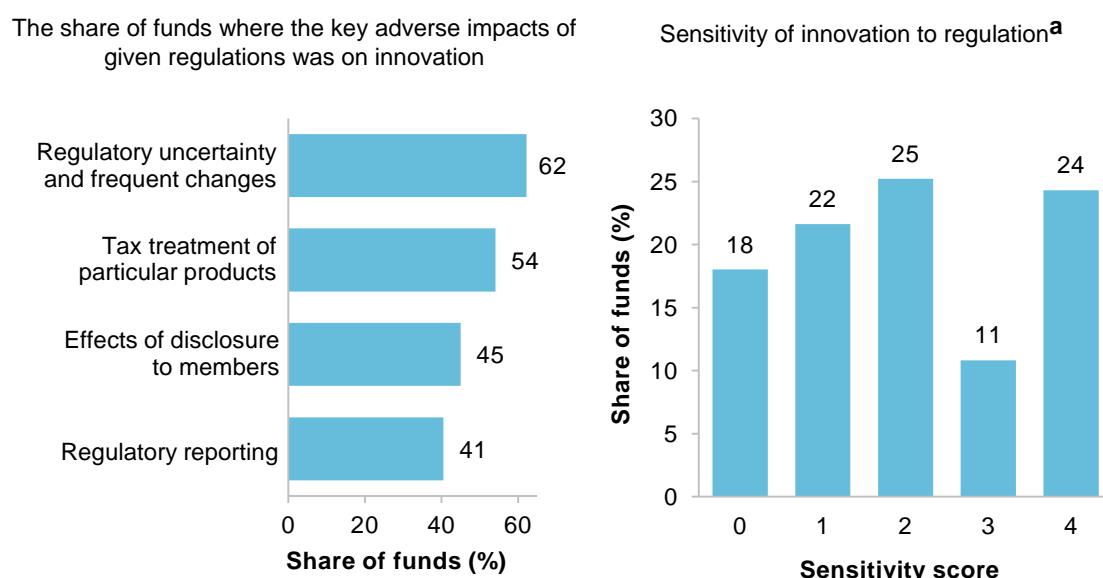
A shortcoming of the superannuation system is that it has failed to engage its consumers, largely due to the compulsory contribution (via employers payroll) structure (which has an inbuilt mandated [funds under management] FUM growth strategy, without ever having to think what to do for individual beneficiaries), and this has stifled competition and in turn innovation. This disengagement facilitates both the lack of investment in innovative products and limited quality improvement in the system. (Tailored Superannuation Solutions, sub. 16, p. 8)

Impediments to innovation

As discussed in chapter 7, competition is deficient in some areas of the superannuation system, and in other cases, competition can foster excessive product variety without creating much value — ersatz innovation. The Commission's policy recommendations are likely to intensify genuine competition both *in* the market (for members who choose) and *for* the market (members who default) and with it, innovation. The Commission's best in show model also explicitly identifies innovation as a key performance measure.

Aside from these market forces, regulation itself appears to be a constraining factor, and was raised in these terms by several participants (ANZ, sub. 73, p. 3; MLC Wealth, sub. 63, attachment; Asher, sub. DR151; FSC and TTS 2017). Regulation can have adverse effects on many aspects of a fund’s performance. The Commission’s funds survey considered four regulatory problems and three performance areas affected by these — higher fees, lower returns and impediments to innovation. Funds reported that regulation had the greatest adverse impacts on innovation. For example, more than 60 per cent of funds claimed that the key impact of regulatory uncertainty and frequent changes was on innovation (figure 4.12). An index of the sensitivity of innovation to regulation revealed that about 25 per cent of funds considered that adverse impacts on innovation was the key problem for all four regulatory problems. Econometric analysis suggests that innovation in funds offering choice products were more adversely affected than others. Of course, the fact that regulations may impede innovation does not necessarily mean that the regulations are unwarranted. Moreover, some of the barriers to innovation — such as means testing treatment of certain retirement income products — appear to have been largely resolved through recent policy changes. In other instances, new regulations, such as a consumer data right as described above, will underpin innovation.

Figure 4.12 Regulation can inhibit innovation



^a The sensitivity score is the sum of the instances across the four categories of regulation when a fund nominated innovation as the key adverse effect. The results above did not vary significantly across fund type, with the exception of choice products. Based on logit and ordered logit regression, funds in the choice segment were more likely to say that regulatory uncertainty and changes adversely affected innovation, and more generally, their sensitivity score were considerably higher than other funds. The results exclude any funds that gave null responses. Results are based on 111 observations.

Source: Funds survey.

5 Member engagement

Key points

- Many Australians find superannuation complex and are disengaged from decisions around their retirement savings. Underlying drivers of disengagement include the: compulsory nature of superannuation, complexities involved, behavioural biases that affect people's decisions about their retirement savings, costs of engaging, and presence of intermediaries and trustees (charged with acting in members' best interests).
- Engagement tends to be higher among those approaching retirement, those with higher balances and owners of SMSFs; while engagement is lowest for the young and those with relatively low balances. For those who want to be engaged, it is *informed* engagement that matters. Around 30 per cent of members have low financial literacy, and while most members know the 'basics' of super, many lack the understanding needed for informed engagement.
- While it is not feasible nor optimal for members to be engaged all the time, some engagement is needed to promote effective competition. But demand-side pressure in the superannuation system is relatively weak. Active members (or their intermediaries) have not exerted material competitive pressure on funds. Most people do not switch funds (historically annual fund switching rates sit below 10 per cent). And around half of this switching is passive — it occurs because members change employer or their employer changes funds. For members who switch to improve their financial wellbeing, evidence shows that the expected improvement has not occurred for a significant minority. Notably, recent data suggests an uptick in switching to industry funds associated with the FSRC, albeit likely to be a temporary phenomenon absent system reform.
- Overall members need better, not more, information — often a simple case of 'less is more'. But product dashboards remain a work in progress; they suffer from the pursuit of false perfection at the expense of the possible. Dashboards need to be salient, simple and accessible to be effective — and most are not. ASIC should, without delay, settle on such member centric product dashboards and publish them on a centralised website. ASIC should also proactively set and enforce standards for the meaningful disclosure of information to members on superannuation products (including insurance).
- Moreover, access to impartial advice (especially for pre-retirees and retirees) remains elusive for many, and the quality of advice provided — including to some owners of SMSFs — is often questionable. But the need for pertinent information and affordable and impartial advice is expected to increase as the system matures and as retirement income products become more complex. In response, the Government should:
 - mandate specialist training for persons providing advice to set up SMSFs
 - prompt people at age 55 to access ASIC's MoneySmart and DHS' Financial Information Service (FIS) websites
 - consider cost-effective options, including possibly expanding the FIS and the business case for investing in digital technology, to help decision-making in an increasingly complex environment.
- The system also lacks a dedicated 'member voice' — an independent body to undertake authoritative data analytics, advocate on behalf of members in policy and regulatory considerations, and to assist members to navigate the system. This is well overdue and the Government should fund such a body as a priority.

In most competitive markets, consumers are informed and engaged and make decisions in their own best interest, exerting healthy competitive pressure through demand for the goods and services they value. But there are good reasons why many members disengage from the superannuation system (PC 2016a). Hence, even in an efficient superannuation system a sizable group of disengaged members would be expected. An efficient super system would also enable members to choose to engage should they desire to do so (and take some responsibility for their choices), along with access to high quality information and advice to support their decision making. Governance arrangements and regulatory safeguards applying to members would be set so as to ensure that members' best interests are the primary focus of intermediaries who act on behalf of members as well as those providing members with information and/or advice.

The chapter begins by examining the levels of engagement among superannuation members (section 5.1). Evidence on the effect of engagement on competition is discussed in section 5.2. Section 5.3 looks at what information and advice members need to help support informed decision making. Section 5.4 then assesses whether the system is providing the type of information that is needed to help members make decisions, identifies several gaps and proposes solutions to minimise these gaps. Similarly, section 5.5 outlines the gaps in advice and information, along with some remedies to ameliorate them. Section 5.6 closes the chapter with a discussion on the role of an independent member assistance and advocacy body. All the recommendations associated with this chapter are presented in chapter 13.

The chapter also provides evidence, in whole or in part, on the following three assessment criteria from the Commission's stage 1 study.

- Is there informed member engagement? (C1)
- Are active members and member intermediaries able to exert material competitive pressure? (C2)
- Is the system providing high quality information and intrafund financial advice to help members make decisions? (E6)

Many of the indicators relevant to this chapter are based on data from the Commission's survey of superannuation members (box 1.7). Further details about this survey are in appendix C while a set of summary statistics and results from the members and funds surveys that support the analyses in this chapter are contained in technical supplements (tech. supps.) 1 and 2, respectively.

5.1 How engaged are superannuation members?

Engaged members are those who are interested in how their superannuation is tracking. They can be expected to be willing to make decisions about their superannuation fund, their superannuation account and their insurance policy, when needed.

Competition in the superannuation system relies on members being engaged but healthy competition requires that this engagement be informed. Informed members are those who know the basic details of their superannuation (or outsource this knowledge to a reliable financial adviser) such as (in approximate) their balance, their projected retirement income, the fees they pay (including premiums for insurance) and how their current fund and product compares to other broadly comparable options. Informed members are also much more likely to appreciate that ‘past performance is not a guarantee of future results’. Informed but unengaged members will not exert competitive pressure and uninformed members who engage will incentivise funds to compete on dimensions not relevant to member outcomes — such as potentially misleading advertising campaigns or unnecessarily complex product design (chapter 4). In a system dominated by informed and engaged members, funds would be more likely to compete to provide better products (for example, lower fees, more appropriate insurance) in order to retain or grow market share. In markets where informed engagement is uncommon, such as superannuation, government intervention in some form is necessary to ensure private entities act in the interest of members.

The optimal level of informed member engagement is hard to determine and there is no single widely accepted measure of engagement, nor of informed engagement. The Commission’s stage 1 study (PC 2016a), however, established a range of indicators to help measure and assess informed engagement. These include direct measures of engagement as well as measures of informed and high quality decision making. Other measures contributing to observed engagement levels include the costs of engagement.

Historically, member engagement in superannuation has been low

Consistent with the experience internationally, and for a range of reasons, member engagement in Australia’s superannuation system has typically been low but many members become engaged at some point in their lives (see below). Several major reviews (Cooper et al. 2010a; Murray et al. 2014; Treasury 2009) within the past decade formed this view.

... and a mix of factors have contributed to low engagement

Many factors affect engagement (box 5.1), and many participants acknowledged these various factors.

The combined effect of these different factors means that engagement may vary with different member characteristics.

It is well known that younger people, on average, are less likely to engage with superannuation (Super Guru nd). As Flanagan adroitly said ‘It’s money for when you are old. Who cares about that?’ (*The Weekly with Charlie Pickering* 2018). But this low engagement, when combined with the current default system, can result in an ‘unlucky lottery’ for some members. Hence, the default system needs to safeguard against young people defaulting into poor-performing funds (chapter 12).

Box 5.1 Many factors affect member engagement

- **Compulsory contributions** coupled with a complex system mean that, for many members, there is little incentive to engage, especially at a young age. Consequently, disengaged members are less likely to move away from higher cost and/or underperforming funds, substantially reducing incentives for superannuation funds to merge.
- **Cognitive constraints and behavioural biases** also contribute to disengagement. Examples include myopia, complexity of long-term decision making, loss aversion, reliance on mental shortcuts, a tendency to procrastinate and general apathy (Benartzi and Thaler 2007; Kahneman 2011; PC 2016a, 2017d).
- **Poor financial literacy** coupled with low literacy and numeracy (along with a range of other factors associated with disadvantage and vulnerability) and poor digital literacy can create barriers to engagement (CPRC, sub. DR196).
- In turn, many members are disengaged because they lack the **confidence** to make big financial decisions and/or they **trust** their fund to do the right thing (Bateman et al. 2012, 2012, 2014; Butt et al. 2015; Deetlefs et al. 2018).
- And it can be **costly** to engage. Making choices involves costs, such as the costs of time and learning, costs of monitoring the decisions of providers, and the costs of switching products or funds or taking action regarding insurance. These costs often lead to widespread procrastination (Barr and Diamond, sub. 74).
- Further discouraging engagement, a proportion of members may be **constrained** from making an active choice (Clare 2010). In this context, the Financial System Inquiry (Murray et al. 2014) considered that removing remaining restrictions on the choice of fund receiving Superannuation Guarantee contributions would remove a barrier to member engagement. Legislation to extend choice of super fund to more employees under enterprise agreements and workplace determinations is currently before Parliament (ATO 2018c).
- The presence of a range of **intermediary ‘agents’** (for example, unions, employers, advisers) and trustees (who are required by law to act in members’ best interests) also reduces incentives to engage. That said, some of these agents may face conflicts of interest which materially detract from achieving the best outcomes for members. For example, employers could potentially be selecting funds based on low administrative requirements rather than on net returns (chapter 9). A range of evidence presented at the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Financial Services Royal Commission (FSRC)) has exposed the conflict between the financial *interests* of the adviser or licensee and the *duty* that each owes their client, which has generally not been resolved in favour of the client (FSRC 2018e chapters 2, 5, 6, 7, and 9).
- A **lack of comparability** of fees and performance information has also been identified as a factor influencing the observed weak levels of member engagement (Murray et al. 2014). Moreover, even when information is standardised and comparable, complexity can get in the way as people often find it difficult to compare multiple options with multiple attributes (Ideas42 2015).

Many members approaching retirement with reasonable-sized balances have greater incentives to engage (PC 2016a). The Australian Institute of Superannuation Trustees (AIST, sub. 39, p. 38) observed that ‘members with balances between \$100 000 and \$250 000 were by far the most likely to contact the fund’.

Nonetheless, not all older people can be expected to increase their level of engagement. A qualitative study commissioned by CHOICE (Souvlis et al. 2017) recently found that less affluent retirees (which comprised around 20 per cent of 65 year olds in 2015): regarded retirement as daunting; faced heightened anxieties around planning for retirement; felt disempowered about superannuation; and were cynical and insecure about superannuation funds and superannuation advisers. As a result, instead of engaging with superannuation these types of retirees were often ‘paralysed into inaction’ (Souvlis et al. 2017, p. 27). That said, many current and past retirees have previously made sensible decisions given the policy environment and system they have faced (chapter 4; PC 2015b).

While low engagement is often rational, there are consequences

Due to the wide range of factors outlined above, it is often not possible nor rational for members to be continually engaged. For instance, for some individuals the time costs associated with decision making mean that it is not rational to be continually engaged — especially when trustees are required by law to act in members’ best interests.

However, there are a range of negative outcomes associated with low engagement. Members may: not choose the investment option or insurance product that best meets their needs; have multiple accounts leading to balance erosion; and/or remain in underperforming superannuation funds or products.

Some level of informed member engagement is needed for competition

An efficient superannuation system needs to deliver efficient and competitive outcomes for those members who choose to remain disengaged. While the Australian Government’s MySuper reforms have made some inroads, more could be done (chapters 11, 12 and 13).

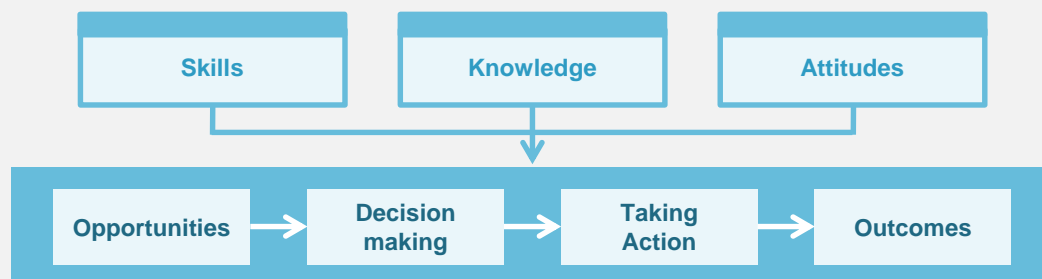
Moreover, some level of member engagement is necessary to create a competitive discipline on funds (section 5.2). But, increasing member engagement — through, for example, enhancing skills, knowledge and attitudes (box 5.2) — is not enough to effectively act as a discipline on funds. Decisions also need to be well-informed by pertinent, accessible and comparable information.

To engender optimal and well-informed decision making by members in a competitive and complex market such as superannuation, a range of consumer aids is required. These could include: readily comparable information on products and services; easy access to the key metrics that matter in making decisions; and access to affordable and impartial advice. In this regard, funds and other system participants (such as regulators) — and the design of the system itself — can have a decisive influence over levels of member engagement, its effectiveness as a discipline on funds’ behaviour, and, ultimately, whether members are able to achieve outcomes that meet their needs. Sections 5.4, 5.5 and 5.6 identifies several areas where improvements are needed.

Box 5.2 What do members need to engage effectively?

To effectively engage with the superannuation system, members require knowledge and skills. However, knowledge and skills are not useful if there is no motivation to engage. Conversely, as outlined in the figure below, a preference for engagement may not translate into good outcomes if members do not have the necessary knowledge and skills.

Skills, knowledge and attitudes to engagement are all important



Source: Figure adapted from ASIC (2013b).

Insights from the Commission's members and funds surveys

The Commission previously divided engagement measures into two types: passive (monitoring) and active (taking action) engagement (PC 2016a). Responses to the Commission's members and funds surveys show that levels of passive member engagement appear to be moderate for many members but levels of active member engagement appear to be low. (Whether low active engagement matters is discussed in section 5.2.) Furthermore, as expected, both passive and active engagement levels are higher among some groups: those approaching retirement, those with higher balances, and among owners of a self-managed superannuation fund (SMSF).

Engagement is mostly passive

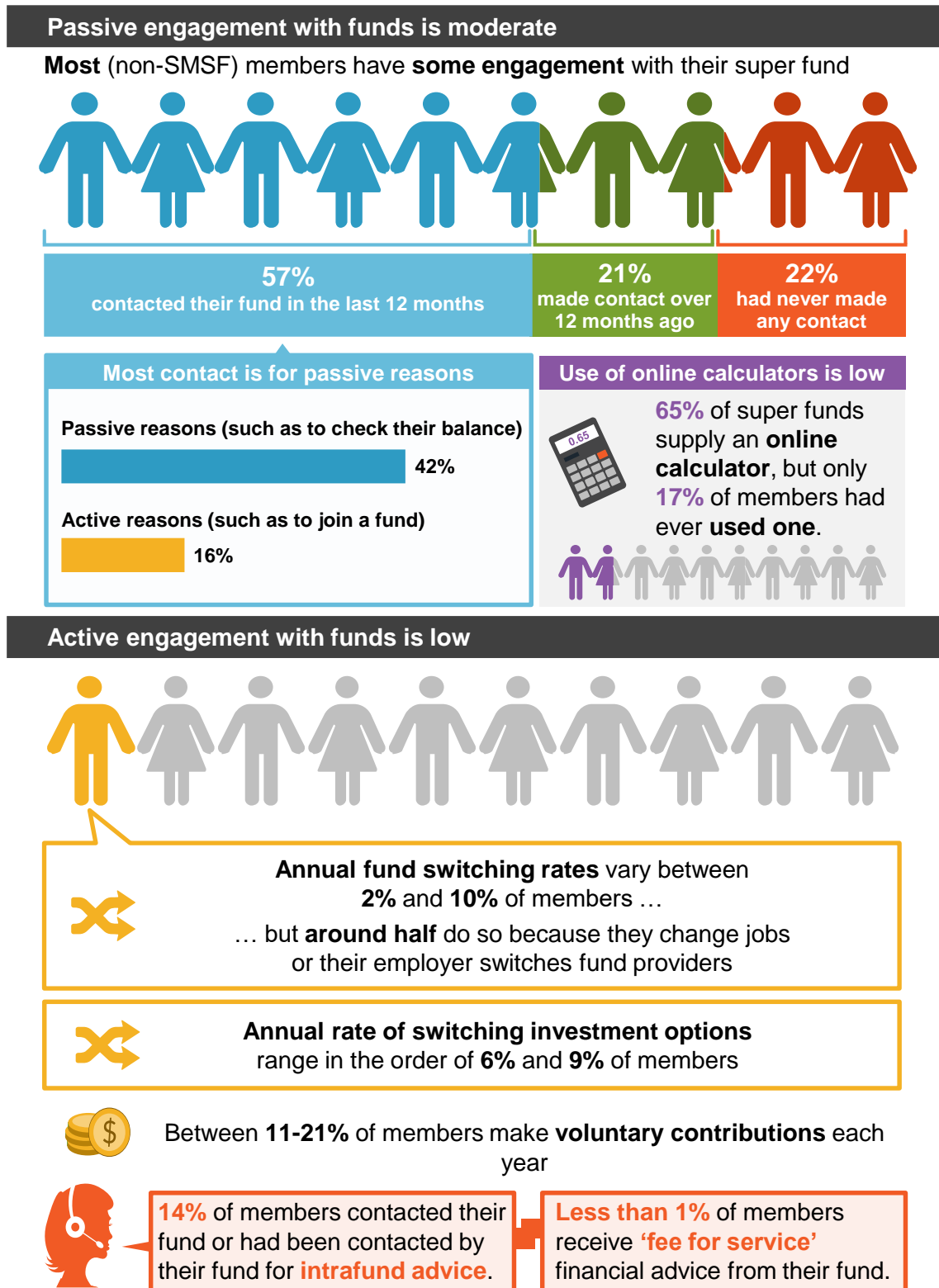
Most members have some form of contact with their fund, but it tends to be in the form of passive account monitoring activities (figure 5.1),⁴¹ which is potentially a sensible decision if a member is in a well-performing fund.

- Fund websites were by far the most popular means of contacting a fund, with call centres the next most common. Rates of passive account monitoring do not seem to differ by age but are higher among male, higher income, higher balance and choice members⁴² (tech. supp. 1).

⁴¹ Measures for passive account monitoring in the members survey include members checking their fund balances, fees and charges, tax rates, rate of return, or risks that apply to their own superannuation account, discussing a query regarding their super statement and/or amending their details.

⁴² In this chapter, choice members are defined as a member not in a default fund *plus* members who made an active decision to stay in (or join) their current default fund. Unless stated otherwise, choice members include SMSF members.

Figure 5.1 Patterns of member engagement



Sources: Members survey and funds survey.

-
- Consistent with the expectations of the Commission, members who are older, members who have higher incomes and balances, and choice members are more likely to have used an online calculator (another indicator of passive account monitoring that potentially informs subsequent active engagement) (tech. supp. 1).

Active engagement is generally low, but some are more active than others

While fund and investment switching rates (figure 5.1; section 5.2) point to relatively low levels of active engagement, other measures⁴³ indicate the presence of more active engagement, especially among older, wealthier and choice members. The members and funds surveys provide the following information on:

- *voluntary contributions* — between 11 and 21 per cent of accumulation members (excluding SMSF members) made voluntary contributions in the year prior to the survey (figure 5.1).⁴⁴ Members more likely to make voluntary contributions are: members aged over 50 years, those on higher incomes (noting that this does not take into account the amount contributed), choice members, and members with account balances over \$350 000 (tech. supp. 1)
- *intrafund advice*⁴⁵ — 14 per cent of members (excluding SMSF members) contacted their fund or had been contacted by their fund (or both) for intrafund advice in the 12 months prior to the survey (figure 5.1). The likelihood of contact is higher among members aged over 50, higher income and higher balance members, and choice members (tech. supp. 1).

Another indicator of active engagement is the use of fee-for-service financial advice from a fund. The Commission's funds survey suggests that less than 1 per cent of members receive such financial advice from their fund in a year. However, this proportion differs by fund type: 3 per cent of retail fund members had received such advice in the 2016-17 financial year compared with less than 1 per cent of industry fund members (tech. supp. 2).

That said, greater member awareness of superannuation associated with the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Financial Services Royal Commission (FSRC)) has cultivated greater switching, with results from the Australian Prudential Regulation Authority's (APRA) quarterly net rollover data showing a dramatic increase in member switching towards industry funds in 2018 (figure 5.2). However, post the FSRC and in the absence of system reform (especially 'best in show', simple and salient dashboards and data), switching rates are likely to return to their historical levels over time.

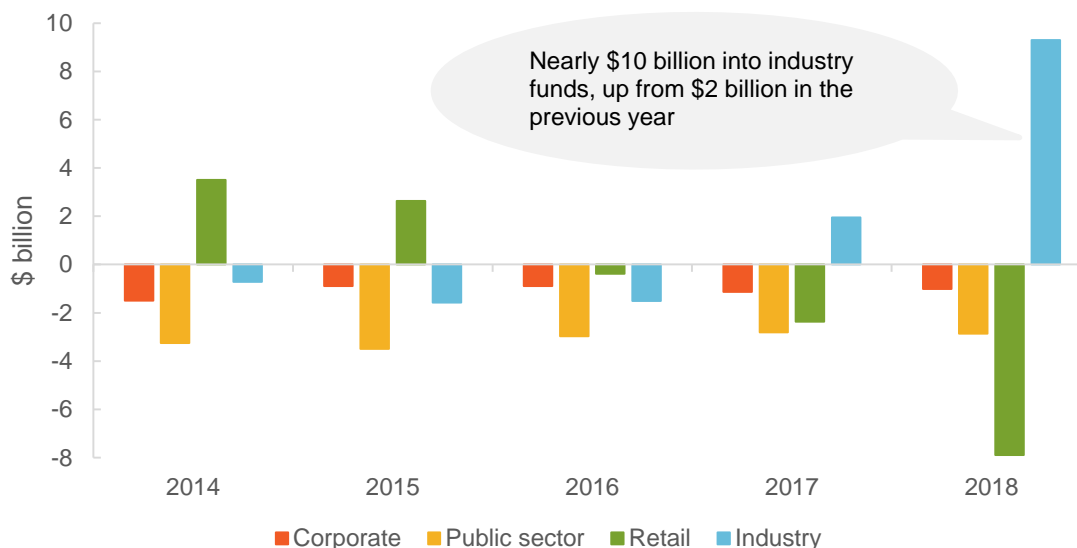
⁴³ Other measures of active engagement include checking or changing investment or insurance options, making voluntary contributions and using intrafund advice.

⁴⁴ If SMSF accumulation members are included, the estimate of voluntary contributions from the members survey increases to 23 per cent of members (tech. supp. 1).

⁴⁵ Intrafund advice is explained in box 5.8.

Figure 5.2 Fund switching by members has markedly increased in 2018

Net rollovers, 2014 to 2018, year ending 30 September^a



^a Data were sourced from Reporting Standard SRF 330.0 *Statement of Financial Performance*. Net rollovers is a derived item. It is equal to rollovers in, less rollovers out. Data are current as at 28 October 2018.

Source: PC analysis of APRA data.

Active member engagement from another perspective: establishing an SMSF

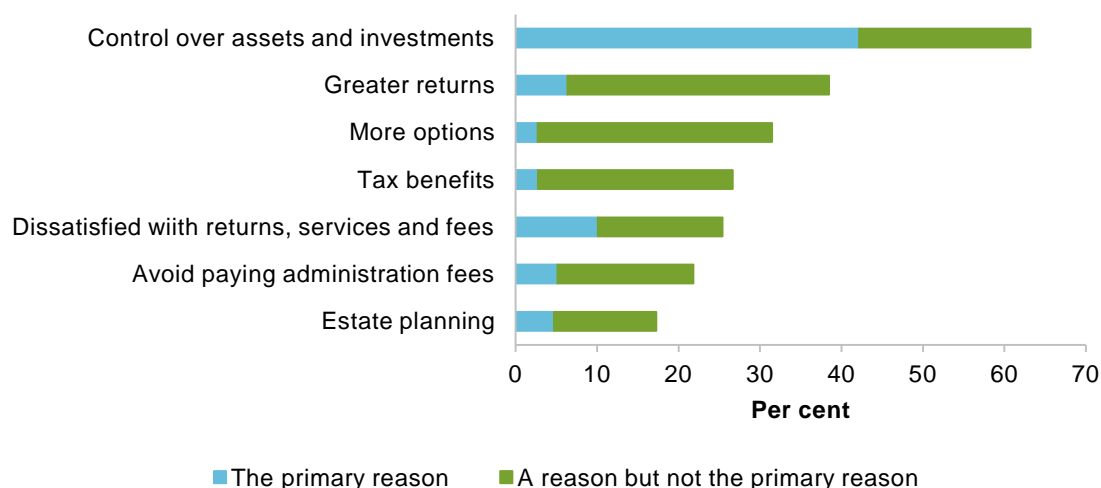
Another signal of active engagement among members in the system is the number of people establishing SMSFs. Between 2006 and 2018 the number of SMSFs increased from about 309 000 to almost 600 000, now representing around 28 per cent of assets under management and around 4 per cent of member accounts (chapter 1).

Consistent with the comparatively higher engagement levels of SMSF members, the members survey suggests that the desire to ‘gain greater control over my superannuation assets and investments’ is the leading motivation for the establishment of SMSFs. Two in three SMSF members cite control as a factor, and over half of those cite it as their main reason (figure 5.3).

These results are consistent with the Australian Securities and Investments Commission’s (ASIC 2018g) qualitative research in *Member experiences with self-managed superannuation funds* and recent survey-based research cited in *Investment Trends (2018)*.

Despite SMSF members appearing to be highly engaged, ASIC (2018g, p. 6), however, recently found that a sizable minority (between 30 and 40 per cent) of SMSF members ‘lacked a basic understanding of their SMSF and their legal obligations as SMSF trustees’. Evidence in chapter 4 shows that highly engaged members (including owners of SMSFs) who are not well-informed often make poor decisions.

Figure 5.3 Gaining control is a key motivator for establishing an SMSF^a
Reasons for establishing an SMSF among members of an SMSF^b



^a Data are weighted using Commission weights. ^b The Commission classifies a reason as 'primary' if it is the only reason listed for establishing a member's SMSF in Q12a or if it is selected as one of multiple reasons in Q12a and selected as the main reason in Q12b.

Source: Members survey.

What factors affect informed engagement?

Financial literacy

Poor financial literacy often results in poor economic decision making (Lusardi and Mitchell 2014). An effectively regulated superannuation system would enable those who lack financial literacy skills to obtain trustworthy and pertinent information and advice, as well as adequately shield them against unscrupulous behaviour (AIST, sub. DR130; ISA, sub. DR162; and Victims of Financial Fraud, sub. DR170).

Broadly speaking, Australians are less financially literate in matters relating to superannuation and retirement planning than in financial matters generally (PC 2015b). Studies have found that while most Australians have a reasonable standard of financial literacy for simpler matters and are capable of making informed decisions, a sizable minority encounter difficulties (PC 2016a). Previous research has found that Australian consumers frequently misunderstand risks relating to financial products. Souvlis et al. (2017) concluded that the interaction of poor financial literacy with the complexity of superannuation often results in avoidance behaviour and cognitive dissonance when it comes to superannuation.

Across a range of surveys, the evidence suggests that around one quarter of all Australians lack an understanding of basic concepts (such as inflation and diversification) (Agnew, Bateman and Thorp 2013; ANZ 2015; ASIC 2016b; Mercer 2013; Wilkins 2018). The

Australian Securities and Investments Commission (ASIC 2013a) surveyed industry participants, consumers and financial literacy specialists and found that 45 per cent of respondents believed that consumers did not understand that higher reward often meant higher risk, and 71 per cent believed that consumers failed to completely understand the risk involved in complex products.

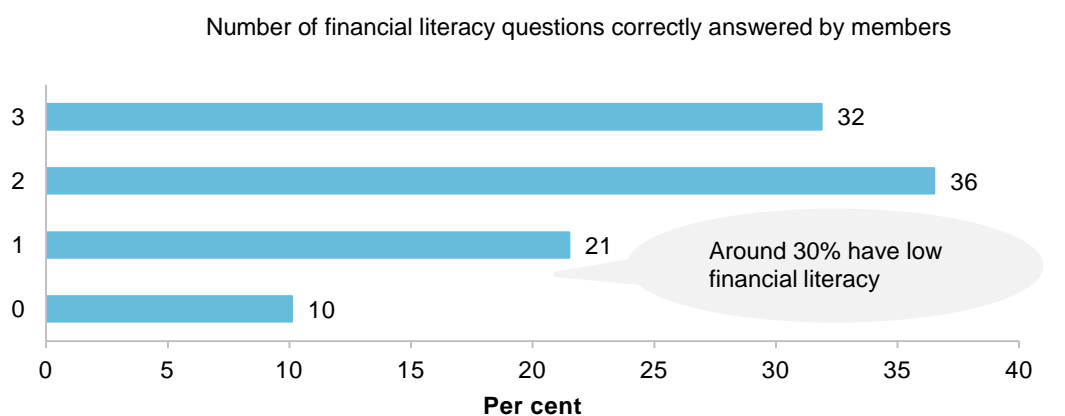
Previous studies have found that certain groups display lower levels of financial literacy on average, such as: young people; women; people with low incomes, wealth and education; immigrants from non-English speaking countries; and Aboriginal and Torres Strait Islander people (Agnew, Bateman and Thorp 2013; ANZ 2015; Bateman et al. 2012; Mercer 2013; PC 2015b; Wilkins 2018). The FSRC also heard evidence and received submissions on the range of other factors facing Aboriginal and Torres Strait Islander people who live in remote areas that compound their already low financial literacy and act to affect their engagement with, and access to, superannuation (FSRC, transcript of proceedings, 13 August 2018, pp. 4704–10; AIST 2018a; ASIC 2018o; PM&C 2018; The Treasury 2018).

Further, evidence on the levels of financial literacy of SMSF members is mixed (Ali et al. 2014; ANZ 2015; Bird et al. 2016b). Bird et al. (2016b) found that while SMSF members on average did not show financial skills that were significantly different from non-SMSF members, they expressed a higher tolerance for risk and a more trusting attitude to financial professionals.

Even if a member's financial literacy is low at a point in time, efforts to enhance it rest on their cognitive abilities. While cognitive ability generally declines with age and cognitive decline in *very* old age can significantly affect the quality of financial decision making (Agarwal et al. 2009), Earl et al. (2015) found a positive link between levels of cognitive ability and financial literacy among older trustees of SMSFs. Recent research on the ageing brain and financial decision making (Mitchell, Hammond and Utkus 2017) found that cognitive performance peaks in the mid-50s, when most people are making retirement plans.

Results from the Commission's members survey are broadly consistent with these observations. Analysis of the financial literacy questions from the members survey suggests that about two thirds of members correctly answered two or more of the three questions designed to test their financial literacy (figure 5.4). The survey also suggests lower levels of financial literacy among members who are young, in default funds, with low incomes and with low account balances (figure 5.4).

Figure 5.4 **Members have moderate financial literacy^{a,b}**



Members correctly responding to at least two of the three financial literacy questions



^a Responses are weighted using Commission weights. ^b Responses of 'Don't know' are treated as incorrect responses.

Source: Members survey.

Superannuation literacy

Most members have a good broad knowledge of superannuation ...

As part of members' capacity to engage, knowledge of the system is also required. Previous studies have consistently found that:

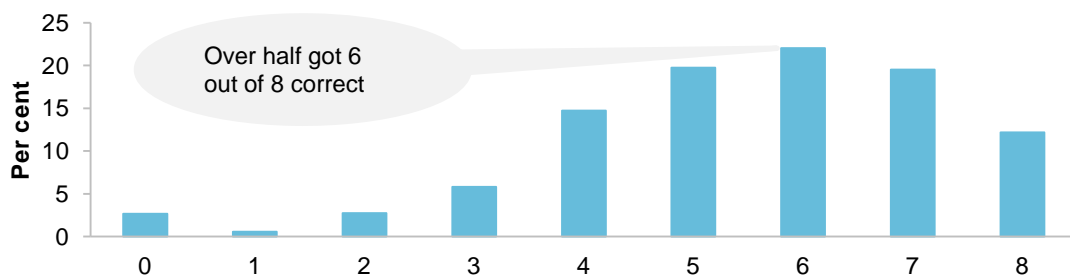
- women tend, on average, to have lower levels of knowledge about superannuation than men, and are more likely to report that they find dealing with money to be stressful (ANZ 2015; Mercer 2013)

- young people tend to have less knowledge of the superannuation system (Ali et al. 2014; ASIC 2016b; Worthington 2008). Financial knowledge generally increases with age, but there is evidence that it then tends to decline in *older* age (Earl et al. 2015; Finke, Howe and Huston 2016).

The members survey tested respondents’ knowledge of a range of statements about the superannuation system. The statements that were mostly answered correctly were: the requirement of employers to make superannuation payments, and the option for employees to make voluntary contributions (tech. supp. 1). However, there were some statements that relatively few members correctly identified (either as true or false) or did not know the answer. Members had relatively low levels of understanding about: the relative tax treatment of superannuation, insurance in superannuation, preservation age, whether employers can give investment advice related to an employee’s choice of fund, and the current level of the Superannuation Guarantee.

Just over half of members correctly identified six of the eight reliable⁴⁶ measures of members’ basic knowledge (figure 5.5). Put another way, members on average correctly identified 5.5 of the 8 statements. Members aged below 30 years tend to correctly identify fewer than the overall average. Older members and members with higher incomes and higher balances were correlated with higher numbers of correctly identified statements, and SMSF and choice members scored higher than default members (tech. supp. 1).

Figure 5.5 Most members know the basics of super^{a,b}
Proportion of correct responses to eight statements testing understanding



^a Responses are weighted using Commission weights. ^b The eight true-false statements are listed in table 1.6, tech. supp. 1. The fifth statement in table 1.6 is not included in this figure due to interpretability concerns.

Source: Members survey.

⁴⁶ The Commission’s Cronbach’s alpha analysis of member’s responses to the nine statements suggests that the fifth statement should be excluded as it is not a reliable measure of members’ knowledge of basic characteristics of superannuation.

... but many lack understanding of superannuation

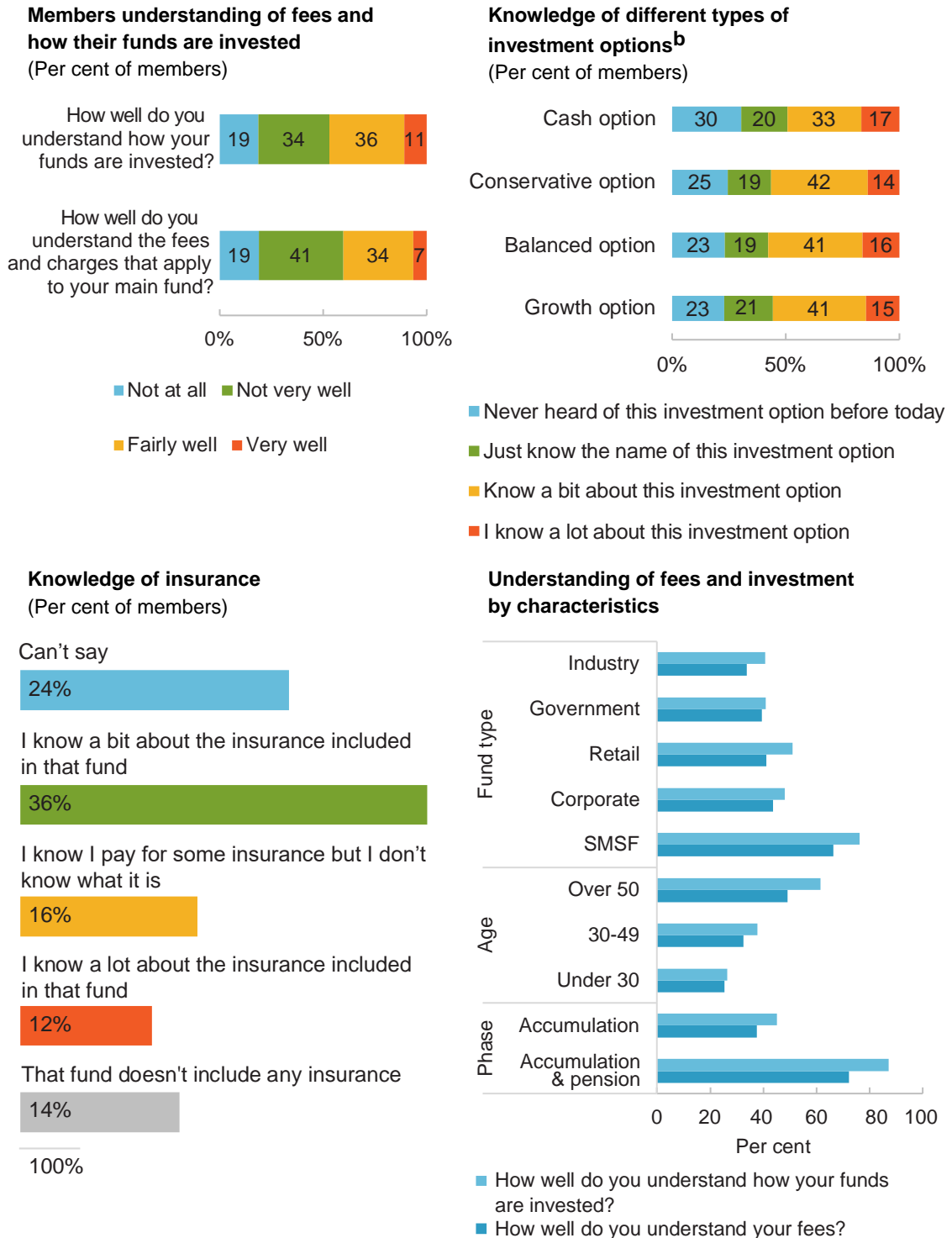
While most Australians have good broad knowledge of the superannuation system, many lack detailed understanding and knowledge of superannuation (often necessary to effectively engage). Members survey results (based on respondents' self-assessment of their understanding) suggest that overall:

- about 40 per cent of members understand 'fairly well' or 'very well' the fees and charges applied by their main fund
- less than half of members understand 'fairly well' or 'very well' how their money is invested by their main fund
- almost 60 per cent know 'a bit' or 'a lot' about the different types of investment options (growth, balanced and conservative) and 50 per cent know 'a bit' or 'a lot' about the cash option
- about half know 'a bit' or 'a lot' about insurance in their main fund
- SMSF members, older members and members with both accumulation and pension accounts claimed to have relatively more understanding of their fees and investments (figure 5.6).

Further, about 7 per cent of members did not know how many superannuation or pension accounts they held. This suggests that campaigns to alert members to the importance of consolidating have to work in clever ways to target some very hard to reach groups. Souvlis et. al (2017) suggested there are subtle differences between different types of disengaged members; which is useful when developing and targeting member education and engagement strategies. Building on a model of engagement (the 'car taxonomy') developed by Souvlis et. al, and the evidence gathered in this inquiry, the Commission has developed and quantified estimates of engagement for five different categories of members (box 5.3):

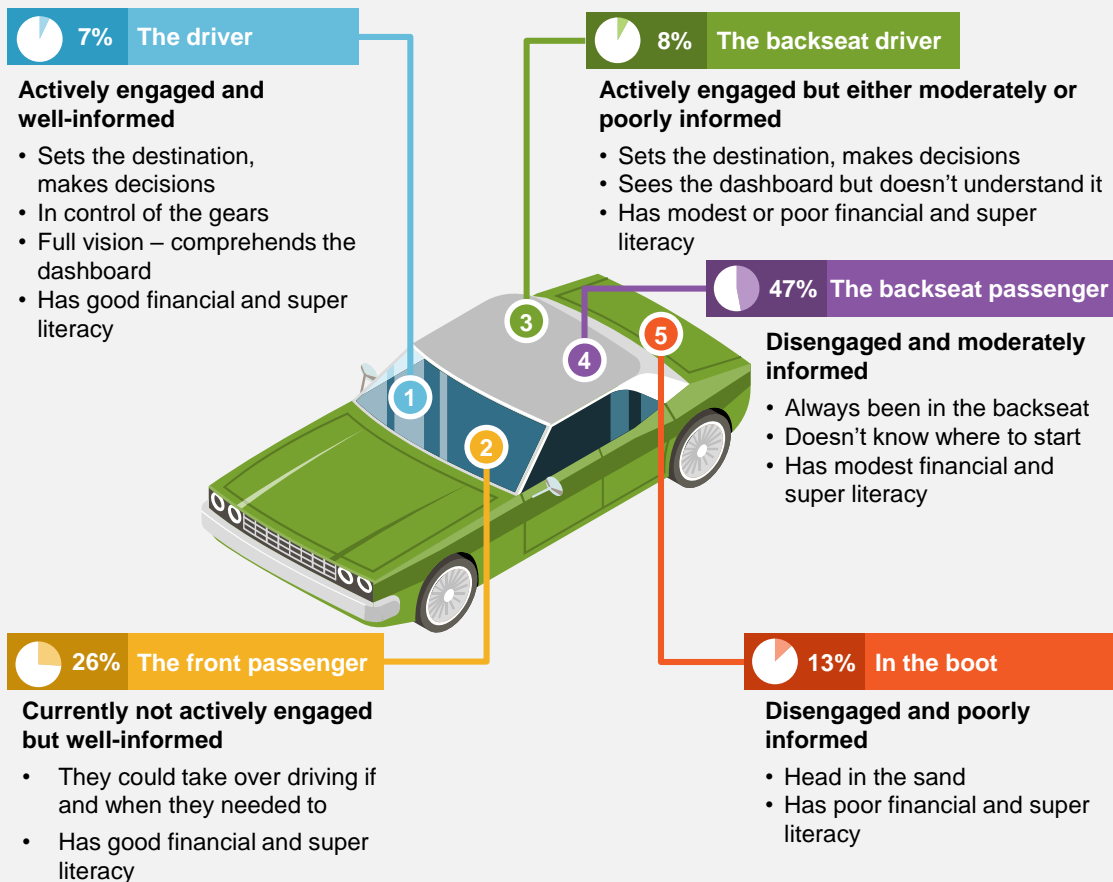
1. 'drivers' are actively engaged and well-informed — they are in control of the direction they're travelling in
2. 'front passengers' are not currently actively engaged but are well-informed — they could take over driving if and when they need to
3. 'backseat drivers' are currently actively engaged but either moderately or poorly informed — they need to learn more about driving
4. 'backseat passengers' are disengaged and moderately informed — they are happy to let someone else drive to an unknown destination
5. those 'in the boot' are disengaged and are poorly informed — they are in the dark and want to stay there.

Figure 5.6 Many members lack understanding of superannuation^a
 But some claim to have more understanding than others



^a Weighted using Commission weights. ^b 'Never heard of this investment option before' includes 'can't say'.
 Source: Members survey.

Box 5.3 Characterising member engagement^{a,b}



^a The Commission's approach to defining and quantifying these characterisations is in tech. supp. 1.
^b Percentages sum to more than 100 per cent due to rounding.

Sources: Adapted from Souvlis et al. (2017, p. 9) and Commission estimates using the members survey.

Costs of engagement

Engagement and decision making is not costless. There are costs in terms of time and learning, monitoring the decisions of providers, and switching products or funds or taking action regarding insurance. Higher costs increase incentives to use advisers to help make decisions (section 5.2).

Tentative evidence from the members survey (based on a relatively small number of respondents who had recently changed funds) suggests that for those who switched their balance into another fund:

- just over half spent less than 2 hours and just over three quarters spent less than 4 hours gathering information for switching to another fund
- 66 per cent were not charged an exit fee (tech. supp. 1).

Further information on exit fees and other costs associated with switching are in section 5.2.

As discussed in chapter 8, while most members find amending insurance cover or taking out new insurance cover to be at least somewhat easy, nearly half of members do not find it easy to opt out of insurance cover. An unresolved question is whether claiming is more or less difficult than claiming on insurance held outside of superannuation.

FINDING 5.1

Across a range of indicators, member engagement remains low on average, though it is not realistic or desirable for members to be engaged all the time. Engagement tends to be higher among those approaching retirement, those with higher balances and owners of SMSFs. Engagement is lowest for the young and those with relatively low balances.

While many Australians have good broad knowledge of the superannuation system, many lack the detailed understanding necessary for effective decision making. Low financial literacy is observed among a sizable minority (about 30 per cent) of members.

5.2 Are active members and member intermediaries able to exert material competitive pressure?

The low levels of engagement in superannuation represent challenges for maintaining demand-side competitive discipline on funds. Ideally, the system needs ‘enough’ engagement to provide demand-side pressure. As occurs among consumers in many other markets, a critical mass of active members exercising informed engagement may not only get the best deals for themselves but also pressure funds to improve their offerings in order to attract and retain members, improving the outcomes for all members. However, as noted at the outset, it is impossible to specify *ex ante* a benchmark size for an ‘engaged’ group that would influence broader outcomes, nor is it easy to predict the effect of such engagement on the outcomes of other members (PC 2016a).

Two (albeit imperfect) signals of active member engagement are fund and investment switching rates.

Fund and investment switching rates are modest

A range of evidence indicates that fund and investment switching rates are modest. While evidence exposed by the FSRC has recently prompted increased switching (figure 5.2), historical estimates of annual fund switching rates vary between 2 and 10 per cent of members. While there are fewer estimates of the annual rate of switching for investment options, they range widely in the order of 6 to 9 per cent, with up to one third of members having ever switched (box 5.4).

Box 5.4 Estimates of fund and investment switching rates

Fund switching

- The Commission previously found very few members switched to another fund in any given year, with less than 2 per cent likely to do so voluntarily (PC 2016a).
- Commission analysis of APRA data reveals that 7 per cent of member accounts switched to another fund in 2015-16.
- Rice Warner's (2017e) analysis of their member-based dataset showed that during 2014-15, 5 per cent of members changed their superannuation fund.
- A recent survey by Customer Service Benchmarking Australia and the Fund Executives Association of around 6000 members from 34 Australian superannuation funds found that around 10 per cent intended to move away from their current fund in the 12 months following the survey (Wootton 2017).
- The Commission's members survey suggests that in the year prior to the survey about 6 per cent of members switched to another fund.
- The Commission's funds survey suggests that around 6 per cent of member accounts switched in the past year, with switching rates higher in retail funds than in industry funds (tech. supp. 2).

Investment switching

- Estimates of the proportion of people who have (ever) switched investment options within their superannuation fund vary, though most suggest that it is less than a third (PC 2016a, box B.6).
- The Commission's members survey suggests that about 9 per cent of members switched investment options in the year prior to the survey.
- The Commission's funds survey suggests that around 6 per cent of members changed their investment options in a given year. This rate is highest among retail funds and lowest among industry funds (tech. supp. 2).

Factors associated with switching funds

Most people do not switch funds. Roughly two thirds of people become default members on entering the workforce or changing jobs, and half of all accounts are in the default product (MySuper) (chapter 1). Further, an estimated 1 million members cannot exercise a choice of fund even if they wished to do so (O'Dwyer 2018b).

The rate of switching funds tends to vary with member characteristics and by fund type. Rice Warner's (2017e) report found that in 2014-15:

- males were slightly more likely to switch funds than females
- the majority of fund switching is concentrated around age 30, then tails off before peaking again just prior to retirement age
- the likelihood of switching funds reduces the longer a person has been with a fund

-
- the retail sector had the highest share of exits across all balance types and was also the primary destination of most fund switches. That said, there was some variation in the likelihood of switching by type of fund. The prospect of switching into an SMSF increased with size of members' balances. In contrast, the prospect of switching into an industry fund was higher among those with lower balances. The chance of entering a retail, corporate or public sector fund, however, varied little by size of balance.

The Commission's funds survey asked respondents to rank the main obstacles faced by members when they decide to switch to their fund. Funds generally agree, regardless of segment, that the time taken to understand and evaluate options is a greater obstacle than the availability of information, which is in turn a greater obstacle than administrative costs. Funds also provide a range of options to facilitate members switching to and from their funds; requests for joining a fund are allowed via writing, email, call centre and online methods for at least 64 per cent of funds. For each of these options, the majority of funds will allow the entire process to be completed via the selected method. Industry funds are more likely and retail funds less likely than the average of all funds to offer each of these major options. Funds responded similarly when asked about the options for moving from their fund (tech. supp. 2).

Results of the members survey indicate that (of those who switched to another fund in the year prior to the survey) most were in the accumulation phase, and aged under 50 years, and nearly half switched into a retail fund while just over one third switched into an industry fund (tech. supp. 1). The greater propensity to switch into a retail fund (irrespective of whether the member is in a retail or an industry fund prior to the switch) is also seen in funds survey data (tech. supp. 2).

Reasons for members switching funds vary but are largely based on members (or their intermediaries) seeking to improve member outcomes.

- Wootten (2017) cited survey data which showed that of those who intended to switch, around one third proposed to do so to achieve better financial returns or lower fees. Another one third planned to switch due to a change in employment, seeking better customer service or to consolidate multiple superannuation funds.
- Commission analysis of Rice Warner's member-based data indicates that a substantial proportion of fund switching in 2017 was motivated by an active decision — of those who switched, 46 per cent was due to consolidation and 37 per cent was due to a decision by the member to switch their balance to another fund (chapter 7).
- The Commission's members survey suggests that just over half (56 per cent) of members switching funds in the year prior to the survey had done so because they had changed employer or the employer had changed funds, with the balance doing so for personal reasons (including being advised by an adviser) (tech. supp. 1).

However, improved member outcomes as a result of switching have not eventuated for some. Rice Warner's (2017e) analysis of member-level data suggests that around half of those switching into an industry, corporate or a retail fund end up paying higher fees (of

around \$83, \$101 and \$263 per year, respectively) and a hefty proportion (over 80 per cent) of members switching into retail funds experienced lower returns (based on four year investment performance to 30 June 2015). Further, in a recent ASIC study of vertically integrated financial advice providers, 75 per cent of advice files reviewed did not demonstrate that the advice complied with the best interests duty in relation to advice to switch super accounts. Moreover, 10 per cent of the files reviewed raised significant concerns about the impact of non-compliant advice on customers, as switching to a new superannuation platform had resulted in inferior insurance arrangements and/or a significant increase in ongoing product fees without additional benefits being identified (ASIC 2018e). This evidence is consistent with other evidence (chapters 2, 3 and 4) that competition in the choice segment has not always resulted in improved long-term outcomes for all members, suggesting that active members (or their intermediaries) have exerted insufficient competitive pressure on funds.

Factors affecting investment switching rates

Previous studies have found that some members are more likely than others to switch investment options. They include: males, members with higher balances and higher incomes; older members; more financially literate members; and those with higher risk tolerances (PC 2016a, box B.6).

The Commission's members survey suggests that (of those who switched investment options in the 12 months prior to the survey):

- members with an SMSF, in a retail fund, aged over 50 years and with higher incomes and balances, and choice members were more likely to have switched options
- almost two thirds had switched to an investment option that they had chosen themselves. Of those (non-SMSF) members who switched to an option chosen by themselves, 72 per cent had switched after undertaking their own research or obtaining advice while around 12 per cent had been persuaded by their fund's marketing or advice to switch to the new investment product/option (tech. supp. 1).

Exit and other costs on new products are not a large barrier to switching or engaging

Exit fees faced by members can dampen their incentives to switch funds and/or investment options. Based on a survey of their members, CHOICE stated:

A number of respondents mentioned exit fees as a barrier to switching. Exit fees on newer products are typically insignificant compared to the increased earnings expected in moving from a poor performing to a good performing fund. ... It is also possible many of the responses came from older consumers on legacy products where exit fees tended to be higher. (sub. 71, p. 8)

More than a decade ago ASIC found that just over half a million Australians had purchased so-called 'old style' accounts from life insurance companies (before the introduction of the

Superannuation Guarantee in 1993) that may be subject to significant exit or termination fees (ASIC 2005).

Today, while exit fees faced by members are relatively common, on average they are not large. The Commission's analysis of SuperRatings data (based on a member with a balance of \$50 000 in 2017), suggests that 46 per cent of assets and 60 per cent of members are in products that include an exit fee. In products with an exit fee, there is a wide dispersion, ranging from \$25 to around \$180 for each withdrawal (chapter 3).

While products are allowed to charge exit fees, regulations restrict them to being charged on a cost-recovery basis. Nonetheless, there is evidence that some exit fees in products remain above cost-recovery levels (chapter 3). While the Government is seeking to legislate to ban exit fees, the Commission supports retaining exit fees at cost-recovery levels (chapter 13).

There are also indirect fees and factors that can affect members' switching decisions in both the accumulation and retirement phases. They are often not explicit fees but may manifest later in a pecuniary form (for example, when moving products triggers a capital gains tax event, or conditions in a long term savings policy or annuity product). The type and extent of such indirect fees and factors, however, is unclear.

As the presence of very high exit and switching fees could preclude switching in existing and legacy products to a more appropriate product, more concerted regulatory oversight will be required. This includes ASIC reviewing whether such fees are unrelated to the underlying performance of the product or unreasonably impede members switching to better products.

Alongside any exit and switching fees, the time spent researching and gathering information to make changes can affect incentives to switch funds or investments.

Results from the members survey (albeit from a modest sample size) suggest that just over half of members spent less than 2 hours gathering information related to switching to another fund. However, just over one fifth (22 per cent) spent more than 4 hours. The small number of observations also meant it was difficult to accurately determine the size of planner/adviser fees among those who used a planner/adviser in their decision to switch to another fund or establish an SMSF.

In summary, modest fund and investment switching rates suggest that active member engagement is low. While exit fees and other costs do not represent major barriers to switching, current workplace-based arrangements prevent around 1 million members switching funds (if they wished to do so). Moreover, a sizable proportion of those who have switched have not achieved better outcomes.

FINDING 5.2

Demand-side pressure in the superannuation system is weak.

- Most members in the accumulation phase let the default segment make decisions for them, at least when they enter the workforce.
- A significant minority of members (an estimated 1 million) are barred from exercising choice even if they wanted to.
- Fund and investment switching rates are modest, suggesting that active members (or their intermediaries) have not exerted material competitive pressure on funds.

Proposed legislative changes to prohibit restrictive clauses in workplace agreements on members' choice of fund are much needed.

5.3 What kinds of information and advice do members need to help them make decisions?

While improving engagement of members cannot, by itself, be relied on to improve the efficiency across the system, providing better information and advice is an important factor in increasing engagement. They strengthen the role of informed decision making in driving competition and efficiency.

The Commission considers that in a well-functioning superannuation system, suitably framed, simple, accurate, accessible and comparable information from a trusted source, and impartial and affordable advice would be expected. Reflecting this, Merton (2014) stated:

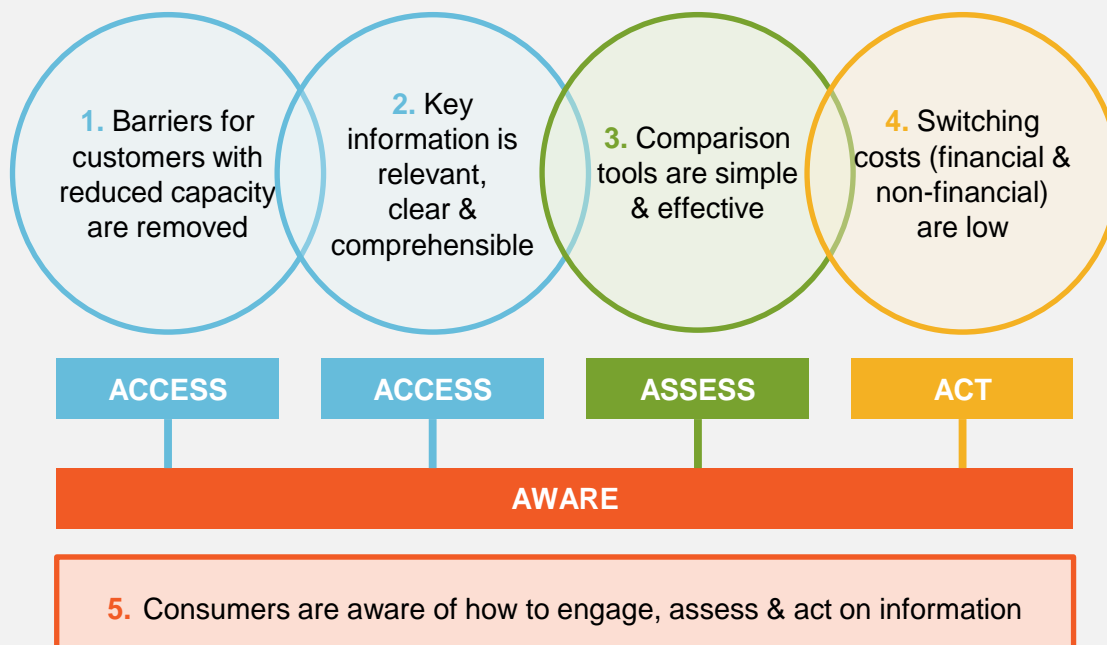
... an effective retirement system must guide savers to good retirement outcomes through clear and meaningful communication and simplicity of choices, during both the accumulation phase and the postretirement payout phase. (p. 11)

The Consumer Policy Research Centre (CPRC, sub. DR196) identified five pre-conditions underpinning effective consumer participation in markets (box 5.5). Oehler and Wendt (2017) suggested similar conditions.

Overly complex information and/or advice will adversely affect members' financial wellbeing and the system's efficiency. The long tail of poor performing products (chapter 2) means that the poorly engaged, less knowledgeable and less financially literate members are perhaps more vulnerable to making poor decisions from lower-quality information and advice than others.

Box 5.5 Five Pre-conditions for Effective Consumer Engagement

The figure below portrays how these preconditions are integrated into a model to focus policy on demand-side interventions.



Source: CPRC (2018), p. 4.

While suitable default and governance arrangements, and prudential regulation, can help to safeguard the interests of members, no matter how engaged, knowledgeable and financially literate they are, the system still needs to help all members' decisions to be *well informed*.

Merton (2014), however, cautioned against simply providing members with more information to help them make decisions. Recent research concluded that 'people don't want more information — they want help to make decisions' (Souvlis et al. 2017, p. 32). CHOICE (sub. DR184, p. 6) stated 'people want a short-cut to the correct answer, not to be drowned in information by every single option'. A range of evidence supports these views.

- Two recent UK-based trials testing different versions of 'wake-up packs'⁴⁷ found that 'information sent to those approaching retirement prompts more action if it is short, simple and succinct' (Adams and Ernstone 2018, p. 5). Indeed, the most effective approach in both those trials was a single page letter. This is consistent with evidence from other trials assessing retirement choices that showed reducing the volume of disclosure can help people pay attention and seek guidance (Glazebrook, Larkin and Costa 2017). In the Australian context, similar conclusions have resulted from the work

⁴⁷ The UK's FCA mandates that firms must provide information to individuals about their retirement savings and how they can access it. This information must be provided approximately 6 months prior to an individual's default retirement date (their 60th or 65th birthday) and a further reminder 4 to 6 weeks after that date.

of Susan Bell Research (2008), Bateman, Lai and Stevens (2012) and Murray et al. (2014).

- The Commission’s choice experiment (tech. supp. 1) suggests that members, especially those aged 35 to 54 years, are much more willing to pay for forms of contact that allow for personalised assistance (such as online chats) than fund-provided measures (such as newsletters and seminars). Stage 1 study participants also submitted that the majority of members wanted access to simple, lower-cost advice (rather than comprehensive advice).

The need for well-designed information and advice also varies across members with different characteristics, and over the life cycle (box 5.6). A well-designed and efficient system will cater for these different needs in the most cost-effective way.

Box 5.6 Information and advice: each to their own

Information and advice requirements vary by type of member

When members are disengaged

... they require little as they rely on the default system to choose a fund and then select investment options and some features (mainly insurance) on their behalf.

When members are engaged

... they require (and use) more information and advice to help them navigate the system and make optimal decisions about their retirement savings, including: those leaving the default system (CHOICE, sub. 71); those contemplating creating and while running an SMSF (Kingsley, sub. 22; Bird et al. 2016a, 2016b); those changing jobs; and financially literate members (PC 2017d).

... and over a member’s life

Early on

... when choosing a fund, information on the set of products (including insurance), investment options, associated risks and fees is important (for those engaged members who wish to access this type of information). When deciding on which fund to choose, younger people tend to value input and guidance from financial advisers, employers, and friends and family more than older groups (PC 2017d).

Approaching retirement

... information about how different accumulation products trade off various risks and combine a member’s expected income needs with the need for continued investment growth becomes paramount (PC 2016a; First State Super, sub. 37).

At retirement

... deciding how to draw down their balance is a key life cycle decision for each member. Given its inherent complexity, many retirees need and use pertinent information and advisory services to help make this decision, especially when choosing some largely irreversible longevity risk products (chapter 4).

Funds, regulators and government all play a role in ensuring meaningful information and impartial advice

Superannuation funds are required to disclose information on investment performance, costs and fees to help members make better decisions. The funds survey suggests that funds *believe* they provide adequate information to a ‘reasonable’ member,⁴⁸ with industry funds being more confident of this than retail funds (tech. supp. 2).

In addition, funds provide different types of advice services to their members. The Commission’s funds survey suggests that responding funds spend an estimated \$154 million annually (representing around 0.02 per cent of their total assets) on different types of advice and tools to help members plan, with most on general and superannuation advice and least on planning tools (tech. supp. 2). Some funds have been embracing online and digital capabilities and tools to do this (AustralianSuper, sub. 43; REST, sub. 49; and IFAA, QIEC and Club Super, sub. 53). Although still in the early stages of development, a few funds had begun to recognise the benefits of digital advice, partnering with digital advice platforms to roll out the capability to their members (Chong 2018).

Three regulators — APRA, ASIC and the Australian Taxation Office (ATO) — are the most prominent regulators of superannuation (chapter 10). These bodies and others also seek to make sure that meaningful information and impartial advice is provided to members (box 5.7). How well funds, financial advisers and regulators perform these different roles and/or achieve these aims is considered below and in later chapters.

Finally, improving the financial literacy of members is a role undertaken by government and regulators as well as some non-government organisations. The Australian Government’s National Financial Capability Strategy (NFCS) (ASIC 2018h) — formerly known as the National Financial Literacy Strategy and administered by ASIC — is the most substantial among the abundance of financial literacy programs operating in Australia at any one time (PC 2015b). The Commission (PC 2015b) previously suggested that systematically evaluating these many programs would enable better targeting of resources to the most cost-effective programs. Since the release of the Commission’s 2015 report a systematic evaluation of all the programs has not occurred. However, ASIC advised that in December 2018 it would hold its first Financial Capability Research Forum to share recent findings, explore research priorities, and ‘inform future research and encourage innovative methodologies to better understand the impact of financial capability interventions’ (ASIC, pers. comm., 15 October 2018, p. 1). Given a recent review of the international literature concluded that financial education interventions can be effective but the effects are small and seem to depreciate rapidly over time (Beshears et al. 2018, p. 224), it is important for initiatives in this area to be cost-effective and subject to formal, independent evaluation for funding to continue beyond the forward estimates.

⁴⁸ In the funds survey, a ‘reasonable’ member is defined as someone with an average level of financial and superannuation literacy.

Box 5.7 Policies and programs focused on the provision of information and advice

Information

The Australian Government and regulators have an important role in increasing transparency and reducing the complexity of information relating to the superannuation system through reporting standards and disclosure requirements on funds (ASIC 2017a, 2017e, 2018b; PC 2016a; chapter 9).

Presenting relevant information in an accessible format for all members (and their advisors/agents) is a key strategy. For example:

- the 'Superannuation and Retirement' section of ASIC's MoneySmart website includes a *Financial Decisions at Retirement* booklet and the recently developed Financial Advice Toolkit (to help people evaluate financial advice they receive) (ASIC 2017b)
- the Department of Human Services (DHS) provides the Financial Information Service, which presents information online, through regular public seminars, a call centre and via one-on-one sessions (ANAO 2016; DHS 2017)
- as part of the Government's 'More Choices for a Longer Life' package, the 2018-19 Budget provided funding to send letters to Australians aged 45 and 65 to encourage them to assess their health, employment options and finances, using an online digital tool (Commonwealth of Australia 2018a)
- the Australian Government has also committed to introducing a Retirement Income Covenant (chapter 4). It will then progress the development of simplified, standardised metrics in product disclosure to help people make decisions about the most appropriate retirement income product for them (Treasury 2018e)
- for prospective and current SMSF owners, complementing the ATO's information (ATO 2018g), is ASIC's tailored information on its MoneySmart website (ASIC 2018m), which includes an information sheet (ASIC 2013e) and a link to a free on-line Self-Managed Superannuation Fund Trustee Education Program (CPA Australia and Chartered Accountants Australia and New Zealand nd), designed to assist trustees in understanding their role and responsibilities.

Advice

The Australian Government's **Future of Financial Advice (FoFA)** reforms in 2013 were designed to improve governance arrangements, particularly relating to conflicts of interest and transparency, in all fields of financial advice. The reforms included:

- bans on conflicted remuneration structures, including commissions and volume payments (although not for existing commission arrangements in super or retail life insurance), in relation to the distribution of, and provision of advice about, retail investment products including managed investments, superannuation and margin loans
- bans on upfront and trailing commissions and like payments for both individual and group risk insurance within superannuation
- a ban on soft-dollar benefits (monetary and non-monetary benefits) received by financial planning firms, representatives and associates in relation to both retail investment products and insurance within superannuation, where a benefit is \$300 or more

(continued over page)

Box 5.7 (continued)

- requirements for advisers to request retail clients to opt in (or renew) their advice agreement every two years, with ASIC being given the power to exempt advisers from the opt-in obligation where it is satisfied that the adviser is signed up to a professional code which obviates the need for opt in
- the introduction of a best interests duty so that advisers must act in the best interests of their clients, subject to a 'reasonable steps' qualification, and place the best interests of their clients ahead of their own when providing personal advice to retail clients (PC 2012).

Minor amendments to these laws were made in November 2015, with the most substantial change being an extension in the timeframe (from 30 days to 60 days) for financial advisers to send renewal notices and fee disclosure statements to clients (O'Dwyer 2015b). In 2015 ASIC (which administers these laws) introduced a Financial Advisers Register (ASIC 2017c).

In 2017, the Australian Government established the **Financial Adviser Standards and Ethics Authority Limited (FASEA)** to set the education, training and ethical standards of financial advisers giving personal financial advice. At the same time, the professional standards for financial advisers were lifted, so that over the period 2019 to 2024 all relevant providers of financial advice must: have a relevant bachelor or higher degree (or equivalent); pass an exam; meet ongoing professional development requirements; complete a professional year and comply with a code of ethics (ASIC 2018i). Following a consultation process, FASEA (2018) recently released a summary of the key parameters for each of the standards to be reflected in proposed legislative instruments.

5.4 Better information is needed to help members compare products

Information is complex and overwhelming for many members

Despite funds being required by law to disclose information on costs and fees to help members make better decisions, a range of submissions and evidence suggests that superannuation information remains complex and overwhelming for many (Bucknell, sub. 16; AIST, sub. 39; AustralianSuper, sub. 43; IFAA, GIEC Super and Club Super, sub. 53; CHOICE, sub. 71; AIA Australia, sub. 76). Several recent studies have concluded that the current summary disclosure formats are ineffective, potentially leading members to make poor and even perverse decisions (Bateman et al. 2016a, 2016b; Thorp et al. 2018). And ASIC's recent work on members' experiences with super funds raised a number of concerns relating to information, such as: poor disclosure of insurance details to members; the low prominence of product dashboards; and inconsistencies between funds in the contents of dashboards (ASIC 2017e). KPMG (sub. DR183, p. 5) stated that product disclosure Statements (PDSs) are 'very rarely aligned to members' needs'.

These views echo the findings of earlier reviews (Cooper et al. 2010a; Murray et al. 2014). And participants in the stage 1 study (PC 2016a) acknowledged that while there have been improvements in the quality of information provided to members in recent years, there was

scope for further improvement in multiple areas including: more consistent reporting on fees and returns across a wider range of products; more granular reporting of costs and fees; and other revisions to dashboards.⁴⁹

Further confirmation is provided in results from the Commission's members and funds surveys discussed below. The unhealthy product proliferation found in chapter 4 is a key factor contributing to members feeling swamped by too much information.

The results from the members survey point to a desire for greater transparency across a range of aspects — from the administration fees charged by their fund to the risks involved in investing in superannuation (tech. supp. 1). The proportion seeking information specifically on how to consolidate accounts (16 per cent) appears comparatively low, although perhaps not surprising given that the majority of members in the survey (77 per cent) indicated they held only one account.⁵⁰ (Although 6.5 per cent said they did not know how many accounts they held, and of those who held more than one account, just over one fifth did so deliberately (tech. supp. 1).)

Further, many members need help to understand and compare the performance of different products. As discussed earlier, close to 60 per cent of members do not understand their fees and charges, and around 40 per cent lack an understanding of investment options. Given its effects on long-term net returns for members, this lack of understanding (especially when combined with the contrary member satisfaction ratings in these two areas) is concerning. It may also indicate that being satisfied with information provision may not reflect a genuine understanding of the products on offer.

As it is difficult to materially improve financial literacy, framing information in a way that guides choices is likely to be more helpful to members. The way default arrangements are modernised through the Commission's 'best in show' arrangements (chapter 12) will also help to simplify choice for everyone in the system.

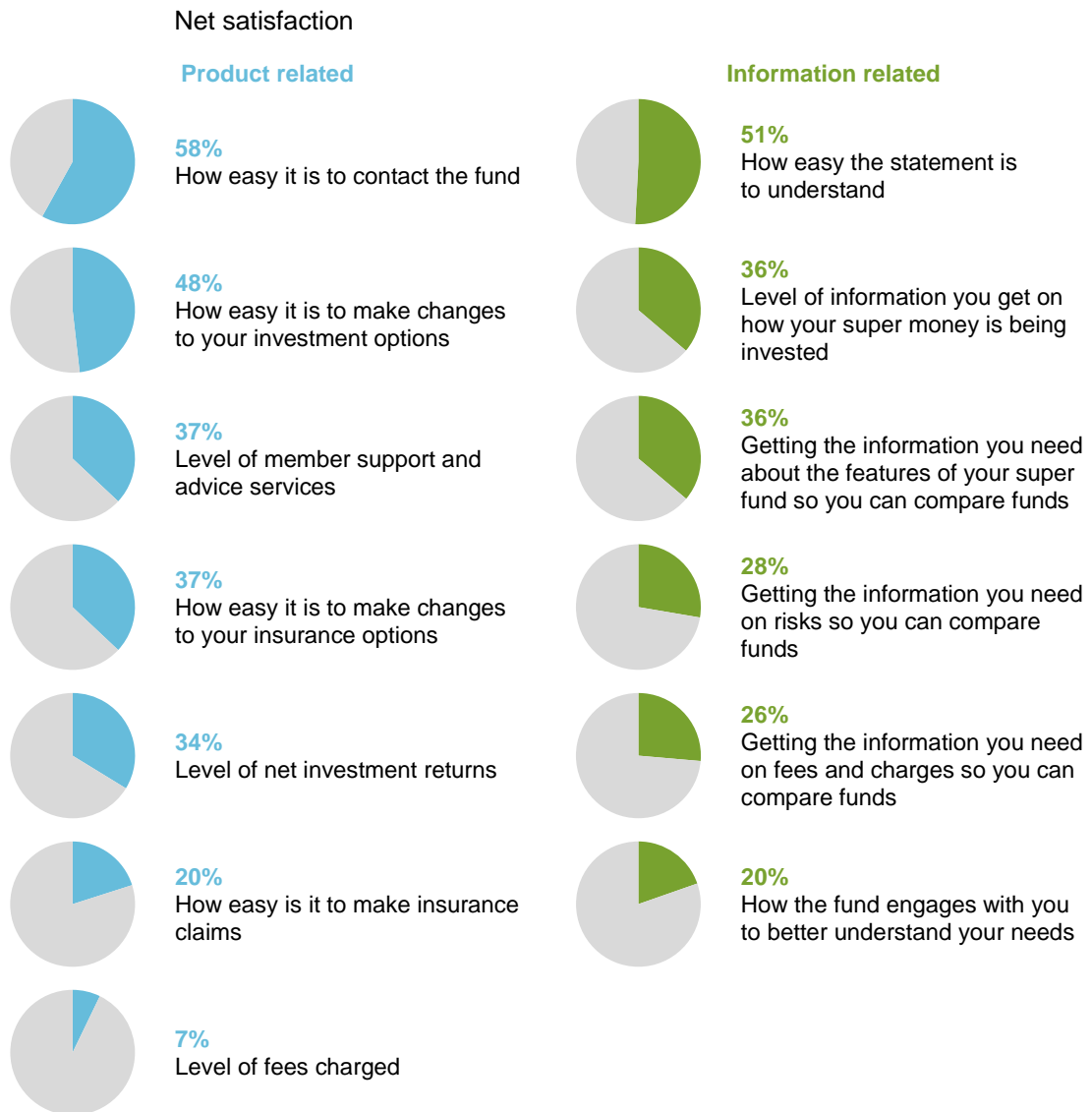
The members survey suggests that higher levels of net satisfaction are observed among some product-related features while lower levels of net satisfaction by members are observed on several information-related elements, including: how funds engage with members to better understand their needs, providing information to make comparisons with other funds, and the level of information on how members' superannuation money is being invested. That said, members' net satisfaction is the lowest when considering the level of fees charged (a product-related feature) (figure 5.7). On average, younger members are generally less satisfied with these elements of their main superannuation fund (tech. supp. 1). This is

⁴⁹ MySuper product dashboards must provide factual information on: the return target, the returns for the previous financial years, a comparison between the return target and the returns for previous financial years, the level of investment risk and a statement of fees and costs (ASIC 2014a, 2014b). Product dashboards in the choice segment will also require funds to publish key information about choice investment products on the fund's website (ASIC 2016d).

⁵⁰ This compares with a figure of 60 per cent based on ATO data (figure 6.4). This difference illustrates members' lack of awareness of unintended multiples and the likely margin of error in survey data.

concerning as younger members stand to benefit more in the long run from informed engagement.

Figure 5.7 Members' net satisfaction across different elements varies widely^{a,b,c}



^a Responses are weighted using Commission weights. ^b Note that some questions were not asked of members whose main fund is an SMSF. Members with no superannuation fund (that is, those only holding retirement products) were not asked these questions. ^c Net satisfaction is calculated as the proportion (excluding those giving 'can't say' responses and those not asked) who stated they were 'highly' or 'somewhat' satisfied, less those who stated they were 'highly' or 'somewhat' dissatisfied.

Source: Members survey.

While net satisfaction levels in the funds survey cannot be directly compared with those of the members survey, a comparison of the relative ranking of net satisfaction across some

common elements suggests that members' and funds' perspectives of members' net satisfaction are broadly similar (tech. supp. 1).⁵¹

Problems identified with dashboards

Even though information on different products and their features (including often complex insurance options within superannuation) is available on many funds' websites or through ratings agencies, gathering intelligence on a large array of products — including through PDSs — to compare the different options available is no easy task.

While product dashboards aim to enable members to compare superannuation products, they remain (at best) a work in progress.

Dashboards for choice products were scheduled to become mandatory from 1 July 2015. Delays with finalising the necessary legislation and regulations have seen the start date pushed out at least twice. As of 1 June 2017 the start date was set for 1 July 2019 (ASIC 2017a). AIST (sub. 39) noted that these delays coupled with Australian Government plans to amend the law so that funds would only need to produce dashboards for their 10 largest choice options mean that:

Members of choice products/investment options do not have a dashboard and so cannot easily compare their returns, fees or costs with MySuper products. ... [and], dashboards will not be required for most choice investment options. (p. 33)

Meanwhile, dashboards for MySuper products (mandatory since 31 December 2013) have attracted criticism (PC 2017d, box 5.3). Not least, information from a 2017 ASIC assessment of 14 funds indicated that some dashboards are missing mandatory elements and some are unduly difficult to locate (ASIC 2017e). ASIC drew similar findings from a 2014 review, prompting further guidance to trustees about their obligations (ASIC 2014a). Moreover, MySuper products (which are meant to be 'no frills' type products) are increasingly difficult to compare with the approval of more life-cycle MySuper products over time (chapter 4).

Dashboards also need to be *salient* to be effective. ASIC's surveillance work on dashboards has revealed that MySuper dashboards are often buried several clicks away from the homepage (ASIC 2014a). The Commission's funds survey suggests that retail funds report an average of 1.9 'clicks' are required to go from their homepage to access product information, compared with 2.4 'clicks' for industry funds (tech. supp. 2).

In response to the Commission's draft report, participants largely concurred with the Commission's view that information is often overwhelming, and dashboards require revising and simplifying to better meet the needs of members (for example, Roll-it Super, DR113;

⁵¹ The funds survey results suggest that funds use different sources of information to gauge their member's satisfaction, and that industry funds use surveys of their members combined with other sources of information (such as focus groups or member feedback) while retail funds make comparatively limited use of these sources (tech. supp. 2).

KPMG sub. DR183; Bateman and Thorp, sub. DR200; APRA, sub. DR204; ASIC, sub. DR206).

FINDING 5.3

While there is no shortage of information available to members, it is often overwhelming and complex. Dashboards should be a prime mechanism to allow for product comparison and need to be salient, simple and accessible to be effective — but most are not, and regulators have left this unresolved.

Better dashboards are much needed

A one-page dashboard is the foundation stone required to make product comparisons — and as such should be mandatory for all default and choice products. The differences between MySuper and choice dashboards should be kept to a minimum.

Producing dashboards involves costs for funds, but those costs have to be weighed against the benefits to members, advisers, researchers and consumer bodies from providing salient, good quality, standardised information.

While there are challenges in designing and implementing dashboards, perfection should not be a barrier to the possible.

Designing simple but meaningful dashboards for all products

Behavioural economics points to the importance of *keeping it simple* to draw the attention of members (Gabaix 2017). The Consumer Policy Research Centre (CPRC, sub. DR196, p. 9) suggested potential lessons could be drawn for designing dashboards from behavioural research in other complex markets such as energy and telecommunications.

While participants generally supported the notion that ‘less is more’ in dashboards, some participants suggested more information should be displayed on dashboards. For example, Ringrose (sub. DR107) and Chant West (sub. DR191) contended that dashboards should incorporate measures of long term risk (that is, the risk of running out of money in retirement) alongside the standard (short term) risk measure. And the CPRC (sub. DR196) suggested incorporating information on service and quality on dashboards.

Prime Super (sub. DR158) argued against isolating different types of costs but to include *all* costs when calculating net returns and publishing them on dashboards. The way in which costs are borne in superannuation can be complex. As McShane’s (2018) *Review of ASIC Regulatory Guide 97: Disclosing fees and costs in PDSs and periodic statements* stated:

Consumers ... do not get an invoice that needs to be paid separately, some amounts are taken out of their contribution money before it is invested, some amounts may be taken out of their account (even this is somewhat difficult to explain given that accounts are on the whole only a notional

concept), most is taken out of the pool of money and assets their contributions are invested into, some is paid for by other parties (e.g. borrower costs and tax benefits) and some is taken out on entry and/or exit as part of the buy/sell spread. (p. 155)

Hence standardising often complex costs and fees will enable engaged and capable members to use dashboards to compare this intelligence across funds, and pull out specific disclosure information as needed. (Standardised data on costs and fees is considered below in the context of better disclosure.)

The Commission is conscious that presenting complex information on one-page dashboards in a meaningful way is highly challenging, but false precision should not become a barrier to finalising the methodology required to establish dashboards for all products. Dashboards should minimise industry jargon to help less financially literate members understand them (CPRC, sub. DR196). Moreover, consumer testing should support the development and implementation of the single-page dashboards (Bateman and Thorp, sub. DR200). Further, publishing the results and incorporating a feedback loop to ensure policymakers and regulators learn about what works (and what does not work) would also be valuable (CPRC, sub. DR196).

In re-designing one-page dashboards, ASIC should consider McShane's (2018) proposals, advice from consumer experts and advocates, and be accompanied by rigorous and comprehensive consumer testing.

Despite some submitters (IOOF, sub. DR138; BT Financial Group, sub. DR149; MLC Wealth, sub. DR174; Chant West, sub. DR191) cautioning against including *all* choice options, the Commission's view is that *all* products should be required to have one-page dashboards, with exceptions only granted on the basis of evidence under the principle of 'if not, why not'.

Making dashboards accessible and prompting members to access them

One way to improve the prominence of the 'new and improved' dashboards is to have them easily accessed online by members and others, such as researchers or consumer bodies. This arrangement would enable members to assess the products on offer and switch to more competitive offers (CHOICE, sub. 71, p. 4).

To enable easy comparisons of a member's current super product(s) to those on the 'best in show' shortlist, dashboards for the member's product(s) should be available via a direct link on the Commission's proposed centralised online service hosted by the ATO (chapter 12) to a website which hosts all the dashboards.

Participants generally supported the notion of publishing dashboard information on a single website and ASIC (sub. DR206) argued in favour of using its MoneySmart website. (Other participants were less prescriptive about what form the centralised website should take (Goodwin, sub. DR115; Bateman and Thorp, sub. DR200).)

To make it easier for members to see how their product is performing and, if desired, switch to a new product and/or fund, ASIC (sub. DR206, p. 10) stated ‘... with appropriate resources, ASIC would work with the ATO and myGov to ensure relevant information is readily and seamlessly accessible to consumers through those sites and services’.

The Commission considers that ASIC and the ATO will need to develop and deploy proactive prompts for members to access dashboards published on ASIC’s MoneySmart website. ASIC and the ATO (while drawing on relevant experts) should consumer-test what prompts work best. For existing members without myGov accounts or who are unlikely to use the centralised online service, alternative avenues to initiate prompts will need to be considered.

Supporting decision making further through comparison tools

Once one-page dashboards have been bedded down and published on MoneySmart, to further enhance supports for member decision making, ASIC should consider developing a comparison tool (based on a searchable database with a consumer-friendly interface) on MoneySmart. (Such a tool would also need to be supported by an ongoing awareness campaign (CPRC, sub. DR196).) For example, REST (sub. DR171) submitted:

While product information is helpful, Rest believes it is important to provide greater context to help consumers make the most of any information. We believe greater investment in tools designed to support consumer decision making will deliver better member outcomes than prescriptive product information alone. (p. 16)

While supporting the approach of the centralised website, the Association of Financial Advisers (sub. DR173) was concerned:

... that the complexity of having all product dashboards on the one single website may be overwhelming for consumers unless there was some mechanism for simplification and summarising. (p. 8)

To support the development of such a tool and provide a framework to capture different levels of information targeted to different categories of consumers (that is, members, intermediaries acting to help guide consumers or researchers), a ‘layered’ approach to the provision of information could be considered in the future. Such consideration should occur only once the one page dashboards have been developed, rolled out for the benefit of both default and choice members, and evaluated.

More effective product disclosure can also help fill information gaps

More sophisticated members and intermediaries who seek more detailed information than is available on dashboards will generally turn to PDSs. But the industry needs to lift its game on disclosure (particularly around insurance offerings) (chapters 3 and 9) with a re-orientation from risk aversion to helpfulness. While the exposure of egregious behaviours by the FSRC has led to some members switching (see above), there is a growing body of

evidence that disclosure in financial markets only has a modest impact on switching behaviour (Adams and Ernstone 2018). Nonetheless, improvements in disclosure documents are needed.

Simplifying PDSs

As PDSs are legal documents that disclose often technical and complex information ‘... a balance needs to be struck between providing more detailed information and keeping messages simple and digestible for consumers’ (McShane 2018, p. 155).

Under the *Corporations Act 2001* (Cth) (s. 1013C(3)), the shorter PDS regime — which came into force in 2012 — requires disclosure for certain financial products to be presented in a ‘clear, concise and effective manner’ (up to a maximum of eight A4 pages). While this shorter PDS regime will help, as superannuation platforms continue to be excluded⁵² some PDSs swamp members, with some extending to hundreds of pages (Donnelly 2018).

But making PDSs simpler for members to digest is no easy task given many members are disengaged from super and many are unlikely to have the required capability to correctly interpret even the shorter PDS — most will want to either avoid or short cut this exercise. Hence, dashboards (and insurance ‘key fact sheets’ (chapter 8)) sitting atop PDSs can help meet the competing goals of transparency, detail and digestibility.

The Commission also anticipates that a range of intermediaries — possibly also drawing on more detailed publication of standardised information (see below) at a more granular level to make assessments when comparing performance across many funds and products — would help to synthesise and simplify matters for all members (especially those with poor financial literacy), and ensure the system works well for those who are disengaged. Complementing this, the CPRC (sub. DR196, p. 7) is undertaking research to develop a ‘meaningful and relatable consumer service and quality metric for consumers choosing between superannuation providers’.

Standardising costs and fees will help

There is much scope for ASIC, as the primary regulator in this area, to revise disclosure requirements for superannuation funds in response to McShane’s (2018) proposals on standardising costs and fees, and proactively enforce them (chapter 9). ASIC (2018d) plans to release a consultation paper by the end of 2018 in response to McShane’s report. It has also been reported that ASIC’s proposed changes to RG97 are seeking to be both ‘practical for funds to implement, while also providing transparency and usable information for consumers’ (Uribe 2018, p. 1).

⁵² ASIC (2018b, p. 1) stated: ‘... As multifunds, superannuation platforms and hedge funds are complex products, there are questions about the appropriate application of the shorter PDS regime to these products’, and that this relief has been extended while the Government further considers the policy position.

5.5 Finding affordable and impartial advice on super is challenging

The deficiencies with financial advice are many

Problems with personal financial advice (defined in box 5.8) were highlighted by Cooper et al. (2010a), Murray et al. (2014), and the Commission's (2018a) inquiry on *Competition in the Australian Financial System*. Most recently, the FSRC classified the issues that had emerged in connection with financial advice into three categories:

- *culture and incentives*, raising questions about how industry participants are paid
- *conflicts of interests, and confusion of roles*, including questions about FoFA's treatment of conflicts of interests and whether they can, and should be 'managed', and the structural issues stemming from vertically integrated entities
- *regulator effectiveness*, including questions covering what responses regulators should make and whether responses have been satisfactory (FSRC 2018e, pp. 329–40).

The fact that advice on superannuation, retirement and SMSF-related matters represented over half of the Australian financial advice industry's revenue in 2016-17 (FSRC 2018e, p. 103) along with the case study-based evidence presented at the superannuation round of hearings at the FSRC (for example, ASIC 2018o) suggests that superannuation members are not immune from these problems.

Of the small share of people who switch super funds of their own accord (section 5.2), most seek professional advice. In 2014 around two thirds of those who sought advice when switching funds obtained advice from a professional financial planners, advisers and/or accountants (Roy Morgan Research 2015b). Roy Morgan's research also found that those who did not seek advice tended to have lower balances and lower incomes. Those switching into an SMSF or retail fund tended to acquire advice from financial advisers or accountants while those switching into industry funds were most likely to obtain advice from an employer or friend/family.

Many recipients of financial advice do not know whether the advice they are receiving is good or bad (ASIC 2012b) and acquiring *impartial* superannuation advice can be hit and miss. ASIC's (2018e) review of financial advice in vertically integrated institutions suggested that some financial advice services lacked impartiality and harmed members. Inappropriate advice and non-compliant advice is most common in relation to switching funds, establishing an SMSF and practices that erode member balances (ASIC 2018k, 2018l).

Box 5.8 What is currently defined as personal, scaled, intrafund and general advice?

The *Corporations Act 2001* (Cth) requires those providing advice to comply with certain conduct and disclosure obligations depending on the type of advice provided, with the strongest obligations applying to the provision of personal advice (ASIC 2017d).

Personal advice

Personal advice is financial advice customised to a person's situation. It typically involves a recommendation or a statement of opinion intended to influence a person's decision about a particular financial product or type of products. Financial advisers are generally required to hold an Australian Financial Services Licence (AFSL) and are subject to the best interest duty obligation (box 5.7; PC 2018a).

Scaled advice

Scaled advice is personal advice that is limited in scope (for example, retirement planning). It remains subject to the best interest duty obligation regardless of the scope of the advice. Financial advisers must take reasonable steps to explain the limited scope of such advice (ASIC 2012a). Funds must charge members individually for scaled advice (ASIC 2013c).

Intrafund advice

Provided the super fund holds an AFSL, it can advise members on switching between investment options, whether to make additional super contributions and the level of insurance cover held with the fund. Under this limited exemption, the fund *cannot* provide advice on switching super funds, or advice on financial products outside super, or advice on general retirement planning (FPAA 2017a; Power 2018). Funds may collectively charge all members for certain types of intrafund advice (ASIC 2013c).

General advice

General advice does not take into account a person's particular circumstances, such as their objectives, financial situation and needs. For example, if an adviser provides information about a product that might be suitable for you, but does not take into account the person's financial goals or actually recommend a person takes up a product, then it is general advice (ASIC 2017h).

Finding affordable financial advice is also difficult: 30 per cent of consumers (who had not sought financial advice and did not intend to do so in the future) said that the high cost was a key reason for not seeking advice (FPAA 2017a). About half of the Australian population had unmet advice needs — with consumers only willing to pay much less for advice than it costs. Estimates of the average amount consumers are prepared to pay for personal advice range between \$300 and \$400 (Rice Warner 2018a) to \$750 (Investment Trends 2016, 2017) compared with the estimated cost of financial advice ranging from a minimum of \$1500 (Rice Warner 2018a) for a basic regulatory-compliant offering to an average of \$2500 (Investment Trends 2016, 2017).

While not all of this unmet need for impartial, quality and affordable financial advice is in relation to superannuation, given the large proportion of Australians with assets in super and over half of the revenue of financial advisers relates to superannuation (PC 2018b,

figure D.7), a fair proportion is likely to include demand for advice on superannuation-related aspects.

Bearing all this in mind, the Commission supports the conclusion, reached by the authors of a qualitative study commissioned by CHOICE, that:

... a gap has opened up for a safe place to go for independent, unbiased advice that will work in people's best interest. There is a need for a trusted adviser with no self-interest that will break down the jargon and help people make decisions quickly and easily. (Souvlis et al. 2017, p. 18)

Helping members access impartial, quality advice

It is hard to escape the conclusion that despite the 2015 FoFA reforms, the presence of conflicted financial advice remains both egregious and problematic. And while the FASEA reforms (box 5.7; ASIC 2018i) — especially when combined with greater regulatory enforcement — will help to lift the quality of advice, the FASEA reforms do not address the fundamental problem of conflicted financial advice. And they also reduce the supply of advice services and increase their costs (Pennington 2018; Taylor 2018).

As the fundamental problem of conflicted advice affects the financial services sector more broadly, this problem cannot be addressed in the superannuation sector alone. Nonetheless, a number of the Commission's proposals in this inquiry will support informed member decision making and reduce its cost, and help to reduce the likelihood of poor financial advice in this complex area. These include the Commission's proposals to:

- improve the saliency of dashboards and disclosure, which would help members make (and financial advisers inform) better decisions
- establish easy-to-understand and credible 'best in show' benchmarks (chapter 12), which would also help members compare alternative funds and products (and switch if desired) as well as provide discernible (and unavoidable) 'if not, why not' points of reference for financial advice
- remove grandfathered trailing commissions (chapter 3), which would minimise the conflicts they promote
- lift the quality of products across the board via an elevated outcomes test (chapter 10), which would remove the risk of a member switching to a particularly poor product
- enhance governance arrangements (chapter 9), which would better manage conflicts of interest in vertically-integrated organisations
- establish a well-resourced, independent member advocacy and advisory body (see below), which would boost the voice of superannuation members on financial advice policy deliberations (among others), and help members interpret complex information reducing the need to resort to expensive financial advice.

Further supporting these are several recommendations from the Commission's inquiry on *Competition in the Australian Financial System* as well as proposals from ASIC (box 5.9).

These are broadly consistent with the Commission’s proposals (below and in chapters 9, 12 and 13).

Box 5.9 Other proposals designed to improve the quality of advice

The Commission’s *Competition in Australia’s Financial System* inquiry (PC 2018a):

- recommended renaming the term ‘general advice’ defined under the FoFA legislation, as it has led many consumers to think they are receiving advice relevant to their personal situation when they are only being provided with product information or marketing material. Hence the term ‘advice’ should only be used in association with advice that takes into account personal circumstances (pp. 290–95)
- recommended augmenting ASIC’s ability to strengthen existing regulations for financial advice obligations through enhanced reporting and publication of products on ‘approved product lists’ by AFSLs (pp. 295–98).
- encouraged the development of credible digital advice services (delivered by unconflicted providers) — especially when used in conjunction with ready access to a person’s electronic financial records. It also stated that this development held much scope as an alternative source of impartial and affordable advice that could be delivered by new entrants or existing providers (pp. 299–300).

ASIC’s (2018) submission to the FSRC discussed a range of potential further remedies to address the problem of conflicted financial advice, including:

- more heavily regulating specific types of financial advice, such as on superannuation in a sales context and restricting unsolicited sales of superannuation
- preventing the automatic deduction of fees for financial advice from superannuation accounts
- providing support for accessible advice at particular times, such as when approaching retirement
- having more effective member advocacy and representation.

While many members will benefit from these systemic proposals, SMSF trustees and members entering the retirement phase face problems which are amenable to targeted policy action in the context of superannuation. These are discussed in turn below.

The quality of advice to SMSF owners is often questionable

SMSFs owners are major users of advice services — representing around one fifth of Australian financial advice industry’s revenue in 2016-17 (FSRC 2018e, p. 103) — and are most satisfied when they actively collaborate with a trusted adviser (SMSFA and CommBank 2017). Some participants appeared happy with advice/support to SMSFs (Ayliffe, sub. 18; Williamson, sub. 19).

However, almost half of SMSF trustees experience unmet advice needs across a range of areas (Investment Trends 2018). Of these, 30 per cent cited lack of affordability as a barrier to meeting those needs, 27 per cent indicated they were dissuaded from obtaining advice

because they lacked confidence in advisers' expertise and 19 per cent pointed to previous poor experiences with advisers (Wootton 2018).

As the cost of establishing an SMSF is relatively high (chapter 3) good advice is imperative. But evidence points to some concerns about the quality of the advice provided to SMSFs.

- Previously, ASIC (2013f) found pockets of poor advice had been given to SMSFs.
- While the process of establishing and growing an SMSF builds trust between the adviser and SMSF members, evidence suggests that clients who form favourable views of advisers tend to maintain those views even when the quality of the advice does not justify their decision (Agnew et al. 2018; ASIC 2012b; Mullainathan, Noeth and Schoar 2012).
- Bird et al. (2016b) found that current and former SMSF members were significantly more likely to trust their advisers and hold them in high esteem compared with non-SMSF members (including those who were thinking about establishing an SMSF). The latter group were more sceptical, rating advisers as self-interested and influenced by commissions.
- Other evidence shows there has been a sharp increase (albeit from a small base) in complaints to the Financial Ombudsman Service (now known as the Australian Financial Complaints Authority) about financial planning advice for SMSF owners (Collett 2017).
- Most recently, ASIC's (2018n, 2018g) research on the quality of advice and member experiences in SMSFs found many SMSF trustees lacked a basic understanding of their legal obligations as trustees and many SMSF advisers often provided questionable advice. For example, ASIC (2018n) found that 86 per cent of advisers had not demonstrated they had prioritised the client's interest, 91 per cent had not complied with the requirement that advice be appropriate, and 62 per cent of advice had not demonstrated compliance with the best interests duty and related obligations. Further, this research concluded that in 10 per cent of the 250 randomly selected SMSF client files reviewed, the client 'risked being significantly worse off' (p. 62) and a further 19 per cent of clients were at an 'increased risk of suffering financial detriment' (p. 62).

What strategies best target prospective SMSF trustees and their advisers?

In response to its (2018n, 2018g) research, ASIC (2018a) has circulated practical tips to SMSF providers on how to provide compliant advice to relevant industry associations for dissemination to their members. It has also committed to:

- working with the ATO to enhance current consumer and member communication material and further encourage individuals to undertake SMSF trustee education;
- requiring Australian financial services licensees to review and remediate clients who received non-compliant advice as identified by ASIC's work;
- focussing on property one-stop-shops. This will include building and sharing data and intelligence with other regulators and ASIC taking enforcement action when we see unscrupulous behaviour; and
- taking regulatory action where appropriate. (2018a, p. 6)

The Commission endorses ASIC's actions and commitments.

Other potential remedies could include:

- **mandatory SMSF training.** Requiring SMSF trustees to undertake trustee education prior to setting up an SMSF was also canvassed by ASIC (2018a). (At the moment it is voluntary.) Depending on the extent of the mandatory education or training required, this option could be unnecessarily onerous and costly for trustees. Accordingly, the Commission considers this option should be contemplated as a future possibility if other measures to improve the advice to, and knowledge of, prospective SMSF trustees fail
- **specialist training for SMSF advisers.** The SMSF Association argued that the unique aspects associated with being an SMSF trustee combined with the complexities of superannuation and related laws, imply that completing specialised SMSF education or accreditation should be a requirement to provide this type of advice (trans., Sydney 20 June 2018, p. 159). ASIC also indicated that it would engage 'in discussions with FASEA about a specific SMSF qualification for advice providers wishing to provide SMSF advice' (ASIC 2018, p. 98). Subsequently, FASEA have proposed that specialist SMSF training be considered a non-formal education component within its annual continuing professional development (CPD) requirements (FASEA 2018b, 2018a). Other options could involve incorporating an SMSF indicator within ASIC's existing Financial Advisers Register (box 5.7) or the ATO establishing an SMSF adviser register similar to its SMSF auditor register. The success of any of these initiatives, however, rests heavily on the delivery of such advice in an unconflicted environment.

Additional options to deal with SMSF-related problems suggested by ASIC, included: prohibiting limited recourse borrowing arrangements; mandating a minimum SMSF balance; and extending the proposed design and distribution obligations regime to the establishment of SMSFs. These proposals and others are further discussed in chapter 10.

Pre-retirees need to navigate an increasingly complex maze

One of the most important financial decisions people make is how to manage their retirement savings. Superannuation will for many be the largest asset during their lifetime, especially for non-home owners and as the system matures. In making decisions in the decumulation phase, people need to take into account their needs for liquidity as well as a regular income, longevity, market and inflation risks, their potential requirement for aged care and eligibility for the Age Pension, the needs of other household members, and their bequest intentions and longevity risk (box 5.6; chapter 4). Moreover, the terms used to describe different ways of generating income from people's assets and the different means test treatment of the same assets for different government supports can be confusing for many.

Following the draft report, the Government announced a Retirement Income Covenant (Treasury 2018e) which will require all funds to offer a Comprehensive Income Product for Retirement (CIPR) — a hybrid product comprising access to capital and longevity risk management — to all members when they retire (chapter 4). While the implementation of

the Covenant has been delayed to 2022, if implemented it will more rapidly expand and diversify the pool of retirement income products and potentially add further intricacies to the already complex problems facing retirees. Decisions at this point can markedly affect a person's future wellbeing — sometimes irreversibly so — and can affect the Government's Age Pension liabilities (chapter 4).

Financial information and advice are important mechanisms for matching people to products and their 'optimal' configuration. However, the Financial System Inquiry (Murray et al. 2014) was critical of the services on offer to help retirees navigate the system and make sensible decisions. Similarly, the Council on the Ageing (COTA) Australia (2014, p. 6) stated that 'consumers report to us that they feel deserted ... once they reach the retirement phase, particularly if they have relatively small balances'. The Commission (PC 2015b) previously canvassed a broad range of evidence on the difficulties encountered by older Australians in understanding information about superannuation. That study also found that many individuals lacked knowledge on where to seek information and advice. Finally, as personal financial advice often lacks credibility and is expensive (a particular obstacle for low-income people) it is unlikely to be used. For example, survey evidence has shown that older people are reluctant to engage financial or other specialist advice to inform their decision about funding aged care costs (PC 2015a).

National Seniors Australia (nd) echoed these sentiments and suggested that a coordinated approach to consolidating government information and supports into one location — utilising appropriate communication channels — was needed. CHOICE advocated that an independent consumer body specialised in helping superannuation members (see below) would be able to guide retirees:

... to advisers they can trust. Ideally non conflicted advisers that are pure fee for service. Under current arrangements, we wouldn't trust any other advisers with consumers' retirements. (trans., Sydney 20 June 2018, p. 13)

Challenger also pointed to deficiencies in the training of advisers:

... the point I want to make is that there's currently very limited training for advisers in the special needs of retirees and what retirement is actually about as opposed to the wealth accumulation, wealth management, tax strategies, estate planning. ... The more sort of actuarial view, if you like, of retirement is simply not being taught to advisers out there. Even issues like cognitive decline, designing a retirement plan that actually still works when the retirees are sort of 80 plus and are increasingly finding it more difficult to make complicated decisions about their finances, you know, advisers need to be taught how to deal with those sort of issues. And I think the evidence is that that's not happening. (trans., Sydney 20 June, pp. 15–16)

While the uplift in qualifications requirements to a minimum of a bachelor degree as part of the FASEA reforms (box 5.7) will improve advisers' skills, it will be likely to increase the costs of advice and may not close the 'credibility gap'.

Reconceptualising the drawdown phase of superannuation as the drawdown phase of *all* savings present at retirement suggests that pertinent information and personal advice services

will be in greater demand. The limited nature of intrafund advice (box 5.8) — however satisfied members are with it (tech. supp. 1) — means it is unlikely to take account of all of the financial circumstances of members nearing retirement. Depending on its nature and quality, personal scaled advice (box 5.8)⁵³ could partially meet this growing need.

Gaps in advice services are also common internationally (Burke and Hung 2015). For example, gaps in providing suitable guidance and advice for pre-retirees and retirees in relation to retirement income products have been identified by the United Kingdom’s (UK) Financial Conduct Authority (see below and FCA 2016, 2017b, 2018).

The Commission previously found that many Australian retirees had made sensible decisions in the context of the relevant policy settings (PC 2015b). However, superannuation assets will rise considerably as the system matures, and recent tax and social security changes and new retirement income products have complicated and will continue to complicate decision making. While the Government’s proposed Retirement Income Covenant seeks to minimise the need for pre-retirees to obtain financial advice, the evidence suggests that pooled retirement income products will only suit some retirees (chapter 4). In this setting, people’s capacity to make well-informed choices are likely to continue to be constrained by poor financial literacy (Bateman et al. 2018) and the high cost of personalised advice. Hence, the need for directions to affordable, pertinent information and personal advice is expected to grow.

Better information and advice for pre-retirees and retirees

While the Australian Government (box 5.7) and other sources — such as COTA, the Financial Planning Association of Australia (FPAA), National Seniors Australia and various websites including SuperGuide and Super Guru — can help, more should be done to help guide retirees in this complex area.

The Commission’s analysis of the Covenant (chapter 4) alongside the tainted history of advice (and its expense) suggests members should be prompted to access affordable and impartial information and advice to help them make retirement income decisions, not nudged to products that may not meet their needs well. Indeed, the dilemma raised by the coexistence of many ill-equipped members and a complex decision-making environment has been the focus of recent UK policy analysis (box 5.10) — with possible lessons for Australia.

⁵³ SuperRatings data show that in 2017 around 85 per cent of funds offered personal scaled advice services to members, with the vast majority delivering scaled advice — on contributions, insurance and investment choice — over the phone as part of a dedicated scale advice team. At the same time, funds have moved away from comprehensive personal advice (SuperRatings 2018).

Box 5.10 **The UK’s proposals to address risk of harm to retirees from making decisions without advice**

Prior to 2015, annuities were mandated retirement income products, but subsequent reforms gave United Kingdom (UK) consumers greater freedom to use their pension savings. To better support pre-retirees to make decisions in this complex area, employers are now *required* to direct their customers to free, impartial pensions guidance^a — soon to be provided through a Single Financial Guidance Body (Department for Work & Pensions (UK) 2017) — or opt out of receiving it.

In its review of those reforms, the FCA (2018) found evidence that many retirees made decisions without turning to guidance or advice, giving rise to concerns that they were at risk of harm. Accordingly, the FCA (2018) is currently consulting on several proposals to address those concerns at three different stages of decision making.

- **Before members access their retirement savings.** Based on trials testing the success of different approaches to engaging with pre-retirees (Adams and Ernstone 2018), existing ‘wake-up packs’ will be modified to make them more timely and useful.
- **At the point members make a decision to draw down their retirement savings.** The FCA’s proposals include:
 - requiring providers offer three ready-made drawdown investment solutions (or ‘investment pathways’) within a simple choice architecture, along with independent oversight of the appropriateness, quality and charges of ‘investment pathways’
 - requiring new consumers to actively agree to be in cash or cash-like options^a with a drawdown feature (rather than being allowed to automatically default into them)
 - requiring annuity providers to ask consumers simple questions on health and lifestyle to assess their need and then use this information when generating a quote and a comparison with another annuity offer on the market.
- **Throughout members’ retirement.** The FCA has proposed that providers: send annual information irrespective of whether people are drawing down; and remind members of their chosen investment and their ability to switch.

^a In the UK, ‘advice’ is distinguished from ‘guidance’. Advice will recommend what you should do, for example, to buy or sell. Guidance will not tell you what to do or which products to buy. The information provided will help you to identify your options (Hanrahan 2018a, p. 31).

Evidence from the behavioural economics literature indicates that merely providing general information about complex products on a website is an ineffective way of increasing engagement and informing decisions. Nudges, prompts and other well-designed ‘marketing’ measures are often critical accompaniments, *but only if, in their own right, they pre-dispose consumers to decisions in their interest*. Moreover, target populations for nudges often need to be segmented for them to be effective (National Foundation for Women, sub. DR127).

There are multiple ways of triggering members to access information. The Commission’s draft report proposed that the ATO should prompt pre-retirees (when they reach age 55) to online information on ASIC’s MoneySmart and the Department of Human Services’ (DHS) Financial Information Service (FIS) websites. In a recent development, the Australian Government’s ‘More Choices for a Longer Life’ strategy (box 5.7) will also promote the ‘Superannuation and Retirement’ section of ASIC’s MoneySmart website to people when

they turn 45 and 65 years old. A further low-cost incremental step would be to prompt all people reaching 55 years to access ASIC's MoneySmart *and* DHS' FIS websites. The proposed independent member assistance and advocacy centre (discussed below) would serve as a useful information source in its own right, but would also provide another gateway to the MoneySmart website and the FIS. These avenues for directing people to relevant information sources would not preclude funds from promoting these information sources to relevant members (as suggested by the AiGroup, sub. DR181, p. 11).

While information on websites may help some, many will need more personalised information when they retire, including on the effects of different drawdown rates on *all* their assets (and the different options available to do this), and the different retirement income products available (for example, the Pension Loans Scheme, account-based pensions, and different types of annuities) and their features (chapter 4). Those with poor financial literacy are especially in need of support (Bateman et al. 2018).

The Australian Government is the sole architect of Australia's complex retirement income system (covering the design and regulation of superannuation, its various tax concessions, the Age Pension, Pension Loans Scheme, among other features), and for this reason alone, there is a strong case for Government to assist retirees navigate a system it has designed.

A potential way to accomplish this is to expand the existing FIS. The FIS offers an information service to almost 60 000 Australians in the form of free, one-on-one sessions and other significant interventions (box 5.11). In 2014-15 almost one quarter of the sessions were focused on retirement-related issues (ANAO 2016, p. 23). While basing its information service on the personal circumstances of individuals and/or couples, the FIS does not provide financial advice as it is defined in law. Its officers refer those needing advice towards private financial advice services (along with information on choosing a financial adviser).

Open tendering for an information service targeting the needs of retirees might be an alternative to an expanded FIS, but the FIS appears to be functioning well, and there would have to be compelling grounds that adopting a 'government stewardship model' would be more cost effective or of higher quality.

If an expanded FIS is implemented, there is a good case for the Australian Government to fund it from general revenue. An alternative might be a levy on the industry, but levies are more complex, might risk giving the industry some power in designing the specific information, and would ignore that much of the retirement income of those using the FIS would come from outside the superannuation system. While co-payments could be considered for those with greater incomes, the impacts on demand would need to be assessed. It would be undesirable to charge co-payments if it resulted in large groups foregoing pertinent information that they needed.

Box 5.11 The Financial Information Service

Background

The Department of Human Services' (DHS) Financial Information Service (FIS) was first established in 1989 and was targeted solely to Age Pension recipients. Since 1991 the FIS has been targeted at the general population, with two subgroups: the under 55 age group and retirees.

The broad availability of the FIS is consistent with the *National Financial Capability Strategy* and has largely focused on informing people about matters such as: superannuation and retirement planning; investing principles; and handling redundancy, divorce, death of a partner, aged care costs and compensation payments, and taxation implications.

The FIS is independent, free and confidential and provides information services to people through seminars, outreach events, by phone and by appointment. People can phone a designated phone service and ask to speak to a FIS officer (FISO). If possible, the FISO will answer questions over the phone. However, if a person's circumstances are complex, the FISO may offer to arrange an appointment at a local DHS service centre.

The FIS is regarded by stakeholders as a 'valuable service providing independent, accurate, and comprehensive information, particularly for those approaching retirement' (ANAO 2016, p. 9).

Funding

Funding for the FIS is sourced from within DHS' appropriation. In 2014-15, FIS expenditure — including on approximately 136 dedicated FISOs — was around \$14.8 million (ANAO 2016). At the same time, FISOs delivered a range of services including: answering more than 35 400 phone calls, conducting more than 56 700 one-on-one interviews, delivering 4672 hours of outreach services, and holding 2606 seminars (DHS 2015).

Sources: ANAO (2016); DHS (2015, 2018; pers. comm., 29 March 2018).

The accelerated development of digital financial decision-making tools has the potential to lower the costs and improve the credibility of targeted information services. Such tools can be readily audited, have low incremental costs once developed, can keep up with policy changes, can undertake calculations beyond the capability of a person (such as the systematic assessment of uncertainty) and eliminate the variability and inconsistencies that occur when people are giving advice without such tools. Recently, the Commission (PC 2018a) stated there was much potential to harness digital developments to help improve the cost-effectiveness of information and advice services and encouraged its development. Regardless of whether it pursues an expanded FIS, the Government should explore the business case for investing in tested, robo-assisted technology to support decisions around superannuation.

An expanded FIS and the development of technologies for empowering good decision-making by members are two possible measures for assisting members in making retirement decisions, but there may be other preferable solutions.

FINDING 5.4

The quality of financial advice provided to some members — including those with SMSFs — is questionable, and often conflicted.

The need for information and affordable, credible and impartial financial advice for retirees will increase as retirement balances grow with a maturing system, and given the rising diversity and complexity of retirement products.

5.6 Creating a strong, independent member voice

Member advocacy on superannuation is lacking. The availability of resources on the industry side has meant that much of the discourse on superannuation has been dominated by the interest of funds and trustees rather than the interest of members. This is at the heart of many of the problems with the system.

Independent consumer bodies are not uncommon for industries with complex products, performing a variety of functions, such as providing consumer assistance (especially for vulnerable consumers) as well as providing input on consumers' perspectives in policy making. The Australian Communications Consumer Action Network and Energy Consumers Australia are examples of such bodies operating in the communications and energy sectors, respectively.

The idea of an independent member assistance and advocacy body to help members navigate the super system and inject a strong member voice in policy and regulatory considerations is also not new. It was first raised by CHOICE in their submission to the Cooper Review (2010a) and is now considered to be a key missing piece in the fabric of the system (Cooper, trans., Sydney 20 June 2018, p. 5). Other participants also supported this view (box 5.12).

A properly resourced, independent member assistance and advocacy body is a priority

The Commission considers that the lack of a single, well-resourced body to effectively advocate the views and perspectives of superannuation members in policy and regulatory deliberations is hampering the competitiveness and efficiency of the super systems and needs to be redressed as a priority.

Such a body could have a central objective along the following lines:

- to promote the long-term interests of superannuation members through: providing assistance to members and empowering them to make good choices; conducting and funding research and analysis; and identifying issues and working with other consumer

organisations, ombudsmen, complaints bodies, funds, regulators and governments to advocate on behalf of super members.

Box 5.12 The need for a strong member voice: participants' views

CHOICE (trans., Sydney 20 June, pp. 4–5) provided evidence showing that the resources devoted to advocacy by super funds (typically paid for by their members) far outweighed the resources devoted to advocacy by the small number of consumer organisations operating in this space.

While CHOICE does our best to represent consumers in this industry, particularly in industry regulatory and legislative debates about superannuation, we're currently only able to devote half the time of one policy adviser to this sector. CHOICE is the only consumer group in Australia that is permanently able to resource this work in superannuation.

In comparison, industry groups have large budgets and staff to influence public policy decision making. ... Based on figures given to the Senate Economics Committee in October last year we've calculated that industry groups like the Association of Superannuation Funds Australia, Industry Super Australia, Australian Institute of Superannuation Trustees, and the Financial Services Council, they collectively have over 100 staff, over 20 of which are solely devoted to superannuation policy and research.

The Consumers' Federation of Australian (CFA, sub. DR188, p. 2) argued that giving members a superannuation-specific voice in policy making and regulatory decision making was a 'powerful way of ensuring the system works in members' interests'. The CFA also identified that while a number of relevant consumer and industry bodies were able to provide limited advocacy services, the complex nature of superannuation meant that members needed a separate consumer advocate with the right combination of knowledge, independence and accessibility.

In response to the draft report's suggestion that regulators should act as 'member champions', Berrill and Watson Layers (sub. DR176) argued that as a matter of principle, ASIC and APRA should not represent consumers on matters of policy.

ASIC (sub. DR206, p. 25) stated that 'an appropriately funded consumer organisation in the superannuation sector will assist ASIC, and other regulators, to more effectively assess and prioritise issues impacting superannuation members' (see also ASIC 2018h, p. 43).

Within this broad ambit, this body would also need to develop tailored outreach and intervention strategies for specific groups, including Indigenous and Torres Strait Islander people. It could also help to cater for the specific information needs of pre-retirees.

In order to undertake these functions effectively, such a body would need to be well-equipped in data analytics.

Considerations in establishing a consumer assistance and advocacy body

Initial steps have been taken to establish a body along these lines, albeit with limited resources. The Super Consumers' Centre (SCC) was established in 2013 as a registered company limited by guarantee, although its operations did not commence at that time (sub. DR214, attachment). In July 2018 (some five years later), the SCC received initial funding of \$2.5 million in the form of a community benefit payment from the

Commonwealth Bank of Australia and ANZ Bank (each paid \$1.25 million) in accordance with an enforceable undertaking by each bank (ASIC, pers. comm., 5 November 2018) arising from the mis-selling of superannuation by those banks. The SCC's business case (sub. DR214, attachment) is broadly in line with the role that the Commission considers appropriate for a member assistance and advocacy body.

In establishing a sustainable member assistance and advocacy body, some threshold questions will need to be considered by the Australian Government. These include:

- what should be the size of the funding envelope, given its remit?
- how should it be funded?
- what are the most suitable accountability and governance arrangements between the Government and the body?
- what governance arrangements should operate within the body? For example, should the body be expected to comply with good governance principles for not-for-profit organisations (AICD 2013)?

6 Erosion of member balances

Key points

- There is much unnecessary erosion of member balances in the system. It is typically regressive and costs members billions each year. Unintended multiple accounts (and particularly multiple insurance premiums) are the most egregious driver of balance erosion. Unnecessary balance erosion is also caused by delayed and unpaid superannuation.
- Too much of the onus to stem erosion has fallen on members, when other ‘lines of defence’ — funds, regulators and government — should have acted. While policy plays the dominant role in unnecessary erosion, funds could have done more to reduce unintended multiples.
- Unintended multiple accounts are a significant problem. They represent about one in three accounts and annually cost members about \$2.6 billion in excess insurance premiums and administration fees. The costs are exacerbated by foregone compound returns. A worker with two accounts across their working life will be over 6 per cent (or \$51 000) worse off at retirement compared with a worker holding just one account. Recent initiatives have made inroads, but are making slow progress by treating the symptoms and not the structural cause.
- A centralised online service (facilitating ‘default once’) would offer a much needed circuit breaker for unintended multiple accounts. Upon new employment, existing members would be presented with their existing fund, or could select a new fund. The service would facilitate consolidation of multiple accounts and the member would be nudged to do so. The ATO has been building the capability for such a service through Single Touch Payroll and MyGov infrastructure. This work should be accelerated as a priority, and online completion of the standard choice form made universal.
- The ‘auto-rollover’ approach — proposed by some in the industry — does not clear the members’ best interest test in terms of policy design, suiting funds more than members. Conservative estimates by the Commission indicate that this would cost members at least \$45 million annually in extra administration fees compared with default once.
- Work to clear the 10 million unintended multiple accounts and 5.7 million ATO-held unclaimed accounts is still much needed. The recent (not-yet-legislated) proposal to empower the ATO to auto-consolidate ATO-held and ‘low-balance inactive’ accounts is projected to capture 3 million of these accounts. Lifting the balance cap to trigger auto-consolidation could increase this number. But in the absence of ‘default once’, these initiatives will never amount to more than ‘mopping up spilt milk’ while unintended multiple accounts continue to be created. And the generation of unintended multiple accounts is unlikely to abate with today’s workforce reality with workers changing jobs more likely to also change industry and occupation.
- Unpaid super remains a significant cause of erosion — about \$2.8 billion per year (4.2 per cent of all super guarantee contributions). It especially impacts low income and young workers. The new regime for employers and funds to report to the ATO (with some important as-yet unlegislated elements) is needed to make monitoring and enforcement simpler and effective.

Beyond maximising long-term net returns and competitive fees, an efficient superannuation system would be one that inherently minimises unnecessary erosion of member balances. In such a system, unintended multiple accounts would not be created, and no accounts would become lost or unclaimed (or, if these situations did arise, they would be rectified quickly). Further, an efficient system would see all Superannuation Guarantee (SG) contributions made in full and on time.

Against these benchmarks, the current system does not perform as well as it should; balances are eroded in a number of ways. The number of accounts and size of balances affected are significant, and have a material impact on member balances and, ultimately, retirement incomes — particularly once foregone compound returns are taken into account. Erosion is typically regressive in impact — disproportionately affecting those with low incomes, interrupted workforce participation or low financial literacy.

Broadly, erosion of member balances can occur in three ways (figure 6.1). First, when unintended multiple accounts are created, or accounts become lost or unclaimed. (Lost accounts are those for which funds can no longer contact the owner or the account is inactive; unclaimed accounts are lost accounts that have been transferred to the Australian Taxation Office (ATO)). Second, through unpaid or delayed SG payments. And third, due to tax (mis)management. Policy design plays the dominant role in unnecessary erosion (by linking member accounts to employers not employees). But funds could have done more. Funds have been slow and some seemingly reluctant to act on inactive accounts and inappropriate insurance policies when fund and member interests have conflicted (FSRC 2018b; Vagg, sub. DR212). Too much of the onus to stem erosion has fallen on members, when other ‘lines of defence’ — funds, regulators and government — should have been relied upon to act.

Figure 6.1 Policy design is the primary driver of balance erosion
Balance erosion by who initiates it, the underlying cause and the magnitude

	Who?	Underlying cause	Magnitude
Multiple, lost and unclaimed accounts	Member	Inefficient default arrangements	\$1.9 billion (premiums) and \$690 million (fees) per year, ^a and foregone returns. 6% lost over the lifetime of a typical member
Unpaid SG	Employer	Inefficient compliance regime	\$2.8 billion annually, plus foregone returns. 7.6% lost over the lifetime of a typical member
Tax management	Funds	Principal-agent problems	Unknown

^a An estimated \$161 million of these fees and premiums is attributable to lost accounts.

While balance erosion from multiple insurance products is covered in this chapter, issues associated with erosion from insurance premiums are dealt with more comprehensively in chapter 8.

This chapter spans the following two criteria from the Commission's assessment framework (PC 2016a).

- Is the system effectively managing tax for members, including in transition? (E4)
- Are other leakages from members' accounts being minimised? (E5)

6.1 How can multiple accounts be eliminated?

The primary source of balance erosion lies in multiple accounts

Members can create multiple accounts if they default (upon new employment) or otherwise open a new account, and do not rollover their existing account. While in some cases this outcome may be intended,⁵⁴ more often than not, the creation of multiple accounts is unintended (tech. supp. 1). These unintended multiple accounts erode members' balances via multiple sets of fees and insurance premiums, and often end up as lost, and then unclaimed, accounts. Commission estimates suggest that there could be about 10 million unintended multiple accounts⁵⁵ (35 per cent of all member accounts held by funds) associated with \$690 million and \$1.9 billion annually in excess administration fees and insurance premiums, respectively (figure 6.2). This estimate of unintended multiple accounts is consistent with work by Minifie et al. (2015, p. 13) and Clare (2007, p. 1). These authors' estimates translated into unintended multiple account shares of 38 per cent and 36 per cent, respectively.

This erosion is exacerbated by the foregone compound returns on fees and premiums that would have otherwise been invested.

The incidence of multiple accounts has been falling, but remains high

Evidence suggests that the incidence of unintended multiple accounts has fallen in recent years. The total number of accounts has fallen by 13 per cent from a peak in 2010, and the average number of accounts per member has fallen by 39 per cent from a peak in 2009 (figure 6.3). Increasing employment, along with greater labour force movement between occupations and industries (chapter 1) and the introduction of 'choice of fund'

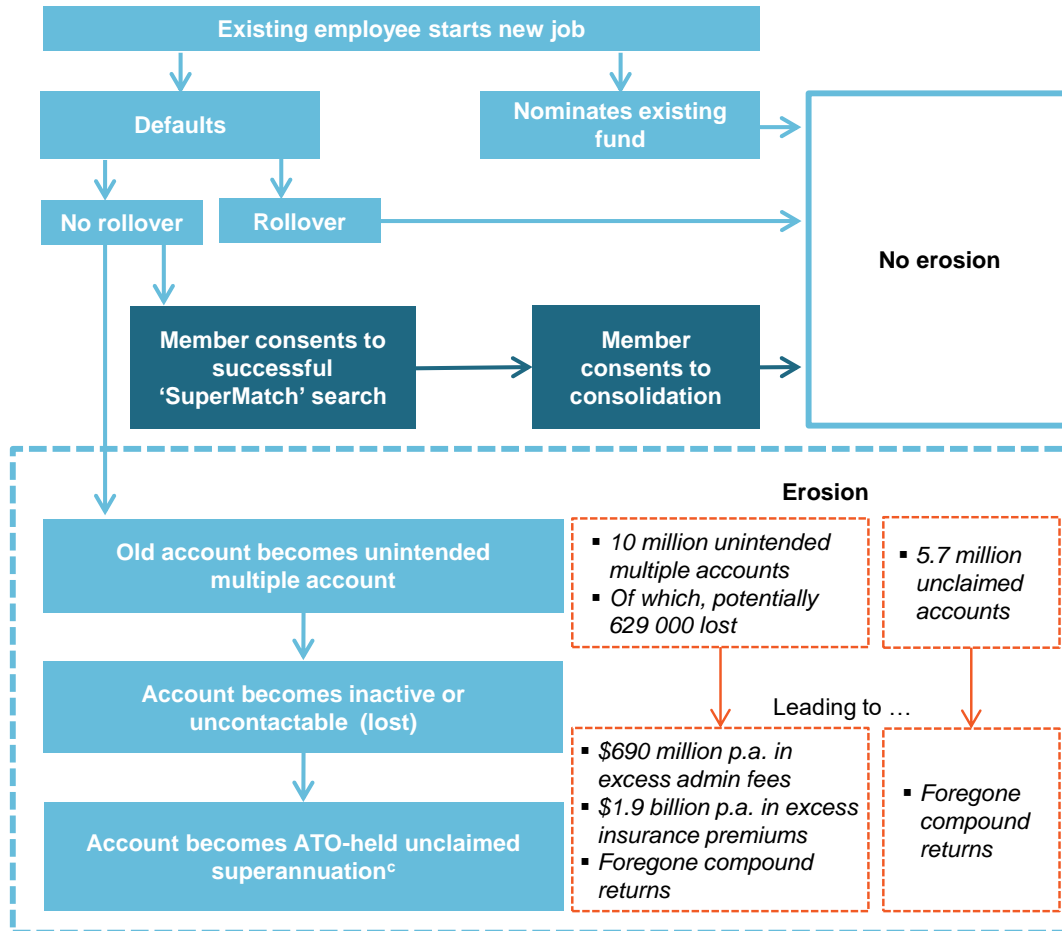
⁵⁴ It has been suggested that most members intentionally holding two accounts are SMSF members maintaining a second account for insurance purposes, or individuals contributing to a defined-contribution account while maintaining a separate defined-benefit account (Cbus stage 2, sub. DR74).

⁵⁵ The vast majority of ATO held unclaimed accounts (discussed below) are also likely to be unintended multiple accounts, so this figure is an underestimate.

legislation in 2005 worked to accelerate the proliferation of multiple accounts in the 2000s. In recent years, the growing use of tax file numbers (TFNs) as unique identifiers, and easier search and consolidation tools,⁵⁶ have helped reverse the trend (ATO 2017f).

Figure 6.2 Multiple accounts lead to significant member balance erosion^{a,b}

The path to erosion from unintended multiple, lost and unclaimed accounts



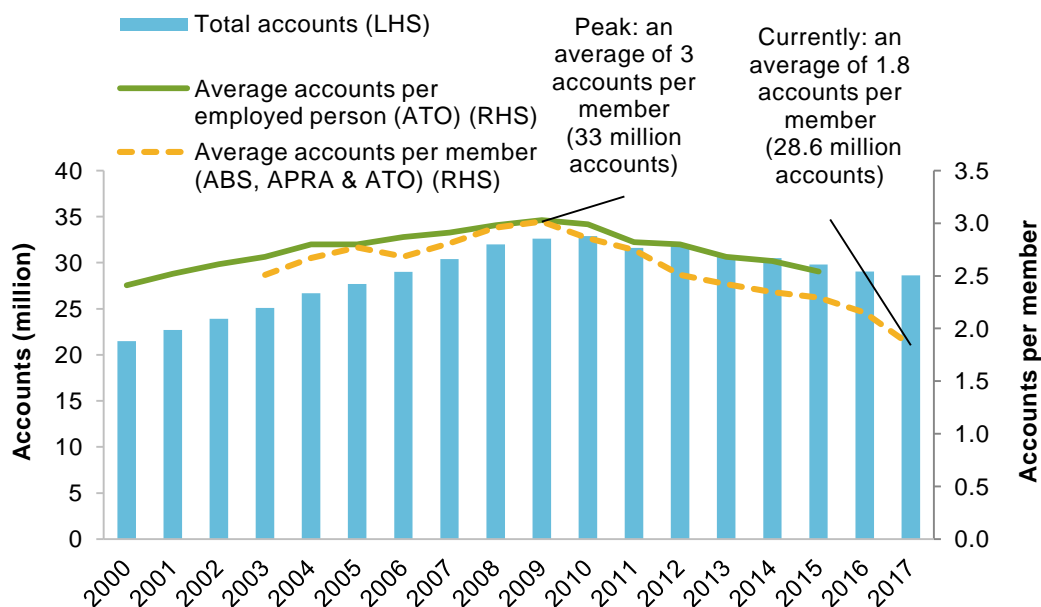
^a This figure is stylised and abstracts away from some (less common) situations. For example, it assumes that all lost and unclaimed accounts start off as unintended multiple accounts. There are cases where this may not be true (for example, temporary workers). These abstractions do not impact erosion estimates.

^b Unintended multiple accounts are estimated as 77 per cent (PC members survey) of total excess accounts (total accounts (APRA) minus number of members (ATO)). This is multiplied by the average MySuper fixed admin fee (\$69 — APRA) to get excess admin fees. It is then multiplied by an average insurance premium (\$340 — Rice Warner) to get excess insurance premiums, after adjusting for the estimated 45 per cent (ATO) of accounts that do not have insurance. ^c ATO-held accounts are not subject to fees and insurance premiums. If they are claimed they only attract interest at the rate of the consumer price index.

Sources: ABS (*Household Income and Wealth, Australia, 2015-16*, 6523.0); APRA (2018b, 2018j, unpublished data); ATO (2017d, 2017f, pers. comm., 15 February 2018); members survey; PC analysis of Rice Warner data.

⁵⁶ Members can search and consolidate via MyGov, and funds can search and consolidate with member consent using the SuperMatch facility maintained by the ATO.

Figure 6.3 Multiple accounts — improving but stubbornly problematic^{a,b}
 Total accounts and average accounts per member, 2000–2017

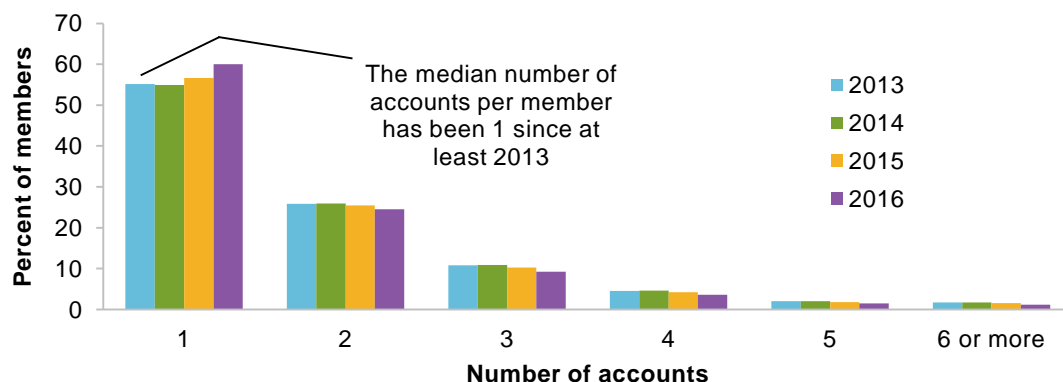


^a ATO estimates per employed persons undercount the number of members by excluding retirees and other non-employed individuals with accounts, but are included for a longer time series. ^b The last data point in the ‘Average accounts per member’ series is calculated using ATO member data (rather than ABS).

Sources: ABS (*Household Income and Wealth, Australia, 2015-16*, 6523.0); APRA (2018b), ATO (2017f).

The share of members holding just one account increased by 5 percentage points from 2013 to 2016 to 60 per cent (figure 6.4), and the share of members with three or more accounts fell by almost 4 percentage points. As indicated above, not all of this duplication is unintended, but it is likely that most members deliberately holding multiple accounts would hold no more than two. This further suggests that the incidence of unintended multiple accounts has been in decline.

Figure 6.4 Fewer people are holding multiple accounts
Per cent of all members by number of accounts held, 2013–2016



Source: ATO (2017d).

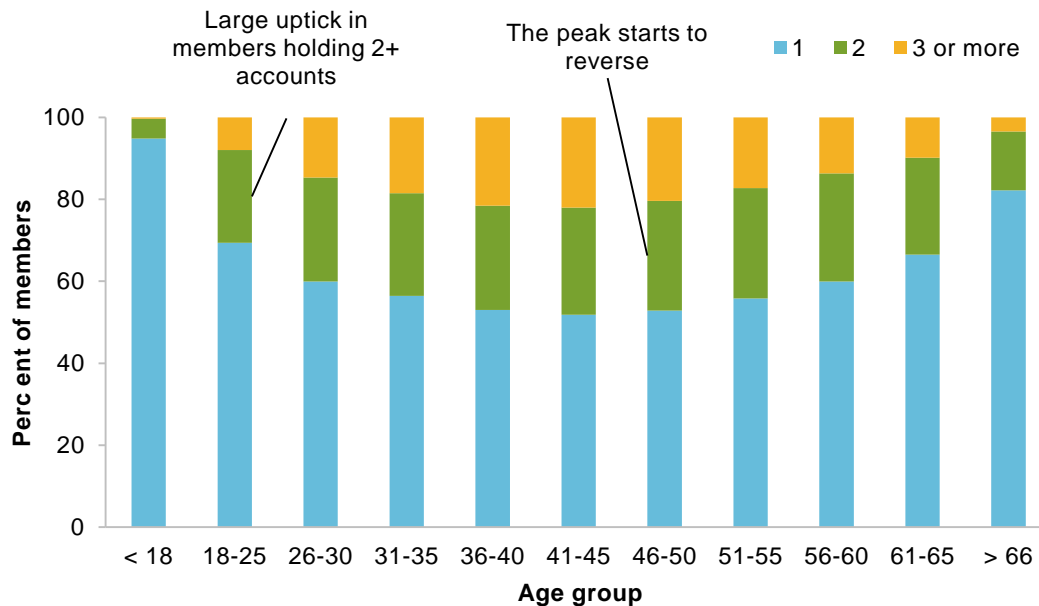
Account proliferation happens early and persists, with significant life-time cost to members

Account proliferation occurs early in adulthood and persists well into middle age (figure 6.5). The largest increase in individuals holding two or more accounts happens between the ages of 18 and 25. This finding is consistent with the widely held view that young people continually default as they move through various casual jobs. The creation of multiple accounts peaks for members in their early to mid-40s, when nearly 50 per cent have two or more accounts (although it is worth noting that members in the middle-age groups are more likely than those in younger ones to have intentional multiple accounts). This illustrates the significant length of time that multiple fees and insurance premiums can work to erode balances.⁵⁷ It is also important to note that, in the absence of action, account proliferation may be worse in the future if modern workforce developments see a more fluid labour market create more opportunities for individuals to default (chapter 1).

As the peak reverses, the decreases are relatively small until the over 66 age group, where the percentage holding two or more accounts drops markedly to 18 per cent. It is plausible that the residual in this group is mostly made up of intended multiple accounts — individuals transitioning to retirement with one accumulation and one pension account, for example.

⁵⁷ Although it should be noted that these are current cross-sectional data, and the typical path of an individual member may be different depending on when they entered the workforce.

Figure 6.5 Proliferation happens early, and persists
Per cent of members by number of accounts by age group, 2017

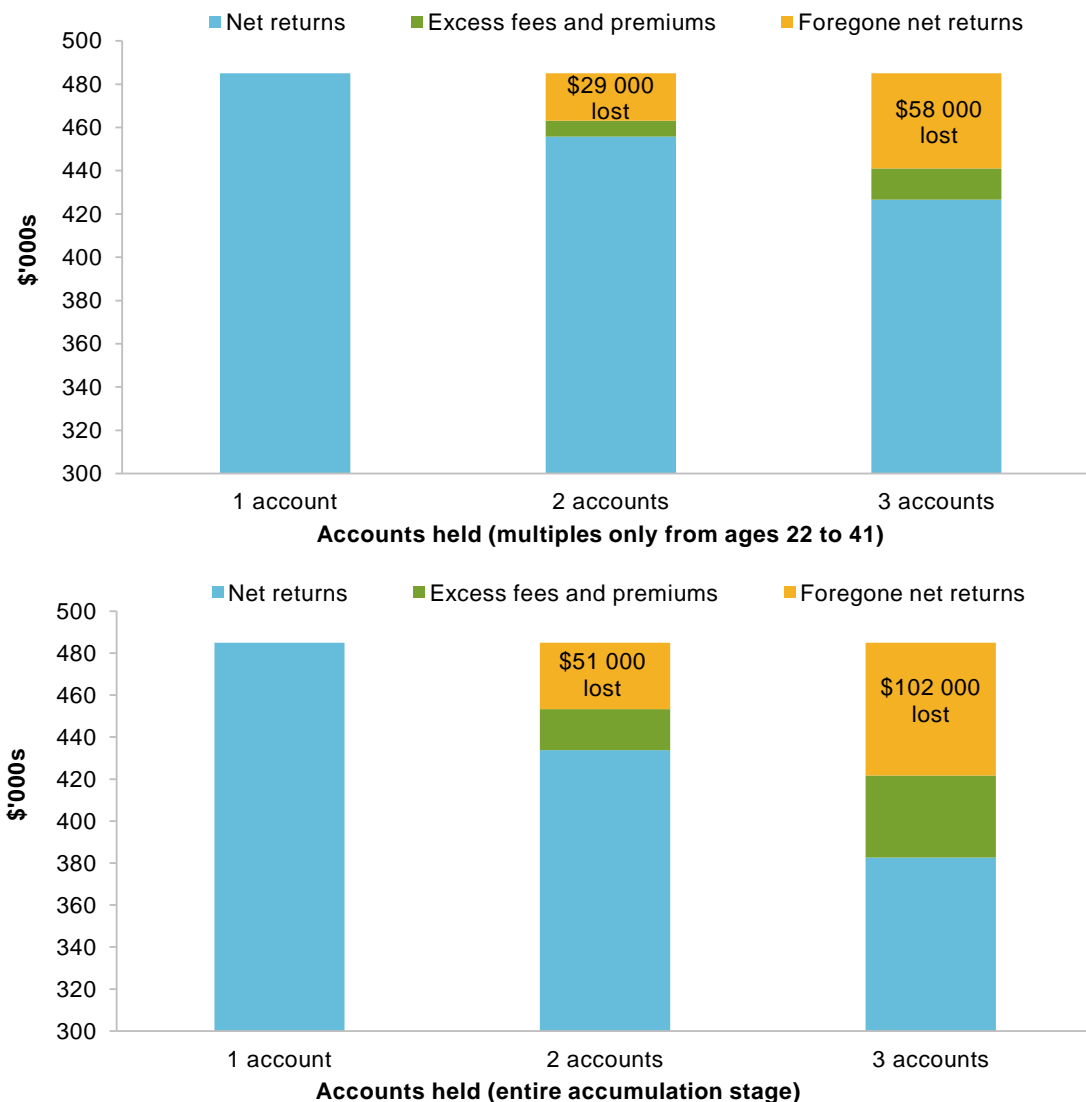


Source: ATO (2017d).

The excess fees and premiums paid by individuals with unintended multiple accounts have a detrimental impact on balances at retirement, especially once foregone compound returns are factored in. The Commission's cameo model (chapter 1) illustrates the average cost of holding unintended multiple accounts for an individual who holds a single multiple account from ages 22 to 41 compared with an individual who does not hold a multiple account at any point. The multiple accounts holder could be \$29 000 (3.5 per cent) worse off at retirement. This balance erosion worsens to \$51 000 (6 per cent) if the multiple accounts are held over the entire accumulation phase (figure 6.6).

Figure 6.6 Multiple accounts — a heavy penalty on retirement^a

Projected returns on contributions by number of accounts held^b



^a The assumptions underpinning this cameo are set out in chapter 1. ^b Returns on contributions of about \$350 000 over the member's working life.

Defaulting once — a much needed circuit breaker

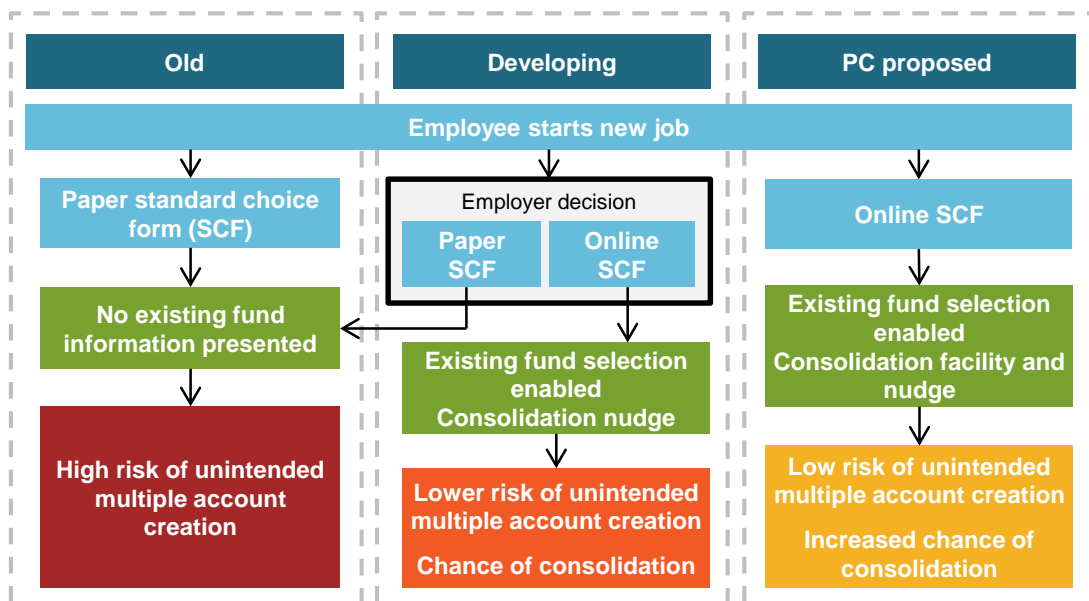
To date, the problem of unintended multiple accounts has been addressed primarily by initiatives treating the symptoms and not the structural cause. These initiatives have targeted both members and funds, but are largely reliant on proactive action by the member. In recent years, engaged members have been able to easily consolidate multiple accounts online on MyGov, and funds have been able to search for multiple accounts in members' names via SuperMatch. Between 2013 and 2016, 1.38 million accounts (4.5 per cent of all accounts in

2013) were consolidated online via member requests (ATO 2017f). However, it is worth noting that not all funds use SuperMatch due to the setup costs associated with using the software (ATO, pers. comm., 5 Feb 2018). Further, the follow-through rate from ‘accounts found’ to ‘accounts consolidated’ on MyGov has been relatively low — an average rate of 21 per cent over the three years 2014–16 (ATO, pers. comm., 24 January 2017, 15 February 2017).

At present, it is too easy for members to default and create multiple accounts. The Commission’s recommendation for default superannuation accounts to only be created once for people who are new to the workforce and do not already have a superannuation account (chapter 12, chapter 13) would significantly stem the flow of future unintended account proliferation. The centralised online service to facilitate this change would also assist with consolidating existing multiple accounts (figure 6.7).

Figure 6.7 **Account proliferation — a digital solution^a**

The old, the developing and the Commission’s proposed frameworks



^a This figure is stylised and abstracts from some complexity. For example, the exact specifications of the developing online standard choice form (SCF) are a work in progress, and the ATO is exploring the potential for it to include a consolidation facility. A consolidation facility would allow the member to enact a consolidation at the point of starting a new job, whereas a nudge would just encourage the member to take action after completing the online SCF (via logging on to MyGov, for example).

This service would draw on the existing Single Touch Payroll (STP)⁵⁸ and MyGov infrastructure that allows businesses and individuals to interact with the Government online

⁵⁸ STP is a broader reform package that aims to streamline employer reporting of salary and wages, PAYG withholding tax and superannuation information to the ATO as they occur. STP for employers with 20 or more employees has been legislated, and took effect from 1 July 2018. STP for smaller employers has been announced to take effect from 1 July 2019, but enabling legislation is still before the Senate.

when someone starts a new job (ATO 2017c; PC 2017d). This infrastructure stems from a stated Government priority to ‘introduce streamlined processes for individuals commencing employment’ (O’Dwyer 2015a). In particular, a voluntary online standard choice form — used by a new employee to nominate the fund that their super contributions are paid into — is being developed (ATO, pers. comm., 5 Feb 2018). This work should be accelerated as a priority, with a view to making the online standard choice form a requirement for all new employees.

Many participants expressed general support for such a universal mechanism (ASU, sub. 28, p. 6; First State Super, sub. 37; PwC, sub. 62; ACTU, sub. 50; Nicholas Barr and Peter Diamond, sub. 74, sub. DR154; Roll-it Super, sub. DR113; AustralianSuper, sub. DR150; Colonial First State, sub. DR163; SuperRatings, sub. DR167; REST, sub. DR171; AFA, sub. DR173; NAB, sub. DR174; Mercer, sub. DR175; Berrill and Watson Lawyers, sub. DR176; CHOICE, sub. DR184; FSC, sub. DR186; Chant West, sub. DR191; Sunsuper, sub. DR197; Bateman and Thorpe, sub. DR200; ASIC, sub. DR206).

This service should present new employees with a list of their existing funds to select from, alongside the option of nominating a new fund — whether that be one personally selected or the relevant default product/s on offer. New workforce entrants should be presented with the relevant default product/s on offer, as well as the opportunity to choose a different product. Consolidation of multiple accounts should be facilitated through the service, with nudges for members to do so. More broadly, architecture around the service and the whole employment commencement process should contain features that nudge new employees to actively engage.

It would be a rare occurrence under such arrangements for an employee to create an unintended multiple account. Previous Commission estimates suggested that switching to such an approach could produce savings to members in the order of \$150 million annually by stemming the creation of new unintended multiple accounts (PC 2017d). This figure would be further amplified depending on the degree to which the current workforce uses the online service to consolidate the existing stock of unintended multiple accounts.

In a modern economy, digital processes are increasingly becoming the norm. Therefore, over the medium to long term, making such processes universal should not create an undue regulatory burden for small- and medium-sized enterprises.

However, importantly and perversely, realised savings from reducing unintended multiple accounts will likely be lower than the figures cited above because average fees may increase as unintended multiples are removed.⁵⁹ Two reasons explain this. First, the cost of administering an inactive account is much lower than that of an active account, meaning inactive accounts are cross-subsidising active accounts. Removing inactive accounts would remove this cross-subsidy. Second, and more fundamentally, fewer accounts at a fund means

⁵⁹ Minifie et. al. (2015, p. 13) estimated the average cost of servicing an inactive account at \$30 p.a., implying total savings of \$300 million. Anthony Asher (sub. DR151, p. 6) suggested that the average cost of servicing an inactive account may be as low as \$10 p.a., implying total savings of only \$100 million.

the fixed costs of administration are spread across a smaller membership base (chapter 3). Even so, removing unintended multiple accounts from the system is ultimately in members best interests and should be pursued.

An 'auto-rollover' approach is inferior

Following release of the Commission's draft report, several participants proposed an 'auto-rollover' approach (for defaulting employees) as an alternative to the Commission's proposed 'default once' (ACTU, sub. DR185; ISA, sub. DR162; Cbus, sub. DR177; AI Group, sub. DR181; AIST, sub. DR198). ISA (sub. DR162, p. 16) explained this approach as 'a member's entitlements automatically transfer[ing] to the member's new active fund when they change employment'. Similarly, AIST (sub. DR198, p. 3) suggested that (under their model) 'employees [starting a new job] will be guided to a shortlist of better quality products suited to people working in their industry', and that the 'consolidation of existing accounts would be built into this model'.

Other participants raised a suite of issues with how this approach would work and impact members.

It would create unnecessary costs from setting up and closing accounts, transferring balances, and buy/sell spreads. All of these would ultimately be borne by members (PwC, sub. DR129; ASFA, sub. DR148; QSuper, sub. DR168; CHOICE, sub. DR184; Sunsuper, sub. DR197; FSC, sub. DR199). Conservative Commission estimates suggest such a model could lead to about 500 000 additional rollovers per annum, costing at least \$45 million (compared with 'default-once').⁶⁰

It is unclear how such a mechanism would deal with employees with multiple jobs (PwC, sub. DR129; Sunsuper, sub. DR197; FSC, sub. DR199). The proportion of people holding multiple jobs increased from 3.7 per cent in 1987 to 6.1 per cent in 2016 (chapter 1). All relevant employers, except the one subject to the most recent start date, would be unable to direct contributions as the accounts held on record are closed. ISA (sub. DR162) suggested that multiple job holders should have contributions directed to the fund with the highest balance. In practice, assuming the balance is rolled over, this is the same as contributions being directed to the account opened at the most recently started employment. In the (likely) absence of member proactivity, it is still unclear how pre-existing employers will know where to direct contributions when the old account is closed and rolled into a new fund.

Automated rollovers may confuse defaulting members and exacerbate member disengagement as the potential for members to form longer-term relationships with funds is diminished (PwC, sub. DR129; ASFA, sub. DR148; QSuper, sub. DR168; CHOICE,

⁶⁰ The estimate assumes that 60 per cent of individuals who 1) start a new job; 2) change industry; and 3) have an existing super account, default. The average MySuper exit fee is used as a proxy for exit costs, and the average MySuper switching fee is used as a proxy for entry costs (ABS 2017g; APRA 2018k). The estimate of the number of additional rollovers is consistent with that of ISA (sub. DR232, p. 1).

sub. DR184; Sunsuper, sub. DR197; FSC, sub. DR199). Members may struggle to keep track of what fund they are in, and its characteristics, for example, in relation to the investment strategy or default insurance cover. They will also have to re-learn how to contact their fund, login to their account, and how to comprehend their new fund's statements.

More rollovers means a more transitory member base, which may impact insurers' ability to offer favourable rates (ASFA, sub. DR148; Sunsuper, sub. DR197), or funds' ability to invest in illiquid assets (CHOICE, sub. DR184; Sunsuper, sub. DR197; FSC, sub. DR199).

And last, a substantive transfer during times of heightened market volatility may crystallise a loss (ASFA, sub. DR148) (although it should be noted a member could equally avoid downside volatility while out of the market).

In short, the auto-rollover proposal appears to suit funds but is inconsistent with members' best interests.

More broadly, as detailed above, online standard choice forms are likely to be the norm in the not-to-distant future. For existing members, implementing 'default-once' in a world of an online standard choice form simply means pre-selecting a member's existing fund, and supporting members to switch and consolidate if they choose to do so. Implementing 'auto-rollover' in this world would presumably mean actively discouraging the selection of an existing fund by either omitting it from the online form (seemingly suggested by AIST (sub. DR198)), or 'hiding' it in some way. Neither approach satisfies the policy litmus test of being in members' (as opposed to funds') best interests vis-a-vis default once.

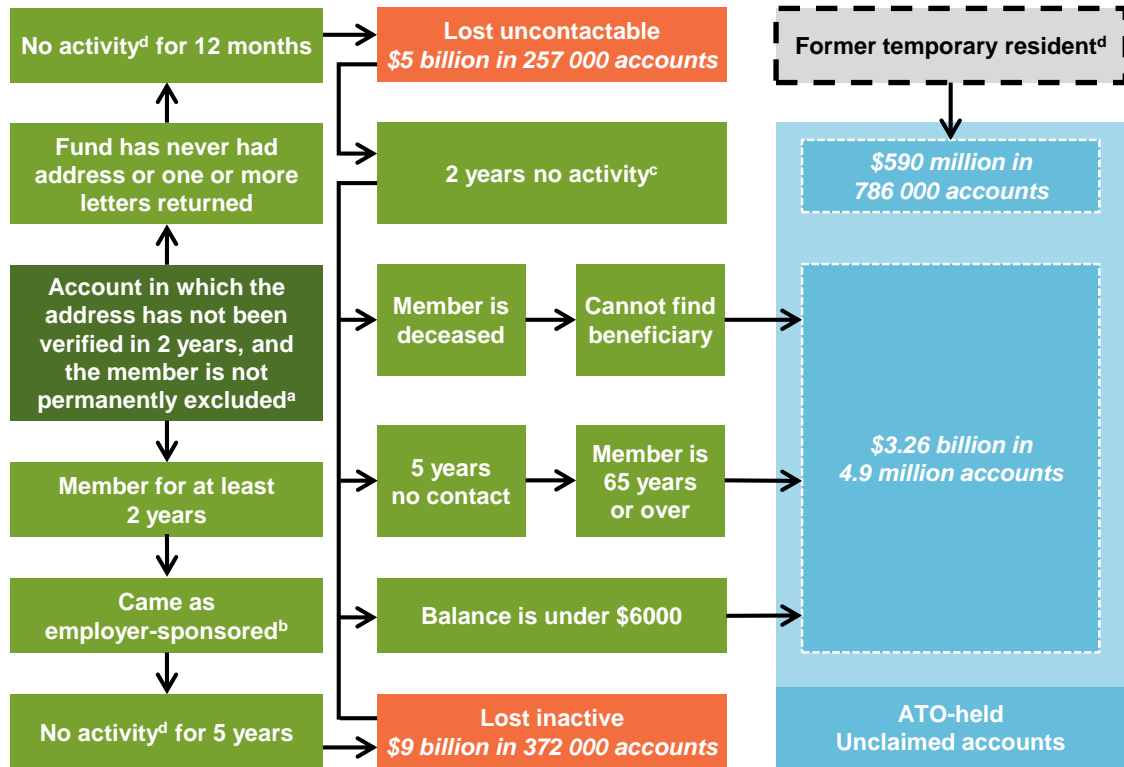
A different strategy is needed to address lost and unclaimed accounts

Rules leading to the creation of these accounts are complex

The lost and unclaimed superannuation accounts framework is complex (figure 6.8). There are two types of lost accounts — 'lost inactive' and 'lost uncontactable' — distinguished by different thresholds for activity and contact, and each is subject to certain exclusions. Many funds send their lost (or on the path to being lost) accounts to an 'Eligible Rollover Fund' (ERF), although there are not strict rules around when and why this must occur (box 6.1). Unclaimed superannuation is lost superannuation⁶¹ that satisfies at least one of three other conditions. Unlike lost superannuation, all unclaimed superannuation is held by the ATO. This complexity appears to have stunted the effectiveness of the framework — only 629 000 (ATO 2017d) accounts are defined as lost, despite there being an estimated 10 million unintended multiple accounts in the system.

⁶¹ With the exception of accounts belonging to former temporary residents, which can be transferred to the ATO before they are 'lost'.

Figure 6.8 **The framework for lost and unclaimed accounts is complex**
Lost and unclaimed superannuation, 2016



^a Permanently excluded means that the member has done something that indicates a preference to remain a member of the fund. For example, they used an online service. ^b Employer-sponsored means that the member defaulted. ^c Activity refers to contributions or rollovers. ^d A former temporary resident is a non-citizen who has not renewed their visa, or been granted a new visa, in at least six months.

Sources: ATO (2015d, 2017g); Superannuation Industry (Supervision) Regulations, r. 1.04a; Superannuation (Unclaimed Money and Lost Members) Act 1999 (Cth).

Box 6.1 Eligible Rollover Funds

Eligible Rollover Funds (ERFs) were established as a temporary repository for the benefit of members who had lost connection with their superannuation accounts. Institutional fund trustees are required to nominate an ERF to send accounts to should they deem it in a member's best interests to do so. Regulations do not provide strict guidance on when this would be the case. ERFs are only allowed to receive accounts from institutional funds and cannot take contributions from members or the ATO.

Originally, ERFs were envisaged as developing the necessary expertise to reunite accounts with members, while administering balances at very low cost. The relevant Cooper Review issues paper noted that the ERF sector had not been performing this role because:

- not all funds sent small inactive accounts to ERFs
- there was a lack of incentives for ERF trustees to re-connect members with their accounts
- different investment strategies had resulted in a wide range of returns, some of which did not effectively preserve balances.

Consequently, the Review recommended ERF-specific RSE license requirements that established an obligation to promote the financial interests of the beneficiaries of the fund and to undertake a single, diversified investment strategy for all assets in the fund. These changes were adopted and resulted in a rationalisation in the ERF sector from 16 to 8 funds. The Review also recommended that ERF trustees be required to match accounts with any active fund that seeks access to its database. However, this recommendation was not adopted. At present, ERFs are currently under no obligation to undertake activity to promote consolidation.

More recently, ERFs were empowered to undertake an automatic consolidation of a member's account into a fund if they could confirm that the receiving account had been active in the past 12 months. At least one ERF has sought to use this empowerment to increase reunification rates.

At present, ERFs make up 9.6 per cent of system accounts (2.75 million), and 0.17 per cent of system assets (\$4.4 billion).

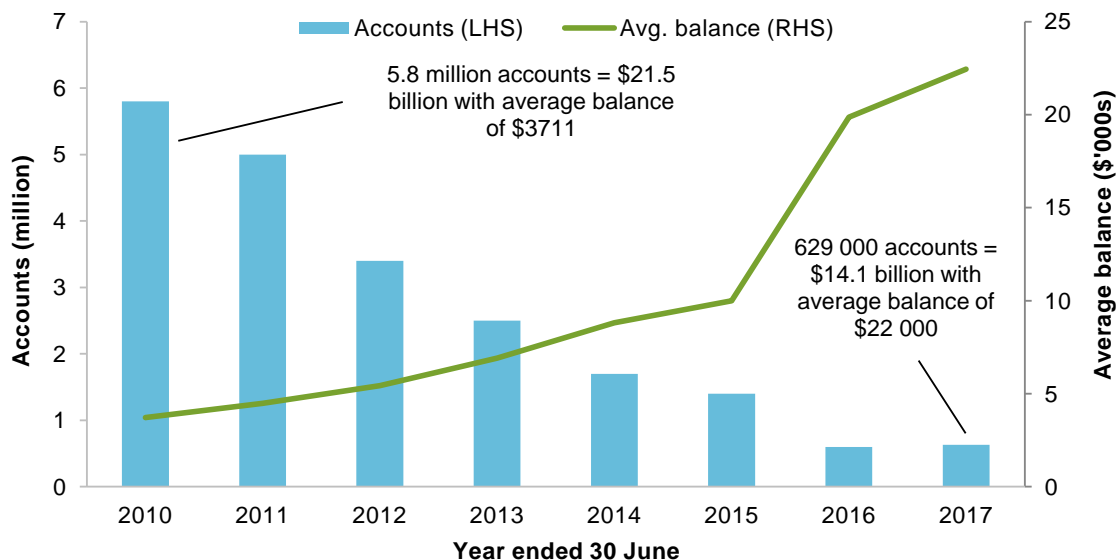
Sources: PC analysis of unpublished APRA data; APRA (2018b); Cooper et al. (2010b); Treasury Laws Amendment (2016 Measures No.1) Regulation 2016; Treasury (2011); Superannuation Industry (Supervision) Regulations, r. 6.29; *Superannuation Industry (Supervision) Act 1993* (Cth), s. 242k; IFS (2017).

The sum of lost and unclaimed accounts has changed little in recent years

The number of lost accounts has fallen markedly in recent years (figure 6.9). As at June 2010, lost accounts comprised about 18 per cent (or 5.8 million accounts) of all accounts in the system. As at June 2017, they accounted for about 2 per cent (629 000 accounts)⁶² (APRA 2018b; ATO 2017f, 2017d). Lost accounts now make up about 1 per cent of total assets in the accumulation phase (unpublished APRA data; ATO 2017d).

⁶² This figure comes from ATO data. APRA (2014b) also collects data on lost accounts but uses different definitions (that appear out of step with the underlying regulation). Inactive accounts are defined as employer-sponsored accounts with a contactable member, but with no activity for two years (instead of five). In the APRA definitions, inactive is defined as distinct from lost. APRA data suggests there is

Figure 6.9 Lost account numbers have fallen markedly
 Number of lost accounts and average balance, 2010–2017^a



^a All dollar figures are in 2017 dollars.

Sources: ABS (*Consumer Price Index, Australia, Sep 2017*, Cat. no. 6401.0); ATO (2017d, 2017f).

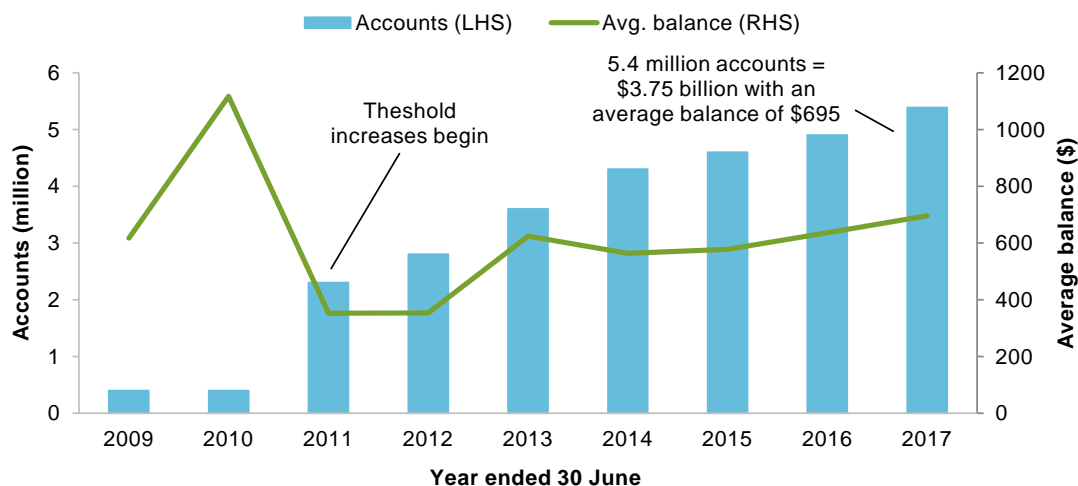
However, the ATO (2017f, p. 33) has noted that the decline in the number of lost accounts (and the rise in the average balance of a lost account) is in large part attributable to gradual increases in the balance cap for the transfer of lost accounts to the ATO as unclaimed accounts. These changes lifted the cap from \$200 to \$6000 starting in 2011, meaning more lower-balance accounts went from lost to unclaimed. Accordingly, this change has also led to a rise in the number of unclaimed superannuation accounts (figure 6.10).

Balances in lost and unclaimed accounts tend to be smaller than balances in the system more broadly. While the average balance for an account in an institutional fund is \$64 000 (APRA 2018b), the average for a lost account is \$22 000 (figure 6.9), and the average for an unclaimed account is just under \$700 (figure 6.10).

The costs to members of reduced balances from lost accounts are largely captured in the costs of unintended multiple accounts. The Commission estimates that lost accounts comprise at least \$161 million of the \$2.6 billion excess administration fees and insurance premiums charged on multiple accounts. The costs of unclaimed accounts are less direct. They arise in the administrative costs borne by the ATO (and ultimately taxpayers) and the foregone returns to members (given the ATO only pays interest in line with the consumer price index (ATO 2018b)).

\$100 billion in 6.5 million of these accounts. Lost accounts are defined as accounts that are inactive and uncontactable (although uncontactable is not clearly defined), and that have seen no activity for 12 months. APRA data suggests there is \$6.6 billion in 333 000 of these accounts (unpublished APRA data).

Figure 6.10 Unclaimed accounts have grown substantially^{a,b}
 Number of unclaimed accounts and average balance, 2009–2017



^a Average balance in 2017 dollars. ^b These data exclude Superannuation Holding Accounts (SHAs). Broadly, these are accounts the ATO have created to deposit unclaimed contributions (and other owed monies), rather than accounts received from funds. In 2016-17 there was \$106 million across 304 000 of these accounts.

Sources: ABS (*Consumer Price Index, Australia, Sep 2017*, Cat. no. 6401.0); ATO (2017f, 2017d).

Recent policy initiatives have targeted lost account creation

While the overall number of lost and unclaimed accounts has changed little in recent years, policy initiatives have worked at stemming the flow. From 2011, SuperStream allowed a member’s TFN to be used as their primary identifier in the superannuation system, and lifted obstacles to member data being provided to funds by employers.⁶³ The ATO’s ‘SuperTICK’ data-validation service, initiated in 2013, complements this by helping funds ensure that incorrect TFN data are corrected (funds use this service about 6 million times per year, although a large number of funds do not use this service at all) (ATO, pers. comm., 4 October 2017). From 2010 to 2015, the share of accounts with a correct TFN rose from 85 to 95 per cent (ATO 2017f, p. 43) (it is currently 96 per cent for APRA-regulated funds (unpublished APRA data)). The ATO also pro-actively updates funds if information attached to a lost account’s TFN changes (for example, a member registers a new address as part of their tax return).

Better information about members has been complemented by initiatives that allow easier consolidation of lost accounts or unintended multiple accounts on track to being lost. Allowing funds to use a member’s TFN as an internal account locator was the ‘trigger for a

⁶³ SuperStream was designed to streamline the ‘back office’ of superannuation. In addition to making TFNs the primary identifier within the system, SuperStream has led to the design of data and e-commerce standards for the reporting of contributions and straight through processing of superannuation transactions.

wave of intra-fund account consolidation’ (ATO 2017f, p. 10). And online services (the MyGov site and SuperMatch) facilitated the consolidation (as mentioned above) of 1.38 million accounts (with a value of \$6.5 billion) between 2013 and 2016 (ATO 2017f, p. 13).

However, while recent changes have made it easier for funds to maintain contact with account holders, as long as individuals can create unintended multiple accounts, the potential for those accounts to become lost and unclaimed remains — and for balances to be needlessly eroded in the meantime. As discussed above, the Commission’s proposal for default superannuation accounts to only be created once for people that are new to the workforce, and do not already have a superannuation account, would act as a circuit breaker.

Making the ATO responsible for reunification efforts will benefit members

While ‘default-once’ has substantial potential to stem the flow of lost accounts, there remains the problem of reuniting already lost and unclaimed accounts (and other unintended multiple accounts) with members. At present, this relies heavily on outreach by funds (ERFs in particular) and the ATO, and on engagement by members.

In the draft report, the Commission proposed that accounts should be sent to the ATO as soon as they are categorised as ‘lost inactive’ or ‘lost uncontactable’ for auto-consolidation with matched, active accounts (*not* to stay at the ATO to enter consolidated revenue) (draft recommendation 8). The Commission also recommended reducing the ‘lost inactive’ activity threshold from five to two years. Contemporaneously, the Government’s ‘Protecting Your Super’ package (Commonwealth of Australia 2018a) proposed a new category of account — ‘low-balance inactive’ — defined by 13 months inactivity, a balance under \$6000 and no insurance⁶⁴. The package proposed that these accounts be sent to the ATO for auto-consolidation with matched, active accounts, regardless of their categorisation in the existing lost and unclaimed account framework. The proposal also empowers the ATO to match and auto-consolidate the existing stock of ATO-held unclaimed accounts.

The Commission considers that this proposed approach is likely to be just as effective (if not more so) at cleaning up unintended multiple accounts as the one proposed in the draft report. As mentioned earlier, the current framework is clearly failing to capture many unintended multiple accounts as it currently defines only 629 000 (ATO 2017d) of the estimated 10 million unintended multiple accounts as lost. The new ‘low-balance inactive’ definition effectively ‘bypasses’ the current framework and will capture many more than the 629 000 accounts currently designated as lost.

Further, the Commission considers that a ‘fund-ATO-fund’ approach would be superior to a ‘fund-to-fund’ approach (in which the ATO directs auto-consolidation in the system, rather

⁶⁴ This last requirement stems from another recent proposal to have insurance be opt-in for balances under \$6000 (chapter 8). In effect, this proposal means that an account under \$6000 that is inactive but has insurance is likely to be an intended account, and thus unsuitable for auto-consolidation.

than receives and transfers the account itself). A ‘fund-to-fund’ approach was recommended by several participants (AIST, sub. DR130; Qantas Super, sub. DR137; ASFA, sub. DR148; BT, sub. DR149; REST, sub. DR171; Cbus, sub. DR177). While a ‘fund-to-fund’ approach may reduce administrative costs and eliminate the risk of an account becoming ‘stranded’ at the ATO, there is a compliance risk associated with the ATO relinquishing control. There is no shortage of reports of funds finding reasons to delay or prevent rollovers, while it is expected that an ATO-led matching and consolidating process would be quick and efficient, particularly given the ATO already has the infrastructure in place to execute this policy (SELC 2018a; brief comments – super fund members, 14, 25 and 39; Vagg, sub. DR212).

That said, there are at least two potential future additions to this auto-consolidation proposal that would help forge a more comprehensive ‘reunification framework’. First, increasing the balance cap. And second, ensuring the existing lost and unclaimed framework works in harmony with the new proposal. There are some other (relatively minor) issues discussed later in the chapter.

There is a critical caveat to this discussion. In the absence of ‘default once’ the system will continue to generate unintended multiples causing much member harm, and auto consolidation will be relegated to the inferior role of ‘mopping up spilt milk’. Moreover the generation of unintended multiple accounts is unlikely to abate with today’s workforce reality of workers when changing jobs more likely to change industry (43 per cent) and occupation (55 per cent) (chapter 1).

A higher balance cap could capture more unintended multiple accounts

The Protecting Your Super proposal has a \$6000 balance cap, which means only accounts under this amount can be auto-consolidated. The proposal is expected to reunite \$6 billion of superannuation balances with 3 million members’ active superannuation accounts in 2019–2020 (its first year of operation) (O’Dwyer 2018a). The number of accounts impacted will naturally increase as more unintended multiple accounts meet the inactivity definition, but any unintended multiple accounts with a balance over \$6000 will still rely on member engagement for consolidation. The fact that the Commission’s estimate of 10 million unintended multiple accounts is far in excess of the 3 million accounts expected to be impacted in the first year of the proposal suggests a considerable proportion of unintended multiple accounts have balances over \$6000.

Therefore, there is merit in revisiting and possibly increasing the balance cap if, after a few years of operation, it appears that there is scope to capture more unintended multiple accounts. This revisiting should occur as part of the ongoing review of the system (chapter 13).

The key reason for the \$6000 cap is that accounts over this value will most likely receive higher net returns in a fund than with the ATO (where accounts will only earn interest at the rate of the CPI). This could be overcome by requiring the ATO to match the inactive account

with an active account *before* the fund transfers the account to the ATO. This would rule out the possibility of an account being ‘stranded’ at the ATO.

The new proposal should form part of a comprehensive ‘reunification framework’

The Protecting Your Super proposal creates a new category of account (a ‘low-balance inactive account’), without removing or amending any of the existing categories in the current framework (figure 6.8). And, as mentioned earlier, the existing framework is complex and not fit-for-purpose. Therefore, the existing framework should be modified to ensure it works in harmony with the new proposal to form a comprehensive ‘reunification framework’.

A key starting point should be to clearly define the purpose of each category of accounts. For example, the ‘low-balance inactive’ account category is designed to capture accounts for auto-consolidation. The ‘lost inactive’ and ‘lost uncontactable’ categories, along with the various unclaimed categories, should be reviewed to ensure they are meeting a clear purpose.

There are potential downsides to an auto-consolidation mechanism, but the benefits substantially outweigh the costs

There are at least three other issues raised by the auto-consolidation proposal: the impact on total and permanent disability (TPD) insurance payout tax liabilities; the impact on trailing commissions; and the impact on the overall Australian Government budget position. Each of these is worthy of note, but not material enough to prevent the proposal from proceeding.

Some participants pointed out that an auto-consolidation mechanism could inadvertently lead to higher tax liabilities on TPD payouts for affected members (Berrill and Watson Lawyers, sub. DR176; ALA sub. DR128). The tax paid on TPD payouts is an increasing function of the ‘age’ of the account. And in the event of a rollover, the receiving account inherits the ‘age’ of the account rolled inwards. This means that an auto-consolidation mechanism will increase the ‘age’, and therefore the tax liability on any TPD payout, of the receiving accounts, despite no action being taken by the member.

Presumably, the rationale for the tax liability to increase with account ‘age’ relates to how long the payout needs to last; a young individual who has a valid TPD claim needs their money to go further than an older individual. In effect, it appears account ‘age’ is essentially a proxy for actual age. At face value, this means that account consolidation is actually making the proxy more reliable by closing the gap between the age of the individual and the ‘age’ of the account. Furthermore, given the Commission’s ‘default once’ proposal should effectively make unintended multiple accounts a legacy issue, it should also make this issue a legacy one as well. Nonetheless, while it is not material enough to preclude an auto-consolidation mechanism proceeding, it could still impact a reasonably large number of current members in a significant way (ALA, sub. DR128). Therefore, it may make sense for the tax arrangements on TPD payouts to be reviewed to ensure they are consistent with the best possible outcomes for the affected members.

Accelerating the transfer of inactive accounts to the ATO could infringe on the property rights of an adviser receiving commissions from an inactive account, impeding the transfer of these accounts. However, if grandfathered trailing commissions are ‘turned off’ this will not present an issue (chapter 13). And last, an auto-consolidation mechanism could see members inadvertently incur exit fees. However, the proposed requirement for all fees (including exit fees) to be levied on a cost-recovery basis (chapter 13) negates this.

Overall, these downsides appear to be small relative to the potential benefits — according to the Regulation Impact Statement the auto-consolidation proposal in the Protecting Your Super package will produce a large net benefit (Treasury 2018d).

ERFs are not an effective policy tool and should be wound-up

Currently, ERFs are supposed to receive, match and consolidate lost accounts, but *prima facie* evidence suggests only a small part of the ERF sector is meeting this objective. In 2016-17, ERFs transferred out only 15.1 per cent of their accounts. This figure overestimates the proportion of accounts that are reunified as it includes those sent to the ATO as unclaimed accounts. This low reunification rate is despite 84 per cent of the 2.75 million accounts in ERFs having a TFN attached (unpublished APRA data). It has been noted that ERFs may not have the correct incentives to effectively promote unification and may not be adequately preserving balances (Cooper et al. 2010b).

It is also surprising that three of the eight ERFs charge exit fees, despite the fact that transferring accounts out is their remit. While this might be justifiable on cost recovery grounds, data suggest these grounds are not upheld for all fees. For example, one ERF charges \$40.70 for an exit (whether to the ATO or otherwise), while another charges just \$0.25 for an exit to the ATO and \$5 for a non-ATO exit (ERF product disclosure statements).

Incentives aside, an ERF’s fundamental role is account reunification. In this respect they are heavily constrained by the data they have access to. At least one ERF (AUSfund) is actively promoting auto-consolidation through data matching with other funds. While this effort and intent are laudable, AUSfund is constrained by the fact that funds are not obligated to participate. In the initial program, only nine funds participated and thus only 54 000 accounts suitable for auto-consolidation were found (IFS 2018).

The Protecting Your Super proposal is projected to capture about 91 per cent of accounts at ERFs, without explicitly directing ERFs be wound up (Treasury, pers. comm., 16 November 2018). There is little sense in leaving a small number of accounts at ERFs indefinitely. A comprehensive ‘reunification framework’ (as proposed above) should ensure those accounts that remain at ERFs are appropriately categorised and sent to the ATO for reunification if deemed necessary. If, after three years, there are still accounts remaining at ERFs, the Government should review the situation with a view to moving the accounts and winding up ERFs.

In sum, the problem of unintended multiple accounts is solvable

The problem of unintended multiple accounts has been allowed to go on for too long. Together, recent Government policy announcements and the Commission’s proposals should make this problem a thing of the past (table 6.1). Implementing ‘default once’ with a centralised online service will stem the flow of new unintended multiple accounts. And over time, an effective auto-consolidation mechanism will clear the stock.

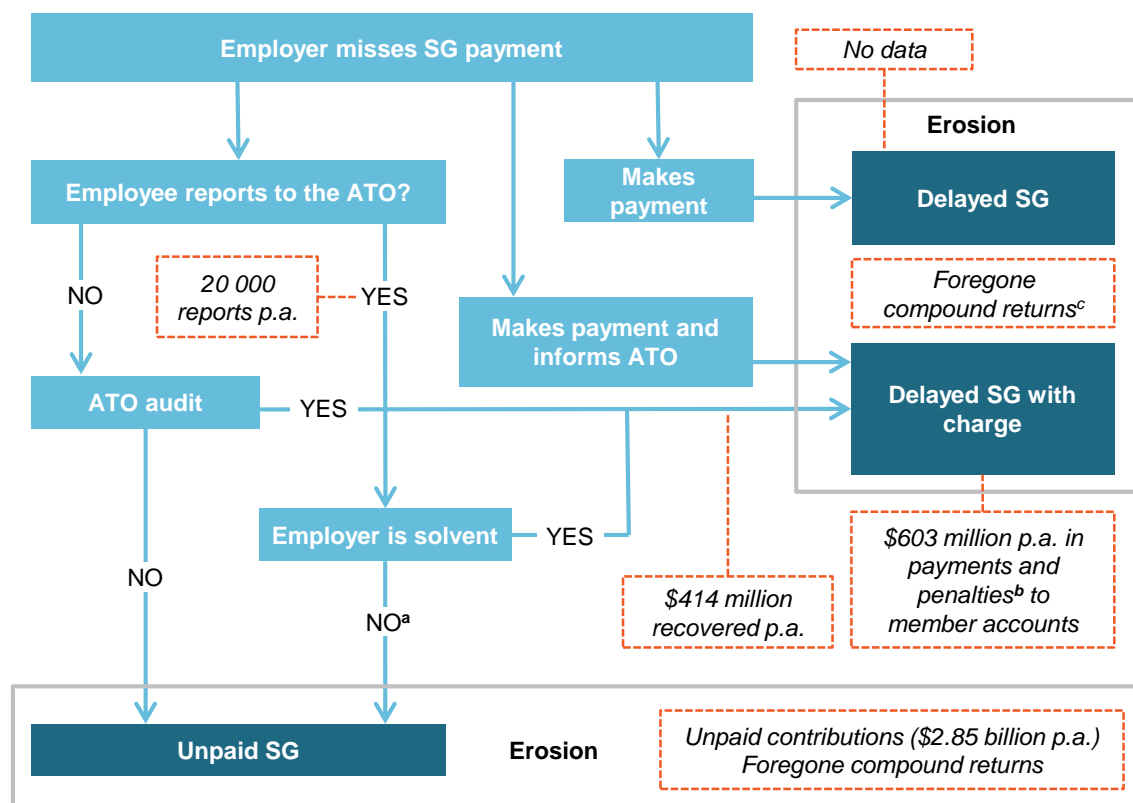
Table 6.1 Unintended multiple accounts: issues and responses

<i>Causes</i>	<i>Improvements in train</i>	<i>Further action needed</i>
Problem: Stemming the flow of unintended multiple accounts		
<ul style="list-style-type: none"> • Inefficient default arrangements 	<ul style="list-style-type: none"> • Voluntary online standard choice form 	<ul style="list-style-type: none"> • Implementing ‘default once’ with the universal online standard choice form via centralised online service
Problem: Clearing the stock of unintended multiple accounts		
<ul style="list-style-type: none"> • Incentives misalignment between ERFs and members • Lack of data sharing 	<ul style="list-style-type: none"> • Transfer of auto-consolidation responsibility to ATO 	<ul style="list-style-type: none"> • Potential increase in balance cap to trigger auto-consolidation • Wind-up of ERFs • Harmonisation of lost and unclaimed framework

6.2 Are efforts to reduce unpaid super effective?

The current SG obligation is 9.5 per cent of an employee’s ordinary time earnings (OTE), subject to the employee being at least 18 years of age (or under 18 and working over 30 hours a week) and earning over \$450 a month. Employers must make these payments at least quarterly. Delayed SG contributions occur when an employer ultimately pays, but after the quarterly deadline. Unpaid SG contributions arise when an employer fails to meet this obligation altogether, and are a significant source of erosion (figure 6.11). Given this leakage effectively occurs before a fund has a member’s contributions, there is little funds can do to rectify it. This issue is primarily about policy and the compliance framework.

Figure 6.11 Unpaid SG contributions lead to significant erosion^{a,b}



^a It may be that a trustee/liquidator/administrator advises that there are sufficient assets to meet outstanding SG obligations. ^b The administration fee component of the penalty is paid to the ATO. ^c Foregone compound returns are offset by nominal interest paid as part of the SG charge.

Sources: ATO (2017a, 2017e, 2018j).

Total extent of delayed SG contributions is unclear

There are essentially two types of delayed SG payments — those that are not observed by the ATO, and those that are, and are subject to the SG Charge.⁶⁵

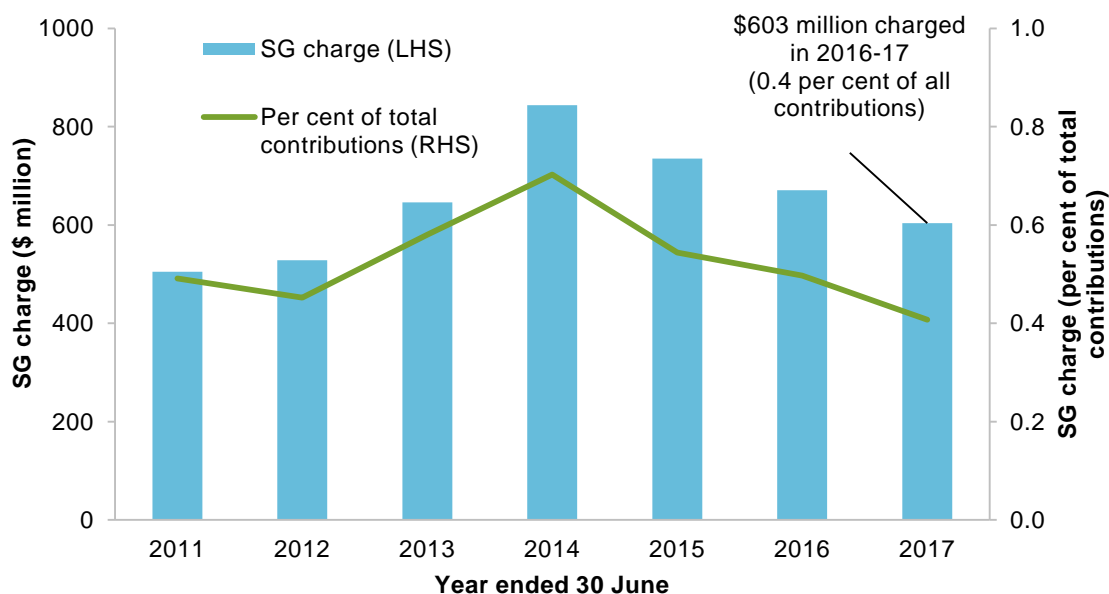
There are no system-level data on the number and value of late payments not reported by employees or employers given they are unobserved by the ATO. Data are available on late payments subject to the SG Charge. They show a fall in recent years, after a peak in absolute terms and relative to total contributions in 2013-14 (figure 6.12).

Compliance activity relating to delayed SG payments can be prompted by employee or employer reports to the ATO of unpaid contributions, or by ATO audit activity.

⁶⁵ The SG Charge includes the amount not contributed, nominal interest of 10 per cent per year and a \$20 per employee per quarter administration fee. There are incentives for employers to self-report late payments that effectively reduce their liability (ATO 2018d).

Figure 6.12 SG charges levied have been falling

Total value and as a percentage of total contributions made, 2011–2017



Sources: ATO (2011, 2012, 2013, 2014a, 2015a, 2016a, 2017a, 2018a); APRA (2018n).

Data on the employees who lodged an SG underpayment notification with the ATO indicate that they are typically younger and lower-income than the working population more broadly. For example, nearly 50 per cent of employees reporting underpayment were aged under 34 years, compared with 38 per cent for all employees. Further, 76 per cent of employees reporting underpayment earned under \$60 000, compared with 66 per cent for all employees.

Moreover, data on the employers subject to ATO action for underpayment show that lower-skilled services industries have the highest incidence of underpayment. In particular, in 2016-17, 7 per cent of all accommodation and food services employers were subject to ATO action for underpayment (compared with an average of 1.8 per cent of employers across all industries). These cases made up 17 per cent of all cases. The data also show that, in absolute terms, construction and retail trade make up a significant proportion of the total complaints (16 and 10 per cent respectively), despite having a relatively lower percentage of employers subject to complaints (1.6 and 2.3 per cent, respectively) (ABS 2018d; ATO, pers. comm., 21 December 2017).

Interestingly, the data suggest that larger employers are more likely to be subject to ATO action for underpayment. While employers with 20 or more employees make up 6.5 per cent of all businesses in Australia, they make up 19.5 per cent of employers subject to ATO action for underpayment (ABS 2018d; ATO, pers. comm., 21 December 2017).

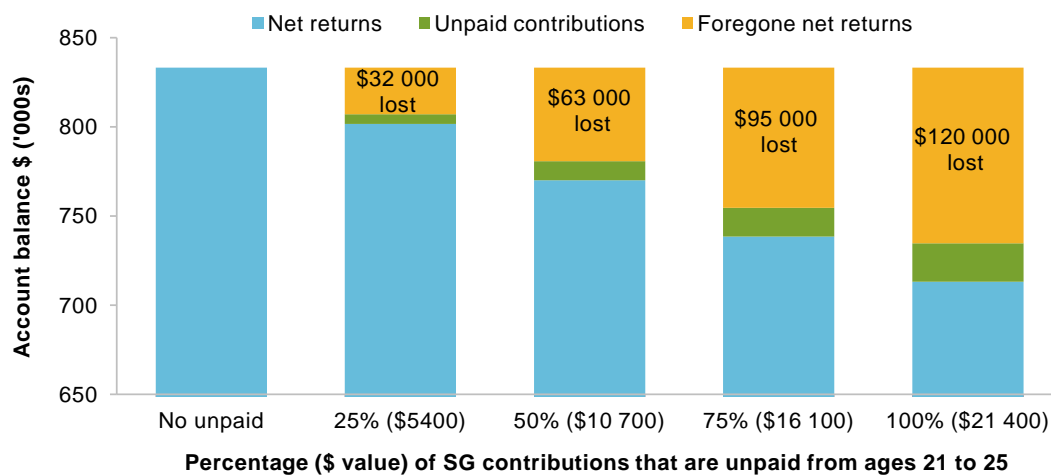
Unpaid SG contributions remain significant, but difficult to calculate

Recent research has estimated the value of unpaid (and unreported) SG contributions in the superannuation system. The most conservative estimate is \$2.8 billion (4.2 per cent of all SG contributions) in 2016-17 (APRA 2017e; ATO 2017e) — indicating that a material share of contributions goes unpaid. And, although there are no data to draw definitive conclusions, unpaid SG is likely to be highly regressive in its impact on member balances.

The potential impact on retirement balances of unpaid contributions and the associated foregone compounded returns can be marked. For example, estimates from the Commission’s cameo model (chapter 1) indicate that a person whose employer does not pay 50 per cent of due contributions during the early years of the person’s career (while they are aged 21 to 25) would have a retirement balance 7.6 per cent (\$63 000) lower than a peer who received all their contributions (figure 6.13).

Figure 6.13 Unpaid SG payments can have a significant impact on retirement balances – cameo results^a

Projected retirement balances by % unpaid SG from ages 21 to 25



^a The assumptions underpinning this cameo are set out in chapter 1.

Impacts of unpaid SG contributions extend beyond lower retirement incomes for affected members. For example, unpaid contributions lead to foregone taxation revenue as contributions and earnings are both taxed. They also allow non-compliant employers to benefit (through lower wage costs) at the expense of their workers and compliant employers. And last, they can void some disability and income protection insurance policies that rely on regular contributions to remain valid (SERC 2017). In other words, unpaid SG contributions can mean some individuals (or their estates) have no policy at all when they believed they did and had a valid claim.

Presently, depending on the relevant industrial instrument, some individuals have recourse to sue their employer in the event they have a claim but no insurance policy on account of unpaid contributions. Ideally, this avenue would be open to all employees, regardless of the relevant industrial instrument or whether superannuation obligations are spelt out in them.

That said, if the proposed unpaid SG compliance measures, ‘default-once’ and the ‘Protecting Your Super’ proposals are implemented, the extent of this problem will be much reduced. The proposed SG compliance measures will make it much easier for the ATO to detect unpaid contributions (detailed below), while ‘default-once’ and the ‘Protecting Your Super’ proposals restrict the number of people vulnerable to such a situation. Hence, it would be worth considering any necessary policy improvements to address the issue of unpaid contributions on insurance payouts once the proposed policy initiatives are in place.

Recently proposed policy changes should significantly reduce unpaid contributions

In August 2017, the Australian Government announced its intention to introduce policy changes that would greatly reduce the potential for employers to avoid meeting their SG obligations (O’Dwyer 2017a) (figure 6.14). If implemented, the changes will mean that:

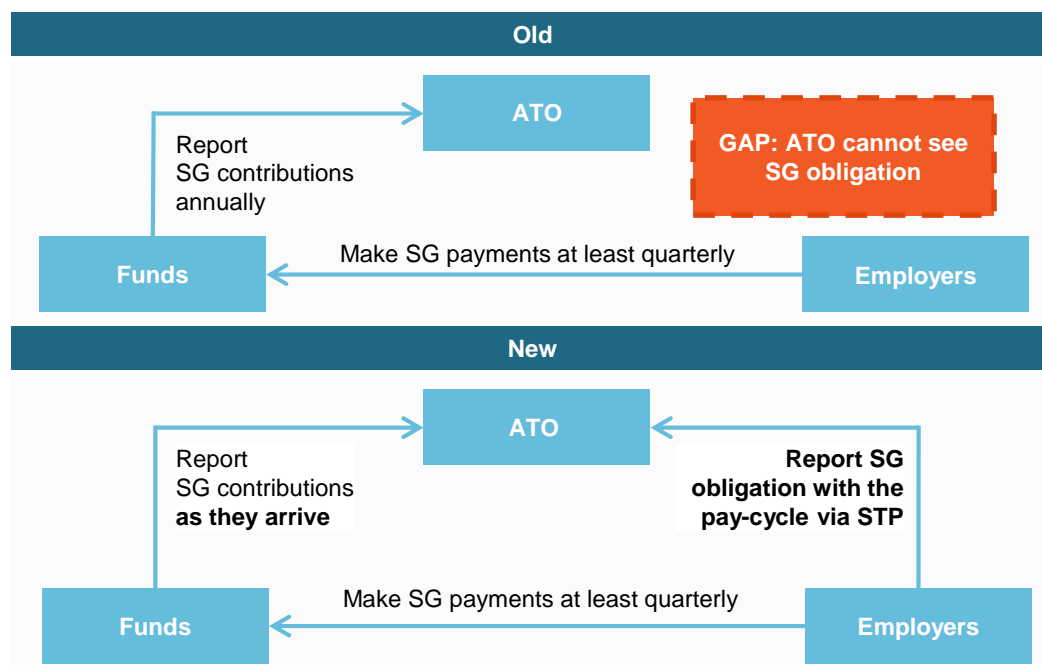
- Single Touch Payroll will be extended to small employers (less than 20 employees), from 1 July 2019 (currently still before parliament (Commonwealth of Australia 2018b))⁶⁶
- funds will need to report contributions to the ATO at least monthly (this can be given effect through a legislative instrument by an ATO Commissioner)
- the ATO will have stronger powers to enact penalties on non-compliant employers and recover unpaid SG contributions (currently still before parliament (Commonwealth of Australia 2018b)).

The extension of STP to all employers is critical, as it would give the ATO regular data on OTE (and thus an employer’s SG obligation), whereas currently the ATO has no direct visibility of SG obligations. This extension, combined with the requirement for funds to report contributions received to the ATO at least monthly (instead of annually), will give the ATO regular data on SG obligations and SG contributions received for all employees. These regular data will enable the ATO to identify non-compliant employers and take action to recover unpaid SG contributions much more effectively than it is currently able to. Given universal digital interaction with the ATO, this extension would not be an undue impost on small- and medium-sized businesses. Strengthened compliance and enforcement tools (for example, employer fines) will also act as a disincentive for potential non-compliant employers.

⁶⁶ STP will mean that employers can report OTE or SG contributions to the ATO directly from their payroll software.

Figure 6.14 **New SG compliance regime fills gaps in the old regime**

Current and new/proposed



As part of another package of policy changes, the Australian Government announced in July 2017 that it would legislate to remove the ability for employers to deduct an employee’s voluntary contributions from their SG obligation. While this practice is not technically an illegal non payment, the legislation will help ensure that unwitting employees do not receive less SG contributions than they are entitled to.

FINDING 6.1

Several proposed policy changes will promote Superannuation Guarantee payment compliance.

- Single Touch Payroll being extended to small employers (with less than 20 employees) from 1 July 2019.
- Funds being required to report contributions to the ATO at least monthly.
- The ATO having stronger powers to penalise non-compliant employers and recover unpaid contributions.

In stage 2, the Commission suggested that a centralised clearing house might improve oversight of employer compliance with SG contributions (PC 2017d). However, the emerging reporting framework and a centralised clearing house would have similar functionality for compliance monitoring. The practical distinction between the approaches is that the ATO will receive real-time data from employers and funds under the reporting

framework, whereas the ATO would facilitate the creation of that data under a clearing house model. The visibility is effectively the same.

COSBOA (sub. DR203) supported an ATO clearing house on the grounds of administrative simplicity for employers. However, as detailed in the draft report (pp. 293, 475), the Commission is not convinced a centralised clearing house would be superior to the current system. The introduction of SuperStream means dealing with multiple funds no longer presents excessive administrative complexities for employers (PC 2018d). Last, it is important to note that the discussions above all rest on the assumption that the employee and employer are visible to the ATO to begin with. There remains the problem of workers in the black economy. However, this issue is broader than the superannuation system. Unpaid SG contributions in the black economy can only be meaningfully addressed by addressing black economy activity more broadly, which is outside the scope of this inquiry.

FINDING 6.2

The superannuation system, primarily due to its policy settings, does not minimise the unnecessary and undesirable erosion of member balances. This erosion is substantial in size and regressive in impact.

- Structural flaws have led to the absurdity of unintended multiple accounts in a system anchored to the job or the employer, not the member. These unintended multiple accounts (one in three of all accounts) are directly costing members nearly \$1.9 billion a year in excess insurance premiums and \$690 million in excess administration fees. For an individual member holding just one unintended multiple account throughout their working life, the projected reduction in their balance at retirement is 6 per cent (or \$51 000).
- Superannuation Guarantee non compliance is hard to estimate, but may be costing members about \$2.8 billion a year.

Recent policy initiatives have improved the situation, but current policy settings are inevitably making slow progress by treating the symptoms and not the structural cause.

6.3 Are funds efficiently managing tax?

Tax management matters for member returns

At a high-level, super funds are taxed on investment earnings at 15 per cent. But in reality the actual rate paid is quite different as investment earnings in the pension phase are tax free, and the use of franking credits and capital gains discounts can greatly reduce the effective rate paid.

While the environment is complex, how funds manage tax (including exemptions and discounts) is important because it can make considerable differences to the net returns credited to a member's account.

Funds are supposed to be optimising tax management

Section 52(6)(a)(vi) of the *Superannuation Industry (Supervision) Act 1993* (Cth) stipulates that trustees must:

... formulate, review regularly and give effect to an investment strategy for the whole of the entity, and for each investment option offered by the trustee in the entity, having regard to ... the expected tax consequences for the entity in relation to the investment covered by the strategy ...

This amendment resulted from recommendations from the Cooper Review (Cooper et al. 2010b, p. 84), which noted that there was 'wide variation in the extent to which most trustees and investment managers have regard to the optimisation of tax outcomes for members'.

While the cost of this suboptimal management was hard to gauge, the Review (Cooper et al. 2010b, p. 87) suggested that '... estimates of the cost of this lost tax efficiency vary, ranging from around 5 basis points per year (considering the impact of turnover alone) up to some 200 basis points per year on a more holistic basis'. Further, Williams (2011, p. 1) has argued that '[f]or super funds, the combined effect of franking credits and capital gains discounts is to improve — that is, add to — the pre-tax return by between 0.2% — 0.5%'. Estimates from the Commission's cameo model (chapter 1) suggest that just a 0.2 per cent improvement in returns over a working life can improve a member's balance at retirement by 5.4 per cent (\$45 000).

However, there have been concerns raised that the amendment to require trustees to have regards to tax efficiency has not had the intended effect of eliciting more 'Tax Aware Investment Management' (TAIM). For example, Mackenzie stated that his research (from 2014) found that funds were not paying adequate attention to tax efficiency:⁶⁷

... of the 19 or so tax strategies that could be applied to funds management in a superannuation fund, the Chief Investment Officer [of each fund in the sample] focused on only two. First, in managing CGT payable by the fund, as in holding assets for at least 12 month to gain the benefit of the 1/3rd discount on assessable gains, and, secondly, with respect to the tax rules for imputation credits. Specifically, ensuring that the 45-day rule (Section 177EA *Income Tax Assessment Act 1997*) was not breached, thereby protecting the funds' entitlement to claim the imputation credits.

This limited application or use of the tax rules is notwithstanding an obligation on trustees of non-SMSFs superannuation funds to have regard to tax when making investment decisions. (stage 1, sub. DR73, p. 5)

⁶⁷ However, it is worth noting that the small sample of 22 funds overrepresented industry funds compared with non-industry funds, and inside of this, it overrepresented both smaller industry funds and larger non-industry funds.

There are well-documented difficulties in implementing TAIM (Mackenzie and McKerchar 2014; Williams 2011), however some large funds, including Mercer, AustralianSuper and UniSuper have made public their use of external consultants to optimise tax management (GBST 2017). This suggests that at least some funds are taking this relatively new obligation seriously, and also that TAIM is not prohibitively difficult to implement. Further to this, there are after-tax benchmarks available for funds to use to assess their tax management. The FTSE ASFA Australia Index Series is one example (ASFA 2017a).

Much fund reporting, including on MySuper dashboards and the way comparison websites showcase performance, requires an after-tax return. This should mean that funds are competing on an after-tax basis, and thus should imply that funds are optimising tax. A lack of interest in TAIM could be indicative of a lack of competition more broadly. (Competition in the system is addressed in chapter 7.)

The available evidence does not allow the Commission to draw firm conclusions on whether funds are optimising tax management.

The transition to retirement

Mackenzie noted issues around tax management upon the switch from accumulation mode to pension mode:

Specifically, we were told when doing our research that because some of these funds hold a member's accumulation assets and pension assets in separate pools, when the trustee moves the funds supporting the accumulation account from that pool of assets to a pool of assets supporting the member's pension account, the value of their interest in the accumulation pool that is transferred is net of any accrued deferred tax liability. In other words, the member is, in effect, paying tax at that point. (stage 1, sub. DR73, pp. 5–6)

However, there are ways that funds can target the tax benefit associated with the retirement phase towards those members entering the retirement phase (QSuper nd; ASFA stage 2. sub. DR96; Sunsuper nd). This has also been noted by the ATO:

Some institutional funds also now offer member directed investment opportunities and some are offering a 'tax bonus' to members moving from accumulation phase to pension phase on the basis that the fund receives a benefit when unrealised gains on assets move into the tax-free retirement phase on the basis that the fund receives a benefit when unrealised gains on assets move into the tax-free retirement phase. (ATO, pers. comm., 21 Feb 2018)

Are tax advantages a motivation for establishing SMSFs?

SMSF members may have an advantage in the transition to retirement as the assets held in accumulation stop accruing capital gains upon the switch to pension mode and, assuming the assets are not sold immediately, the liability is extinguished. This extra level of control that comes from not having a wide membership base is noted by the ATO:

The relevant tax provisions are the same for both SMSFs and institutional funds. Nevertheless, the variance in the operational structure and membership between SMSFs and institutional funds means that these common tax provisions can give rise to different outcomes at a member level in various scenarios. (ATO, pers. comm., 21 Feb 2018)

Dixon Advisory argued that SMSFs were more likely to have better tax outcomes for their members compared with APRA-regulated funds:

... APRA funds do not allow their members to achieve tax outcomes that are already utilised by SMSFs (i.e. separation of capital gains income out from investment income would allow unitised funds to apply a 10% tax rate to capital gains, rather than applying an overall tax rate of 15% to all income). (sub. 61, p. 4)

AIST noted that the ability to gear has given rise to a tax advantage for SMSF members:

The use of [limited recourse investment vehicles] to gear property, and the relatively extensive investment into private trusts suggests that SMSFs are quite often tax driven. (sub. 39, p. 81)

Previous surveys have suggested that, while tax flexibility is relatively important as a motivation for establishing an SMSF, it generally ranks lower than choice and control over investments. For example, Bird et al. (2016b) — based on a survey of 500 SMSF members — found that of the 21 possible reasons for having started an SMSF, ‘minimisation of tax’ ranked third in importance behind ‘choosing investment myself’ and ‘manage fund myself’ (p. 22).

The results of an online survey of over 500 SMSF members conducted by the SMSF Association and the Commonwealth Bank (2017), suggested that the desire for higher returns was also a key driver for establishing an SMSF. It found that the top three most important reasons for establishing an SMSF were ‘to achieve better results’ (59 per cent), ‘to take more control over personal finances’ (53 per cent) and ‘lower cost/fee structure (43 per cent). In comparison, 28 per cent of respondents nominated that ‘it’s more tax effective’; ranking it sixth out of eight possible reasons.

The results from the Commission’s members survey are broadly consistent with these observations (chapter 5). While SMSF members commonly consider tax flexibility, it is rarely a driving factor in the decision to establish an SMSF. About one fifth of SMSF members cite ‘tak[ing] advantage of the tax benefits’ as a factor that motivated them to set up an SMSF but less than 4 per cent said that tax flexibility was their main motivation.

In any case, any tax advantages (over institutional funds) that SMSF trustees may use are likely to show up in returns, but are not necessarily observable in the data. This means that the Commission’s findings regarding the relative performance of SMSFs compared with institutional funds (chapter 2) are subject to the caveat that different tax arrangements are not completely controlled for.

7 Market structure, contestability and behaviour

Key points

- No single or simple metric indicates whether markets at the retail and wholesale levels of the superannuation system are performing competitively.
- Some metrics suggest much of the system is potentially conducive to rivalry and contestability.
 - The retail level has many funds, low concentration and a contestable choice segment. While structural features of the system create challenges for new funds to enter the market, these barriers are not prohibitive or even high. Nor does existing fund's strategic use of integrated business models to gain members stifle contestability in the choice segment.
 - Smaller, higher cost funds have been exiting the industry at a higher rate than other funds.
 - Larger funds ability to insource functions, such as administration and investment management, provides some competitive pressure in wholesale markets.
 - Significant economies of scale have been realised, particularly in administration.
- Other evidence points to the absence of effective competition, at the expense of fund members.
 - In the default segment, there are high barriers for new entrants, a marked absence of competition *for* the market and muted competition *in* the market. And the risk of employer inducements (of no benefit to members) is a concern.
 - In the choice segment, underperformance, high fees, fees for no service, product proliferation and the absence of simple comparable data are among symptoms of unhealthy competition.
 - Unrealised economies of scale are significant — there remains a large number of small funds (93 with assets under \$1 billion and collectively holding 1.7 million member accounts).
 - In the investment management market, concentration is low but evidence suggests that managers have some market power. As a consequence, smaller funds, in particular, pay higher fees than they would be if competition was more robust.
 - Horizontal integration has contributed to impairment of some members' best interests. Vertical integration, while not a problem per se, is associated with higher costs. And evidence suggests some funds are outsourcing to related parties ahead of more efficient (but unrelated) service providers.
- Scale benefits also manifest through increasing returns — but only in the not-for-profit segment.
- There is little evidence that realised economies of scale have systematically been passed through to members in the form of lower fees. Scale benefits may have been 'passed through' in the form of member services, increases in reserves or the costs of meeting new regulatory requirements. And not-for-profit funds, on average, might have passed through some scale economies by investing more heavily in (higher cost) unlisted assets and obtaining higher returns. Data limitations preclude firm conclusions about the form pass-through takes, and thus how members are actually benefitting and whether in a form they value.

Healthy competition would spur superannuation funds to deliver better returns, lower fees, provide products that meet members' needs and innovate. Does it exist in the superannuation system? This chapter makes an assessment against the following five criteria.

- Is the market structure conducive to rivalry? (C3)
- Is the market contestable at the retail level? (C4)
- Are there material anticompetitive effects of vertical and horizontal integration? (C5)
- Are economies of scale realised and the benefits passed through to members? (C7)
- Do all types of funds have opportunities to invest efficiently in upstream capital markets? (E3)

7.1 Is the market structure conducive to rivalry?

Rivalrous behaviour is driven by multiple entities competing for the same objective: more members in the case of funds; more clients in the case of service providers. Market structures with multiple entities should be conducive to rivalry, and the competitive pressures that come with it. And a strong enough threat from potential new competitors could drive incumbents to behave as though they face competition. How does the super system look?

At the retail level (APRA-regulated funds and SMSFs)?

There are many funds ...

Nearly two-thirds of total superannuation assets sit with Australian Prudential Regulation Authority (APRA)-regulated funds (APRA 2018b). Significant consolidation over the past 12 years, particularly among corporate funds, has seen the number of these funds fall (figure 7.1), but about 200 remain — comprising retail funds and not-for-profit entities (public sector, industry and corporate funds).⁶⁸ The same period has seen significant growth in self-managed super funds (SMSFs), to close to 600 000. SMSFs now account for nearly 30 per cent of total assets.

... many of which are small ...

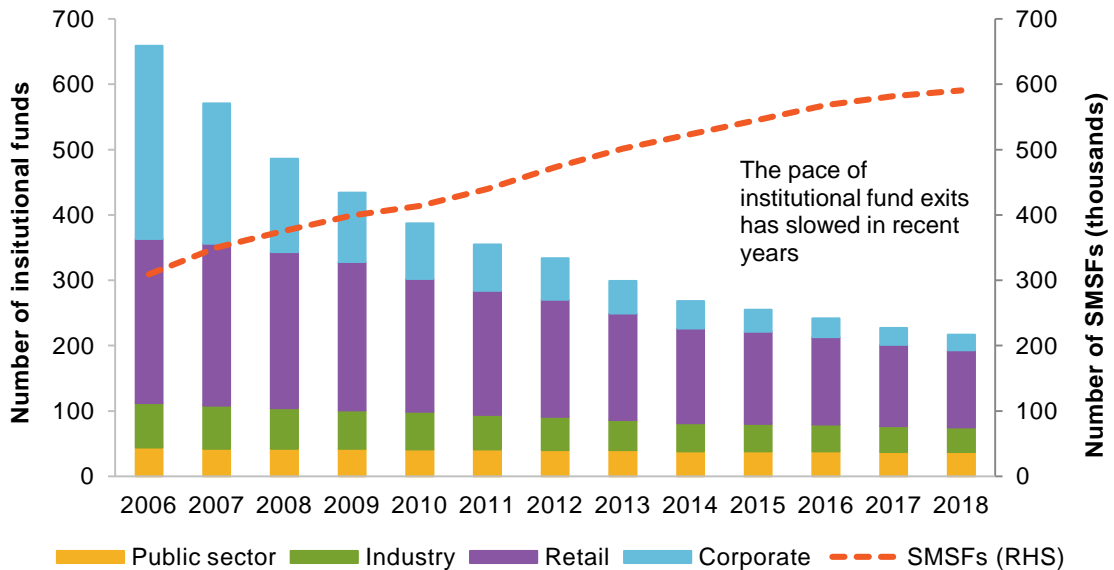
APRA-regulated funds vary markedly in size (figure 7.2). Nearly half (93 funds) are very small — holding less than \$1 billion in assets — and a further quarter hold between \$1 billion and \$5 billion in assets. Although these funds collectively account for only 8 per cent of total assets (managed by APRA-regulated funds), they hold just over 20 per cent of member accounts. At the other end of the scale, the 10 largest funds manage

⁶⁸ Figure 7.1 includes 19 public sector funds that sit outside the APRA-regulated sphere and are, therefore, not a focus of this chapter. The number of these funds has changed little over the past decade and, today, they account for about 5 per cent of total assets.

over \$50 billion each and account for nearly half of total assets and one-third of member accounts. The largest fund manages over \$120 billion.

Figure 7.1 There has been significant fund consolidation but more is needed^{a,b}

Trends in the number of funds, 2006–2018



^a Includes both APRA-regulated funds and exempt public sector schemes — or, collectively, ‘institutional funds’. ^b Data are for the June quarter of each year.

Sources: APRA (2018b, 2018n, 2018p).

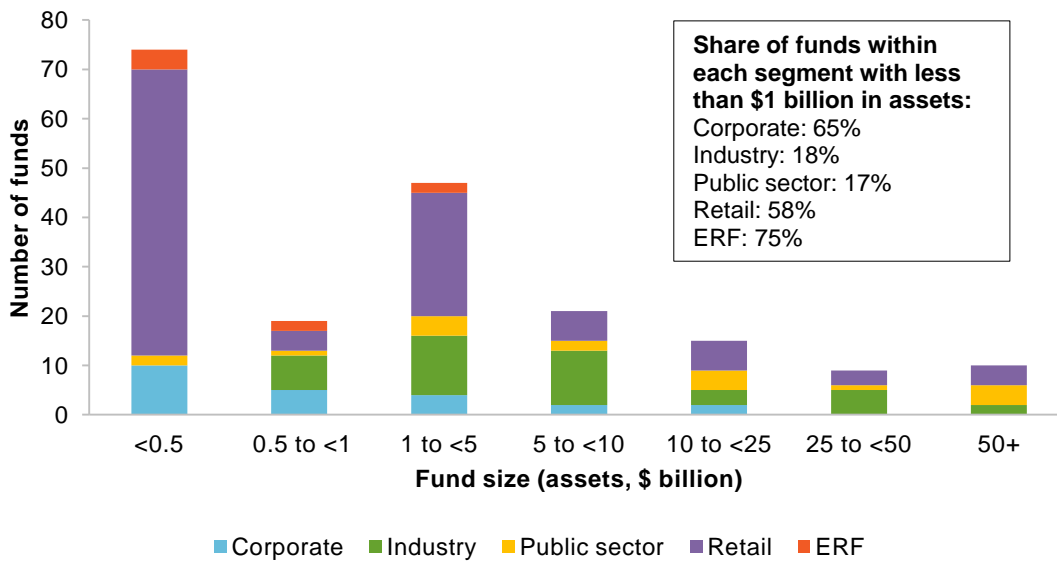
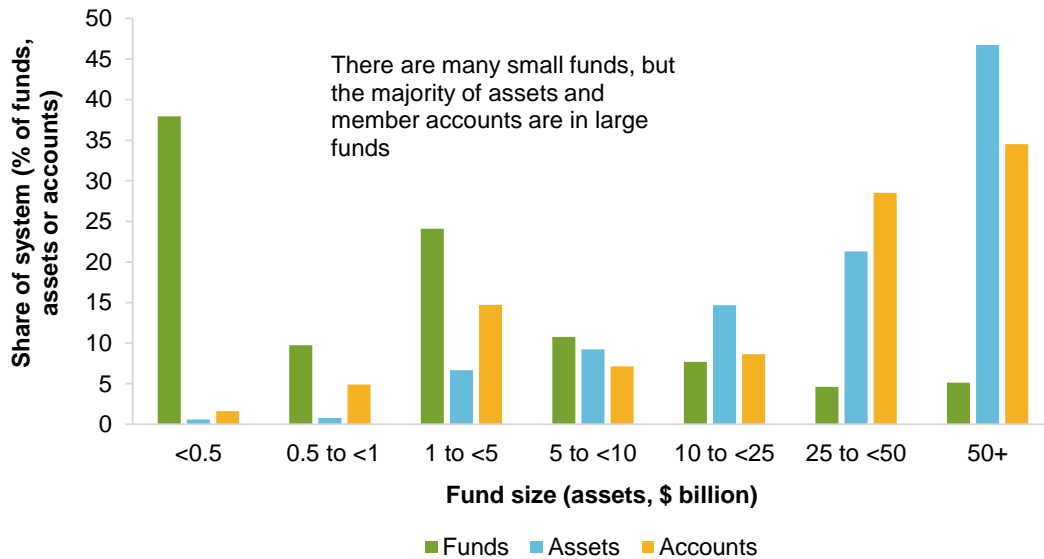
The large majority of very small funds operate in the retail segment (figure 7.2), most under the oversight of a registrable superannuation entity (RSE) licensee with responsibility for multiple funds. This phenomenon — RSE licensee responsibility for multiple funds — is common in the retail segment but almost nonexistent among not-for-profit licensees (APRA 2018b). And the incidence of small funds is highest in the corporate segment.

... but levels of market concentration are relatively low

Market concentration among APRA-regulated funds is low based on generally accepted thresholds (figure 7.3). Concentration in the default segment is moderately higher than in other parts of the system, most likely reflecting higher barriers to entry, which has implications for contestability (assessed in section 7.2).

Figure 7.2 A large number of small funds remain

Distribution of fund size and assets; APRA-regulated funds, June 2017^a

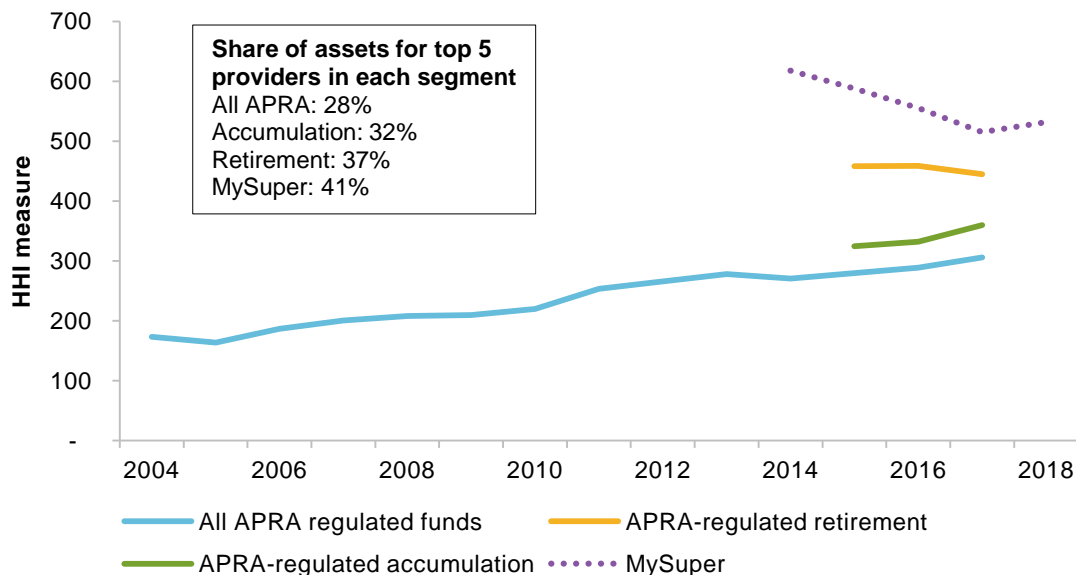


^a This figure does not include funds that reported zero total assets or zero total members in 2017.

Source: PC analysis of unpublished APRA data.

Figure 7.3 **Retail market concentration is low^{a,b,c}**

Market concentration in the system and key segments, 2004–2018



^a In this figure, market concentration levels were estimated using the Herfindahl–Hirschman Index (HHI), a commonly accepted measure of market concentration (ACCC 2017b; DOJ 2015; PC 2016a). While there is no prescriptive threshold, levels around 2000 are generally considered to be approaching highly concentrated. ^b The HHI for all segments was estimated using data on funds’ share of assets. ^c The top 5 estimates of the market share of assets are for 2017, except for MySuper, which is for 2018.

Sources: PC analysis of unpublished APRA data and APRA (2018k, table 1a).

At the wholesale level?

Outsourcing is prevalent

Administration and investment management services are the most material expenses for APRA-regulated funds (figure 7.4), and funds outsource extensively to tap into external expertise, to access scale or to meet other strategic objectives (ASFA, stage 1, sub. 42). During the year ending 30 June 2017, 71 per cent of funds’ service expenses were attributed to external providers (down from about 80 per cent in each of 2014–2016) (APRA 2018a, table 7b). Two-thirds of this expenditure was for non-associated (or unrelated) external providers. The extent of rivalry in wholesale markets will, therefore, have an important bearing on the fees paid by members and on broader system efficiency.

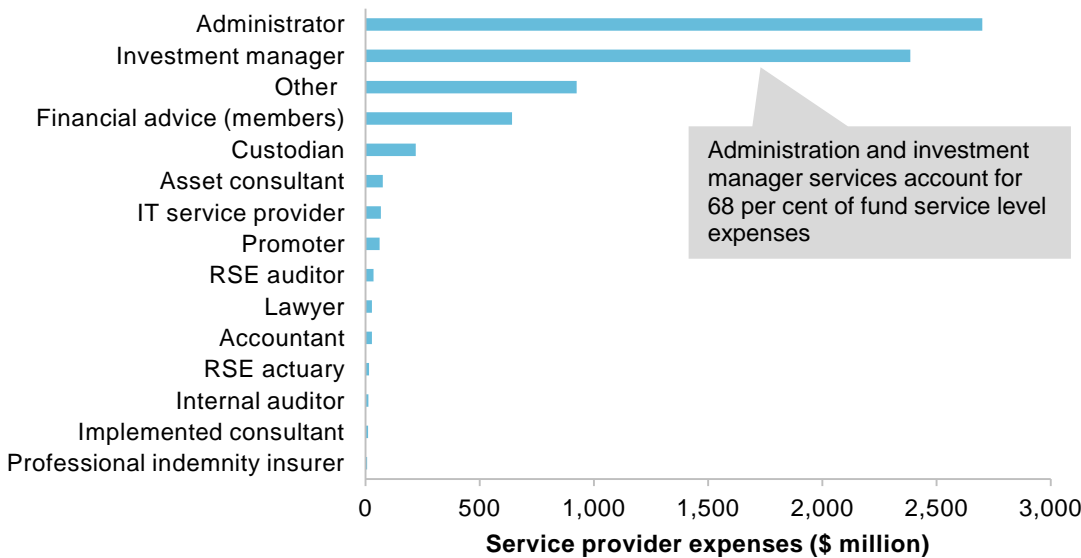
... but defining wholesale markets is challenging

The first step in assessing market concentration is to define ‘the market’. This is not straightforward. At a conceptual level, the main question is whether the service market includes only independent external providers or in-house supply as well (as a substitutable

option). At a practical level, there are challenges with assembling data to pin down concentration levels. While APRA has collected services expenses data from 2013-14, it has concerns about the consistency of these data and reporting gaps (APRA, sub. 89).

More fundamentally, APRA service categories may not neatly align with the product dimensions of a market for the purposes of competition analyses. For example, an aggregate view of the investment management market would understate the level of concentration where there is significant specialisation by some managers in particular asset classes or types of products. It would also risk abstracting away from a more complex supply chain within the investment management sector (PC 2018a). Similarly, an aggregate view of the administration market could mask the ability of funds to unbundle their service requirements and separately purchase or deliver components, such as information technology (IT) systems or call centre functions.

Figure 7.4 Administration and investment the largest expenses^a
 Composition of fund service level expenses, 2016-17



^a Service categories represented in this figure are defined in APRA (2015b), with the exception of 'Other', which is not explicitly defined.

Source: APRA (2018a, table 7).

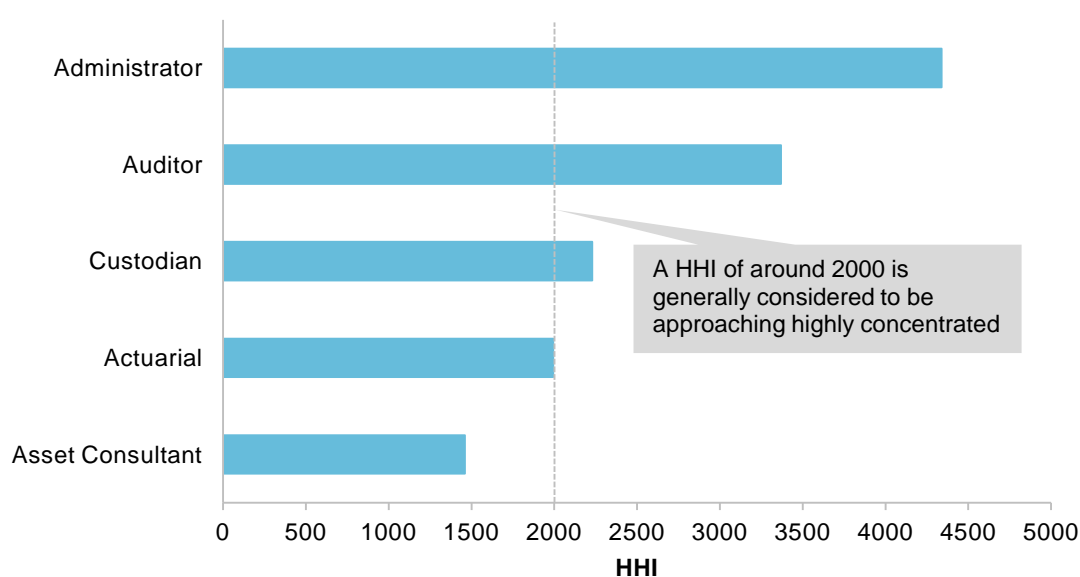
Concentration is evident in some wholesale markets

The Commission estimated concentration levels in markets for five APRA-defined services using APRA data on non-associated providers. Markets for administration and auditing services are the most concentrated; markets for actuarial, asset consulting and custody services appear to be more moderately concentrated (figure 7.5).

Lack of data at an asset class level — and gaps in data on investment management expenses (chapter 3) — precluded the Commission from estimating concentration in the investment management market. Nevertheless, given the importance of this service in fund expenses, this market warrants further discussion (below); likewise, the market for administration services.

Figure 7.5 Concentration is evident in some wholesale markets^a

Wholesale service market concentration levels, 2016



^a Refer to figure 7.3 for an explanation of the Herfindahl-Hirschman index (HHI).

Source: PC analysis of unpublished APRA data.

High concentration in administration services likely reflects economies of scale

The wholesale market (defined as non-associated providers) for administration services has two large players and several niche providers (ASFA stage 1, sub. DR98). By far the largest provider is Australian Administration Services (owned by the Link Group), which administers about 10 million (or 36 per cent of) member accounts, followed by Mercer, which administers 2 million member accounts (Link Group 2018; Mercer 2018). Acquisitions by both in recent years have increased concentration in this market.⁶⁹

Commission analysis of confidential APRA data indicates that the two largest providers account for about 85 per cent of the total expenses attributed to non-associated external

⁶⁹ For example, in 2016, Link Group (2016) completed its acquisition and integration of Superpartners (an administrator jointly owned by five industry funds), which had 2 million member accounts, while Mercer (2016) acquired Pillar Administration, which had 1.1 million member accounts.

service providers. Others have estimated that Link accounts for 70–80 per cent of outsourced member accounts (ACCC 2016; Clare and Craston 2017).

Generally, high concentration in this market is attributed to significant scale advantages in providing administrative functions, with outsourcing being a means for funds to access scale benefits and service-provider expertise (for example, ACCC 2016; IFAA et al, sub. 53).

Funds switching (or threatening to switch) to in-house supply for administration could add to competitive pressure in the upstream market. However, not all funds could be expected to make this transition, especially for services like data management and statement processing that require large upfront investments in IT systems, and equipment and expertise to navigate complex regulatory requirements (ACCC 2016). To date, there are few examples of funds having made the transition from outsourcing back to insourcing for their ‘full suite’ of administrative service needs. There is a suggestion, however, that larger funds have the option of making this transition or of negotiating better deals in the outsourcing market (First State Super, sub. 37). And just over half (56 per cent) of larger fund respondents to the Commission’s funds survey reported that they have a high degree of influence on the outsourcing market (compared with 27 per cent of small funds).

But high barriers to entry (particularly the cost of IT systems), and customer reluctance to switch provider (because of the considerable risks and costs involved), mitigate against new entry (ACCC 2016).

The investment management market is not concentrated but competition does not appear to be strong

APRA-regulated funds both invest directly and use external investment managers, with outsourcing the predominant channel. At the end of March 2018, according to APRA data, 38 per cent of assets were directly held by funds (APRA 2018o), but this does not necessarily mean that the assets were internally managed. That is because investments selected by external managers but held in a fund’s name are classified as directly held. Commission analysis of unpublished APRA data indicates that the share of assets managed internally is closer to 6 per cent.⁷⁰ Nearly 80 per cent of funds have some assets of this type, but these holdings typically represent only a very small share of their total assets. Ten larger funds account for nearly 60 per cent of the assets managed internally (and for 31 per cent of total assets).

At an aggregate level, the market for investment management is not highly concentrated. A 2016 report (FSC and Morningstar 2016) found that the top 10 managers in Australia accounted for around 58 per cent of the market in 2015, and the top 10 positions had continually changed, both by constituents and market share from 2009.

⁷⁰ Based on data collected in *Form SRF 531.0 Investment Flows* (APRA 2018e) and provided as a tailored request to the Commission.

Participants took different perspectives on the state of competition in investment management markets. Some argued that this is a highly competitive space and that the rates for mandates negotiated by superannuation funds (as institutional investors) are generally competitive by international standards (ASFA, stage 1, sub. 42; ASFA 2017; FSC, stage 1, sub. 29; Mercer, stage 1, sub. 45; MLC, stage 1, sub. DR115). Others expressed concern that the fees being paid by some funds have been very high and have not decreased as expected in line with system growth (for example, ISA, stage 1 sub. DR106). There was greater consensus that larger funds are able to exert more purchasing power in upstream markets, at least up to a certain point (Rice Warner 2014b).

That said, collective evidence points to outcomes that are inconsistent with strong competitive pressures.

- In contrast with participants' views, evidence from the Commission's funds survey indicates that fees for listed asset classes in which most domestic assets reside (that is, domestic and international fixed interest and listed equity products) are higher than those observed internationally (chapter 3).
- While there might be some cost efficiencies in larger mandates that justify lower fees, the differences reported by Rice Warner (2014b) are very large. For example, for cash, mandates of up to \$50 million were charged a median fee of 20 basis points, versus 6 basis point for mandates over \$500 million. The markedly lower fees paid by investors with bargaining power suggest that investment managers are earning above-normal profits.
- Evidence suggests that at least some investment managers enjoy relatively high net profit margins. The ABS estimated the profit margins for the industry subdivision covering investment management services at 35 per cent in 2016-17, in contrast with an average of 12 per cent for a large group of other industries (ABS 2018a).
- Larger funds can realise significant cost savings through insourcing (PwC 2016) — in the United States, the costs of in-house management are about one-third the fees charged by external managers. There is nothing to suggest that significant differences would not also apply in Australia.
- Fees are typically tiered, with a smaller percentage charged as mandates meet larger thresholds. Given the costs of managing additional money are likely to be very low for many asset classes, and probably zero over some ranges, this charging structure looks to be inconsistent with that which would emerge in a strongly competitive environment.
- An APRA thematic review of related party arrangements found that 'related parties providing investment management services were unlikely to be terminated for poor net performance against benchmarks' (APRA 2018q, p. 3).

A recent review of the UK asset management market by the Financial Conduct Authority (FCA 2017a) similarly concluded that price competition is weak in many parts of that market, and proposed a package of remedies (box 7.1). Concerns about investment consultancy raised by that review prompted an investigation by the Competition and Markets Authority (UK), which has found evidence of competition problems (CMA 2018). The (limited) evidence cited above appears to be consistent with aspects of the UK experience.

Overall, while the investment management market appears to be broadly conducive to rivalry, it also appears that some funds are paying more than they would in a market characterised by strong competition. Fund growth — both organic and through consolidation — should add to competitive pressure at the wholesale level of the market. This is an argument for ensuring that beneficial mergers proceed. (Barriers to mergers are discussed in chapter 9.) The evidence also supports elevated outcome assessments for every investment option offered by a fund (chapter 10). Where relatively low returns are attributable to high fees, funds will have an increased incentive to renegotiate those fees.

Box 7.1 Weak competition in the UK asset management market prompts regulator action

In recognition of the impact of the asset management market on savings (inside and outside pensions), the conduct regulator for UK financial markets embarked on a study of the market in late 2015 to ensure it works well. The Financial Conduct Authority (FCA) (2017a, pp. 4–5) found:

- weak price competition in a number of parts of the industry
- evidence of sustained high profit margins (with profits as a share of revenue averaging 36 per cent)
- underperformance of benchmarks (on average) by both active and passive managed funds
- larger institutional investors could negotiate fees effectively with asset managers, but a long tail of smaller institutional investors, typically pension funds, found negotiation difficult.

The FCA recommended a package of remedies, including: a strengthened best interests duty for fund managers; a requirement for a minimum level of independence in governance structures; improved disclosure; and continued work to remove barriers to pension scheme consolidation (to support the realisation of economies of scale in investment expenses). The FCA also asked the competition regulator to investigate the investment consultancy market and has launched a market study into investment platforms.

There are no barriers to investing in upstream capital markets that warrant action

In a competitive market, all funds should have the ability to invest in upstream capital markets in order to maximise long-term net returns and manage risks to their members. Some inquiry participants (for example, SISFA, sub. 60) argued that this is not the case for SMSFs (and some small institutional funds), because they are generally unable to directly (or as cost effectively) invest in unlisted infrastructure or corporate bond markets.

The asset holdings of SMSFs are difficult to observe in Australian Taxation Office (ATO) datasets due to the way asset classes are defined and viewed (which is not on a ‘look through’ basis, that is, assets within various trusts and managed funds are not assigned to specific asset classes). In any case, the ATO’s approach is inconsistent with APRA’s (chapter 2), rendering comparisons difficult.

Class Limited provided the Commission with some data on a look through basis, and these suggest broadly similar conclusions to the less granular ATO data (tech. supp. 4). On average, SMSFs hold a higher proportion of assets in cash and domestic equities than APRA-regulated funds, and much less in international equities and fixed interest products. It also appears that, on average, SMSFs hold significant assets in unlisted property and in pooled investment vehicles (such as managed funds and listed and unlisted trusts), which may be investing in a range of assets (PC 2016a).

There is no evidence to suggest that SMSFs cannot access any particular class of financial asset by way of such vehicles, albeit likely at greater cost. Nor does the evidence suggest that institutional funds are precluded from investing in certain asset classes. Fund level data from APRA reveal that funds of all sizes hold a significant proportion of unlisted assets. And there is no clear relationship between fund size and the share of unlisted assets in a fund's portfolio (tech. supp. 8). Other factors, such as investment strategy and fund type appear to offer more likely explanations for differences between funds in exposure to unlisted assets (BT, sub. 32; PC funds survey).

There may, however, be higher costs associated with entering a pooled arrangement, particularly for smaller mandates (as noted above), compared with direct investment.

These observations do not warrant action per se (indeed they are to be expected in a 'normal' market), but they do point to a source of potential economies of scale (discussed in section 7.4), and reinforce the imperative for mergers by subscale funds (not least, the 93 funds with assets of less than \$1 billion).

FINDING 7.1

The market structure of the superannuation system (as distinct from its policy and regulatory settings) is conducive to rivalry. At the retail level, there are many funds and products. At the wholesale level, there is concentration in some service provider markets for outsourcing (like administration). However, a growing ability for larger funds in particular to insource all, or parts, of their service requirements adds to competitive pressure.

While concentration is low in the investment management market, evidence suggests that managers have some market power. As a consequence, smaller funds, in particular, pay higher fees than would be the case if competition was more robust.

7.2 Is the market contestable at the retail level?

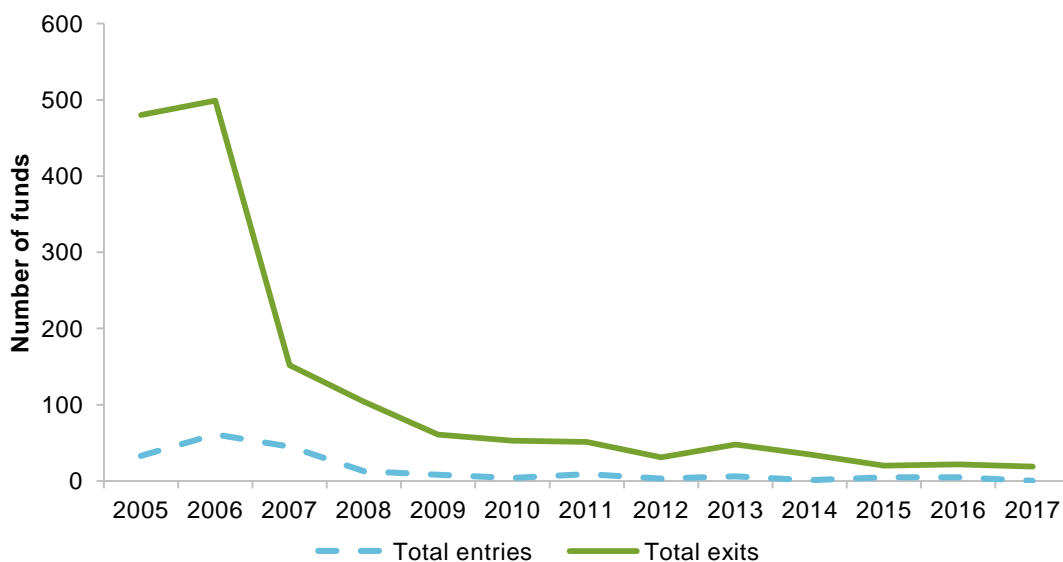
Even in a system characterised by many funds and products, barriers to the entry and exit of new funds could reduce contestability, or the competitive pressure on funds to meet members' needs.

Entry and exits are consistent with contestability

New fund entry has stagnated in recent years ...

Four new RSE licences were granted in the five years to 2016 (APRA, stage 1, sub. 32), and one since then (APRA, pers. comm., 23 Oct. 2018). Over the past decade, APRA-regulated fund ‘exits’ (either through wind-ups or mergers) materially exceeded new fund ‘entries’ (figure 7.6).⁷¹ (High levels of exits in the mid-2000s reflect consolidation prompted by the introduction of RSE licensing in 2004 (Hanrahan 2018b).)

Figure 7.6 **Entries versus exits in the superannuation system**
APRA-regulated funds, as at June, 2005–2017



Source: PC analysis of unpublished APRA data.

... but new forms of ‘entry’ and product expansion are evident ...

Though the number of APRA-regulated funds has been falling, there has been exponential growth in investment options, and growth in new product types (chapter 4). In the *default segment* the main trend has been the (regulatory-induced) introduction of MySuper products — with 105 in the market at June 2018 (APRA 2018n).

A notable trend in the *choice segment* has been the entry of ‘millennial funds’, often targeting a younger member demographic. This form of market entry is, in effect, at the sub-fund or product level, as these new entrants partner with an existing RSE licensee (Carruthers 2017; Uribe 2017). As distinct from pure ‘white labelling’, these new entrants often offer products

⁷¹ As distinct from new product entries perceived as new entrants (discussed below).

with some unique characteristics, such as new digital applications, platforms designed to help foster member engagement and/or focusing on particular types of investments — forms of ‘non-price’ competition (Grow Super, sub. 36; St Anne 2017). Some have also reduced their fees since first entering the market (GROW Super 2017; Spaceship 2017). Whether these entrants represent an enduring and competitive force, or are constrained by their upstream relationships (for example, in terms of which service providers they use), is yet to be seen.

Strong growth in SMSFs over the past decade has been another form of entry and has generated competition in the choice segment. In 2017, 15 per cent of members who switched funds went to an SMSF (Rice Warner 2017a), and a growing number of people are establishing SMSFs at a younger age (APRA 2017f; PC 2016a). Some APRA-regulated funds have responded by developing products with SMSF-like features (chapter 4).

... and smaller, higher-cost funds have been over-represented among exits

Exits over the decade were dominated by corporate and retail funds, and exiters were more likely to be smaller and higher-cost (figure 7.7).

Many expect consolidation will continue over the medium term, as funds come under pressure from scale disadvantages or negative cash flows, posing an elevated fiduciary duty for trustees to consider merging (APRA, stage 1, sub. 32; Chant West 2017a; Rice Warner 2017h). Future consolidation trends will be influenced by the intensity of competition between funds alongside regulatory settings and regulator oversight activities (chapter 9).

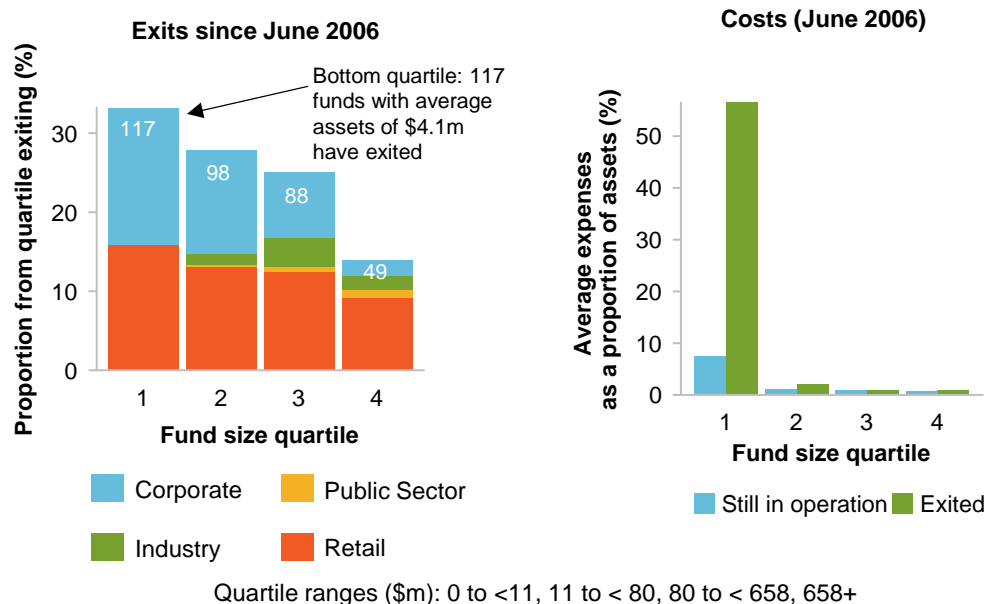
There are some barriers to entry in the system

Barriers to entry may limit the pressure on incumbent funds to continually improve member outcomes. They could arise from (ACCC 2017b; PC 2016a):

- **regulatory barriers** created by licensing, market entry conditions and restrictions on new entrants servicing particular segments (such as default members)
- **market barriers** associated with structural features of the market (such as substantial economies of scale or customer inertia), or particular characteristics of the system itself (such as payment processes and interactions)
- **strategic barriers** generated by the conduct of incumbent firms (such as some funds leveraging their vertically and horizontally integrated business models to limit distribution channels for new entrants).

Figure 7.7 **Smaller, higher cost funds over-represented among exits^{a,b,c}**

Exits between June 2006 and June 2016 by size and average expenses



^a Exits capture both funds that wound up or that merged with another fund. ^b Fund size quartile 1 is the smallest size and quartile 4 is the largest. ^c 2017 data are not included because fund exits are identified by the proceeding year's data.

Source: PC analysis of unpublished APRA data.

Regulatory barriers to entry exist

Regulatory costs of entry are not prohibitive ...

Limited new fund entry in the APRA-regulated sector could be explained by the costs of: obtaining a license from APRA; raising the necessary capital to meet minimum operational reserves; having a MySuper product authorised; and (if required) obtaining an Australian Financial Services License from the Australian Securities and Investments Commission (ASIC) (APRA, stage 1, sub. 32; ASFA, stage 1, sub. 42).

Participants generally considered the 'regulatory' costs associated with entry requirements to be a necessary part of the system. Indeed, several considered these provide an appropriate minimum standard for new entrants, work to protect members' interests and help promote system stability and product quality control (for example, ASFA, stage 1, sub. 42). Some participants went further and argued that current entry rules do not set the bar high enough: there was strong participant support for proposed reforms by the Australian Government to lift the requirements for MySuper authorisation under a revised 'outcomes test', focusing on performance, products and services (chapter 10).

Others, including respondents to the Commission's funds survey (111 funds responded on this issue), argued that the impact of rising regulatory and reporting costs in recent years

were a drag on fund and system efficiency. Logically, these costs will factor into the entry decision, though some recent ‘entrants’ (as discussed above) have outsourced their trustee function to an existing RSE licensee.

... but rules impede access to the default segment

While default members represent about half of the accounts (and a quarter of the assets) in the system, nearer to two-thirds of people default on starting a new job. Eligibility for default status confers an advantage on funds that have it, and a disadvantage for those that do not. The default market is unique in that there is an absence of competition in the market driven by the member. As such, the relevant consideration is whether the *process of selecting defaults* is contestable and competitive (that is, there is competition *for* the market), and selection is undertaken by those best placed to make the decision in terms of expertise and incentives.

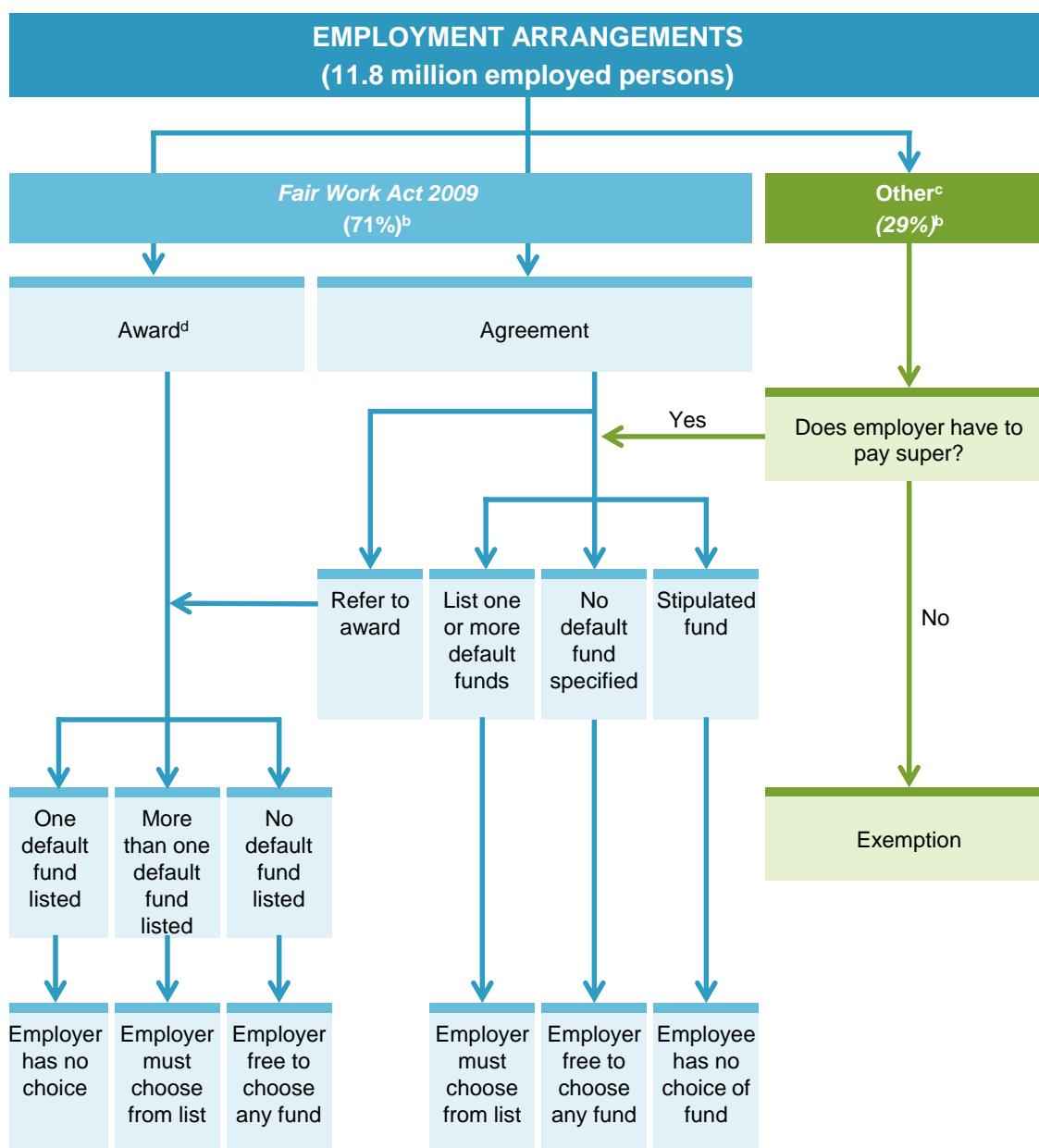
The rules and processes surrounding how default members are allocated to a default product vary significantly across awards, agreements, contracts and other employment arrangements (figure 7.8). These arrangements have largely evolved through the workplace relations system (chapter 12). Employers’ choice of a default fund for their employees is often constrained by the default fund(s) listed in a relevant award or the fund negotiated into an agreement. Some employers, however, can choose from any MySuper product.

There are no data collected on the number of employees who derive their default fund via an award listing, or the number of employers who have unfettered choice among MySuper products. Nevertheless, it is clear that access to the default segment has hinged mainly on funds being listed in an award, either because that leads directly to being chosen by employers or because it has led to inclusion in an enterprise bargaining agreement or influenced an unconstrained employer’s decision (PC 2012). The Commission estimates that award-listed funds account for about 80 per cent of total MySuper assets (APRA 2017g).

Given muted competition *in* the market, is the process of selecting defaults contestable and competitive (that is, there is competition *for* the market)? In other words, do all funds that offer an eligible default product have an equal opportunity to be assessed for listing, and do funds face competitive pressures that create incentives to deliver better member outcomes?

The award-listing process is administered by the Fair Work Commission (FWC). Participants were divided on whether it has been contestable. Several argued that it has not, largely because it has restricted default status to funds associated with unions or employers (for example, FSC, sub. 69; BT, sub. 32). Others argued that it was not difficult for funds to access the award system, and pointed out that retail funds can be (and are) listed (for example, AIST, sub. 39).

Figure 7.8 Default funds in Australia's workplaces^a



^a All default funds must offer a MySuper product or be an Exempt Public Sector Superannuation Scheme. ^b Numbers in brackets are the approximate share of employed persons under the specified work arrangements, sourced from PC (2015b), and the number of employed persons reflects levels in late 2015. ^c Includes State-based systems and common law employment contracts ^d Where there are grandfathering provisions in a modern award, employers can generally continue to make contributions (on behalf of their employees) to a previously selected default fund, even if it is no longer listed in the award (PC 2012).

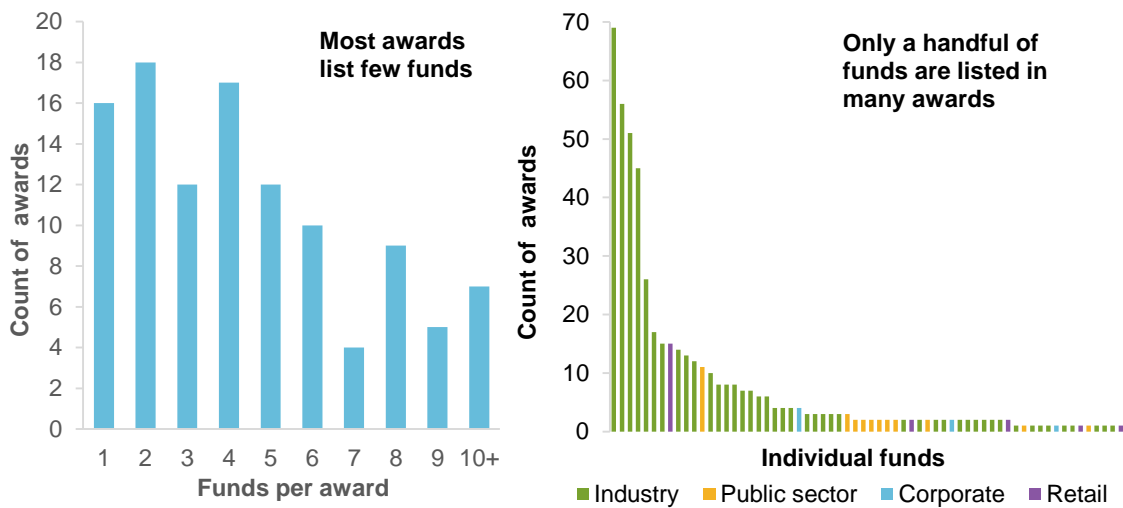
The Commission reviewed the award-listing process in 2012 and concluded that it was not fully contestable (PC 2012). Some funds found it difficult to present their case to the FWC, because standing was typically restricted to industrial parties. Moreover, the Commission observed that award listing was based primarily on precedent, not merit — there was no

process for identifying funds most likely to meet members' best interests, nor for removing underperformers.

A new default process was legislated in 2012 (chapter 12). However, the process stalled in 2014 and has not recommenced, meaning not much has changed since 2012. There is still a high degree of fund concentration in many awards, many funds are only listed in a handful of awards (figure 7.9), there is limited evidence of new entry or exits and there is no process actively in place to remove funds that are underperforming (or wound up or merged) from awards.

Figure 7.9 Award listing is concentrated^{a,b,c}

Counts of awards within funds, 2017



^a The FWC lists 122 modern awards on its website. ^b Not all superannuation contributions made under awards are made to default funds listed in awards. 'Grandfathering' clauses in all modern awards allow employers to continue to contribute to funds to which they were contributing before 12 September 2008 (FWC 2017; PC 2012). ^c This figure includes six funds that have now merged or appear to no longer be in operation, but where it is unclear whether a successor fund is able to be selected as a default fund within each award.

Source: PC analysis of the 122 modern awards listed by the FWC (2017).

Overall, while the default segment has generally outperformed the system overall, it has not always guided members into the very best funds available, and has enabled some underperformers to remain in play (chapter 2). Over time, a lack of contestability from outside and from within the award listing process may not only lock some good funds out, but could also stifle dynamic efficiency if incumbent funds have more muted incentives to continually improve their products and services than in a fully contestable market. There is scope for improvement and a case to consider the merits of a different default mechanism to drive competition for the market. This mechanism is discussed in chapter 12.

But market structures do not appear to create significant barriers to entry

Barriers to entry could arise from inherent structural features of the market or particular characteristics of the superannuation system.

The presence of economies of scale (section 7.4) could limit the viability of new fund entry below some minimum efficient level (in terms of assets and members). Against this, however, is evidence: of some entry; of low market concentration levels and unrealised scale economies; and that size does not always necessarily explain the returns delivered to members (chapter 2; section 7.4). New entrants may also have the ability to generate scale in adjacent or upstream markets (such as in investment management, or in other countries), or through outsourcing relationships (section 7.1).

Achieving scale in a timely manner is not the only potential structural challenge facing new entrants. Entrants need to invest in the infrastructure needed to support the payment and data flows that occur between stakeholders in the system (members, funds, employers and regulators). In its stage 2 draft report, the Commission flagged the possibility of a central clearing house (along the lines of the system in New Zealand) as a means of simplifying administration for employers and funds, and lowering the costs faced by new entrants. The weight of feedback on this proposal was that such an architectural shift was unnecessary, as there is a well-developed market for clearing house services, and the SuperStream reforms have markedly improved the efficiency of transactions.

On the available evidence, the Commission considers that barriers to entry arising from a need to invest in infrastructure are likely to be low, and do not materially bear on the contestability of the market for prospective new funds.

System characteristics and potential barriers on the demand side will also enter the calculus of a new entrant. Chapter 5 described weak member engagement, strong reliance on defaults or other intermediaries (such as employers and advisers) and low switching rates. Such behaviour may be perfectly rational given the long-lived nature of superannuation and where members are happy in their current fund. However, it does present a challenge for a new entrant — even a highly efficient and attractive one. New entrants will rely on having or developing distribution channels to attract members — whether through defaults, existing relationships with consumers or innovative marketing.

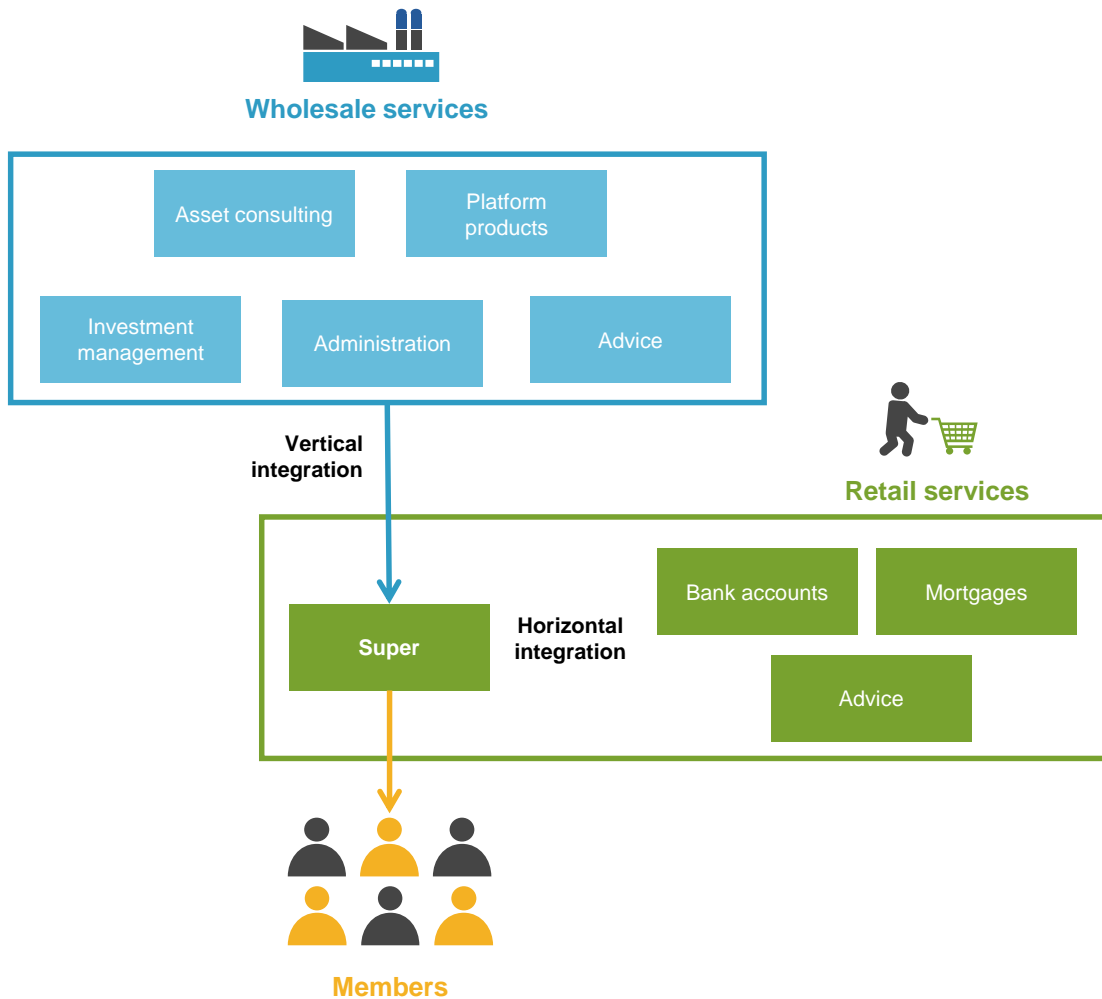
Overall, while structural features of the system on the supply and demand side are likely to create challenges for new entrants, on the available evidence it would be an overstatement to characterise them as prohibitive or even high barriers to entry.

And strategic conduct from integration is unlikely to create high entry barriers

Horizontal and vertical integration (figure 7.10) is common in the superannuation system. Some superannuation funds are able to leverage horizontal and vertical relationships as distribution channels to attract and capture members, including through bundling, cross

selling or the use of related-party adviser networks (PC 2016a). From a contestability perspective, concerns would arise if these business models locked out otherwise more efficient funds from entering the system (or expanding to other market segments) to compete for members.

Figure 7.10 **Vertical and horizontal integration in the super system**



Integrated business models have been used to attract members ...

There are no system-wide data on the extent to which funds rely on integrated business models to attract members. The Commission’s funds survey attempted to address this gap, but the Commission could not derive meaningful results from the responses provided. It is clear, however, that these distribution channels are used, particularly by some retail funds.

Retail funds have been relatively successful in attracting people who switch fund — 5–10 per cent of members each year. Rice Warner (2017e) found that retail funds attracted 44 per cent

of switchers in 2015, compared with 35 per cent for industry funds and 15 per cent for public sector funds.⁷² Retail funds' success in attracting switchers can be partially attributed to adviser distribution channels and direct cross selling (Rice Warner 2017e). (Recent APRA data, however, show a dramatic increase in member switching towards industry funds in 2018 (chapter 5)).

Financial advisers have long been a distribution channel for bank-owned superannuation funds (ISA, sub. 5), and those linked to banks have had a tendency to recommend in-house products (those manufactured by a related party). In a study of advisers connected with five of Australia's largest banking and financial services institutions, ASIC (2018e) found that 69 per cent of customers ended up with in-house superannuation or pension options despite in-house products (of all types) comprising only 21 per cent of the products on the advisers' approved product lists.

Studies have also found that bank-owned superannuation funds have a large proportion of members who use banking and other services with the same group. Likewise, the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Financial Services Royal Commission (FSRC)) heard evidence about the Commonwealth Bank of Australia and the ANZ using their bank branches to sell superannuation products from related trustees (FSRC 2018b). But evidence suggests that cross selling is not particularly effective (Roy Morgan Research 2013, 2014, 2015a), and three of the large banks have divested their wealth management arms or are in the process of doing so (Maley 2018).

... but integrated business models have not stifled contestability in the choice segment

While some funds have a market advantage in being able to leverage their vertical and horizontal connections to attract new members, this has not locked out competitors. Relatively large shares of superannuation assets are held in not-for-profit funds' choice products and SMSFs (MLC Wealth, sub. 63; chapter 1). And, as noted above, a material proportion of members switch into industry funds.

This evidence suggests that other distribution channels are effective. Some funds have access to default members. Marketing and advertising are used extensively by all types of funds (or on their behalf). And funds are increasingly using new ways of interacting with new and potential members (such as mobile phone applications and social media platforms), and introducing greater personalisation of material (Frost 2016b; Willis Towers Watson 2016; MLC, stage 1, sub. DR115).

Barriers to exit are not an impediment to entry

Evidence (above) indicates that there are no insurmountable barriers to exit. Of greater concern and policy relevance is whether there are barriers that are frustrating the realisation of

⁷² The remainder went to SMSFs (4 per cent) and corporate funds (2 per cent).

economies of scale. Several participants argued that regulation inhibits fund mergers. Their arguments, and Commission’s recommendations around mergers, are considered in chapter 9.

FINDING 7.2

Fund-level regulation creates a significant cost of entry and some structural features of the system are likely to create challenges for new entrants (including gaining scale by attracting members). However, these are not prohibitive or even high barriers to entry. Nor does the strategic use of integrated business models to gain members stifle contestability in the choice segment.

In the default segment, regulatory settings limit access to the market (including difficulty being listed in a modern award), competition *for* the market is absent, and competition *in* the market is muted.

Unhealthy competition is evident in both market segments

Contestability in the choice segment has not always delivered for members

While the choice segment of the system is largely contestable, a key question is how *effective* (or healthy) competition in this segment has been in delivering long-term outcomes for members in the form of net returns, fees and service quality. Members being channelled, via cross selling or upselling techniques,⁷³ into higher fee or underperforming choice products is viewed as a symptom of unhealthy competition in the market, and as stemming from a conflicted business model (AustralianSuper, sub. 43; ISA, subs, 5, 59, 87; AIST, stage 1, sub. DR102).

Robust (regularly-collected) system-wide data or evidence linking the use of inappropriate cross selling or upselling to poor member outcomes remain elusive. Data on *intrafund* and *interfund* switching on their own do not indicate whether a member switched due to marketing practices or for some other reason (such as a member seeking out a product that better meets their individual needs) (MLC Wealth, sub. 63; Rice Warner, sub. 56).

However, the ASIC (2018e) report on the use of related party advisers (discussed above) highlighted conduct that is of concern, as did the FSRC evidence on the inappropriate behaviour of Commonwealth Bank of Australia and ANZ branch staff in apprising customers of in-house superannuation products (FSRC 2018b). Coupled with the many examples from the FSRC of actions contrary to members best interests in the retail sector, this evidence indicates that horizontal integration has contributed to (or at least facilitated) some members’ best interests being compromised.

⁷³ Cross selling can be defined as the sale of additional products in addition to the primary product, including via bundling; while upselling could take place where a member is encouraged to switch from a lower fee to a higher fee superannuation product.

Across a range of indicators, the evidence suggests that competition *in* the choice segment has not always delivered better long-term outcomes for members in terms of performance, products and services. Indicators of poor outcomes include:

- greater variation in returns that is sometimes not obviously explained by differences in product design and asset allocation (chapter 2)
- a long tail of high fee choice products (chapter 3)
- charging of fees for no service (chapter 9)
- poor comparability of products (due to poor data and product proliferation — tens of thousands of options) that exacerbate the risk of poor choices by members (chapter 4)
- an apparent disconnect between members’ needs and the offerings of providers (chapter 4).

Some employer inducements reflect unhealthy competition in the default segment

With few exceptions, the ultimate decision on the choice of a default fund rests with the employer. This creates a principal–agent problem between employers and employees. There is a risk that employers do not have the time, expertise or incentive to act in the best interests of their employees.

Several participants expressed concern about direct and indirect inducements offered by funds to employers to secure default status for their fund (for example, AIST, sub. 39). And evidence presented to the FSRC:

... suggests that, at least to some extent, employers choose a default fund based on relationships with executives and employees of superannuation funds and are influenced by inducements or experiences offered to them, including by way of corporate hospitality. (FSRC 2018b, p. 91)

Legislative protections are in place to mitigate these risks and ASIC has found no evidence of breaches. However, ASIC has noted that contraventions are difficult to enforce. And the FSRC noted that the relevant legislation only applies where employers are offered inducements *on condition* that their employees join a fund (2018b). A recent survey by ASIC (sub. 90) suggests this could be an area of ongoing concern — key results are summarised in chapter 9. While there are piecemeal ways to stem this behaviour — *Superannuation Industry (Supervision) Act 1993* (Cth) obligations and regulator oversight and enforcement (chapter 9) — the Commission’s proposed default approach directly addresses the problem by removing employers from the default allocation process (chapter 12).

7.3 Vertical integration is not serving all members well

Vertical integration occurs when a fund sources services internally or from a related party. Both retail and not-for-profit funds use related parties, but under different models — retail funds may use service providers from within the same corporate group entity, while

not-for-profit funds (or trustees) may use service providers in which they are directors or their fund has an ownership interest.

Vertical integration might enable a fund to capture efficiencies in the supply chain that benefit it and its members, or act as a competitive check on any market power that upstream (unrelated) service providers may otherwise exert (FSC, stage 1, sub. DR110; section 7.1). On the other hand, there are longstanding concerns that in the absence of competitive pressure from members, and given pressures on corporate groups to make profits, funds might outsource to related parties ahead of more efficient (but unrelated) service providers, leading to higher fees, lower returns or poorer services to members (AIST, stage 1, sub. 30).

The evidence suggests that vertical integration causes inefficiencies, at least in some parts of the Australian superannuation system.

Use of related parties is reasonably common

Particularly among retail funds ...

Based on data reported to APRA, associated providers (a proxy for related parties) are more typically used by retail funds (figure 7.11). Use of providers within the RSE licensee is also materially higher for retail funds.

These data have limitations. APRA (sub. 89) warned of a lack of consistent information reported on expenses paid to associated entities, partly due to the uncertainty about the definition of associate in APRA's reporting standards, and also the collection of expenses only in respect of arrangements between the RSE licensee and service providers (and not between the RSE and service providers). As APRA noted (sub. 89, p. 2):

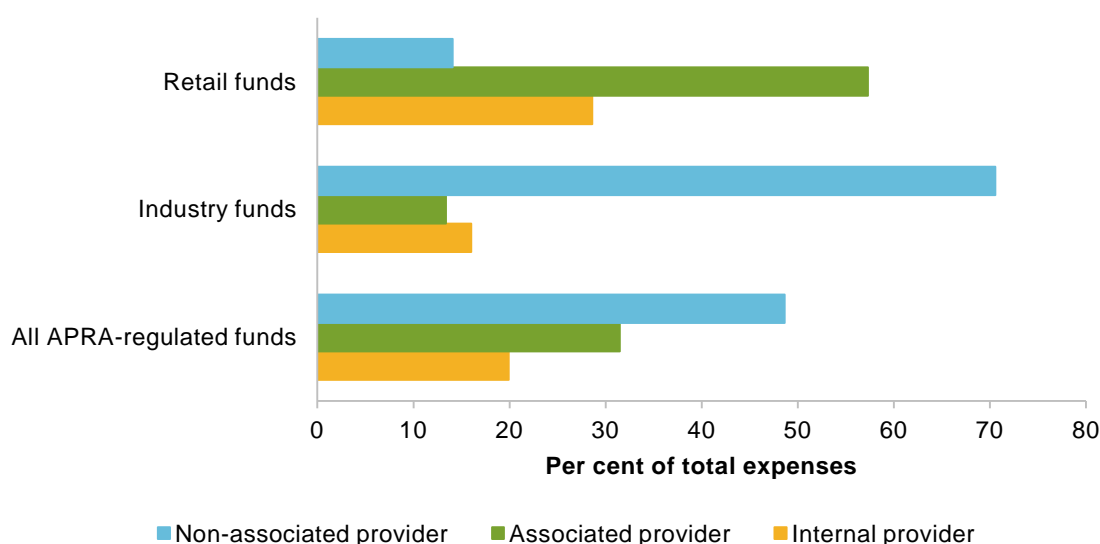
This limits both APRA's and external stakeholders' ability to understand, and compare, how fund assets are being used in the management of fund operations.

The use of associated (or related) parties in the system could, therefore, be greater or less than reported, both overall and for particular types of funds. APRA is consulting on improvements to this reporting framework (APRA 2017g), and is also considering how to collect service provider expense data on a look-through basis.

Even more troublesome is that APRA data cannot be used to credibly estimate the proportion of funds that outsource investment management to associated parties (let alone potential differences in costs, or by assets or asset class) due to limitations in the way that the current reporting framework captures investment expenses (discussed further in chapter 10 and technical supplement 8). This is highly problematic given that investment management expenses form one of the largest components of funds' total expenses and are an area prone to potential conflicts of interest. This further highlights the egregious poor reporting and disclosure of investment management arrangements and fees for related parties.

Figure 7.11 **Associated providers: more common in the retail segment**

Share of total expenses by provider type, 2017



Source: APRA (2018a, table 7b).

Liu and Ooi recently examined the extent of related-party outsourcing by superannuation funds for a range of services and the impact on member outcomes — investment management services were not examined because of a lack of effective disclosure of these arrangements by funds (Liu and Ooi, sub. 92). The authors estimated that retail funds made extensive use of related parties for administration (68 per cent of funds) and asset consulting services (63 per cent of funds), and less for custody (23 per cent), and auditing services (0 per cent); while not-for-profit funds were found to make very low use of related parties across all services in comparison — although not-for-profit funds can (and do) also use related parties.

... but it is hard to get a sense of trends over time

A lack of APRA time series data also make it difficult to determine whether the propensity for funds to use associated and internal providers has increased or decreased in recent years, both across the system and within the not-for-profit and retail segments. The short series available (APRA 2018b) — which is subject to the data limitations noted above — indicates that internal, associated and non-associated providers accounted for similar expense shares for industry funds in 2017 and preceding years (2014–16). For retail funds, the share of internal provision rose markedly, from 29 to 50 per cent between 2016 and 2017, with a commensurate fall in the share of associated providers. The size of this change is more suggestive of data problems than an actual shift in the sourcing of services.

The Commission sought data through its funds survey on the use of associated parties in 2011-12 and 2016-17 for both administrative and investment services. These data suggest no change overall in the share of administrative services sourced from associated parties

over this period. Survey response rates were comparatively poor for retail funds, particularly with respect to investment expenses (tech. supp. 4). Responding funds reported little change in the proportion of administration expenses sourced from related parties between the two time points for which data were collected, but the share of investment expenses nearly doubled to 18 per cent.

Use of related parties limits the contestability of service markets

Robust contract review processes and evidence of funds switching service providers would indicate that — notwithstanding the use of related parties — these service markets are contestable.

Unpublished APRA data indicate that only 57 per cent of service provision arrangements (with both associated and non-associated parties) had been reviewed in the three years to 30 June 2018. Ten per cent had not been reviewed for at least 10 years. Consistent with these data, APRA’s thematic review of related party arrangements found that some agreements lacked termination triggers and rights and were also open ended, lacking a timeframe for market testing or benchmarking to assess performance (APRA 2018q). APRA also found that:

... RSE licensees should have a credible process for testing whether the pricing and terms from the related party service provider are commensurate with others available in the market. Among the RSE licensees reviewed, there was clear room for improvement in this area. Some of the sampled RSE licensees were not ensuring that their selection or benchmarking processes for related party service providers were comprehensive and rigorous. (APRA 2018q, p. 4)

This evidence suggests that use of related parties limits the contestability of service markets.

Unfortunately, there is no robust evidence on the extent of funds switching from associated to non-associated providers (or vice versa). The Commission attempted to address this evidence gap in its funds survey, but was thwarted by a very low response rate — funds that responded represented less than one-quarter of total assets and member accounts.

Related parties appear, on average, to be higher cost

Work by Liu et al. points in that direction

Research by Liu and Arnold (2010, 2012) concluded that retail funds that outsourced administration and insurance services to related parties paid higher costs (and charged higher fees) than those that outsourced to independent providers. However, these findings were strongly contested by several participants (for example, FSC, stage 1, sub. DR110; Mercer, stage 1, sub. DR104). Participants also argued that this analysis is obsolete due to a strengthening of the regulatory protections around conflicts of interest and outsourcing. And APRA (sub. 89) noted that, collectively, this regulatory change ‘limits the relevance of analysis undertaken prior to the implementation of those reforms’.

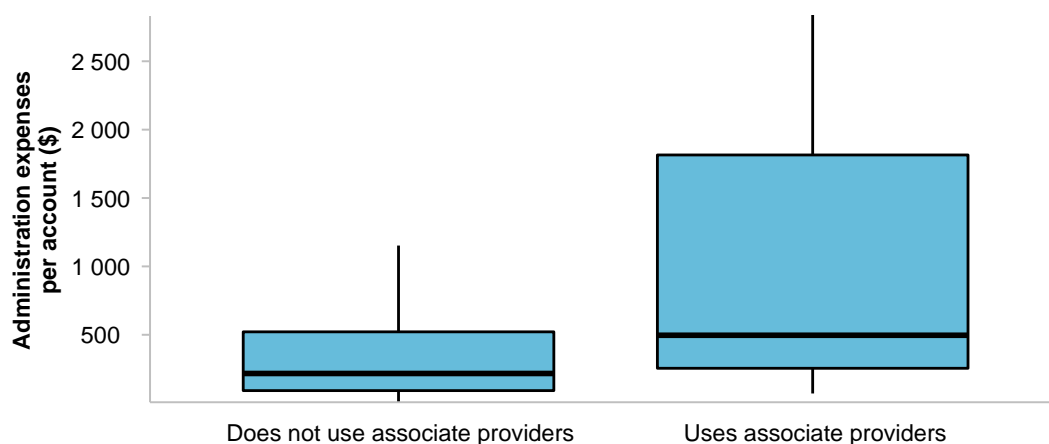
More recent research (Liu and Ooi, sub. 92) found that, among other things, retail funds that use related-party providers (for administration, asset consulting, custody, insurance and auditing) and affiliated trustee directors tend to significantly underperform their peers across a range of investment performance metrics.

Other evidence points in the same direction

Commission analysis of confidential APRA data on administration service expenses indicates that funds that use associated providers (mostly but not exclusively retail funds) have higher median administration expenses (per member account) than those that use non associates (figure 7.12). These results have some caveats. Higher costs could reflect differences in the scope and quality of services procured rather than signal inefficiency. And, more fundamentally, the results are subject to limitations with the underlying data (outlined above).

Figure 7.12 Higher costs using associate administration providers ... but data less than robust^{a,b,c}

Administration expenses per account by use of related parties, 2016-17



a The Commission's analysis combined information from a confidential dataset provided by APRA and publicly available APRA fund-level data for 2016-17. **b** Funds are classed as 'using associate providers' if more than 85 per cent of their administration expenses are with associate providers. Funds with fewer than 50 members are excluded from the analysis. This analysis controls for fund scale (total assets) and fund classification (not-for-profit or retail status). **c** The horizontal line through the middle of each box is the median cost. The box ranges from the 25th to the 75th percentile of the distribution. The vertical lines below and above each box depict the overall range of costs in the data (although values greater than 1.5 times the interquartile range are not shown).

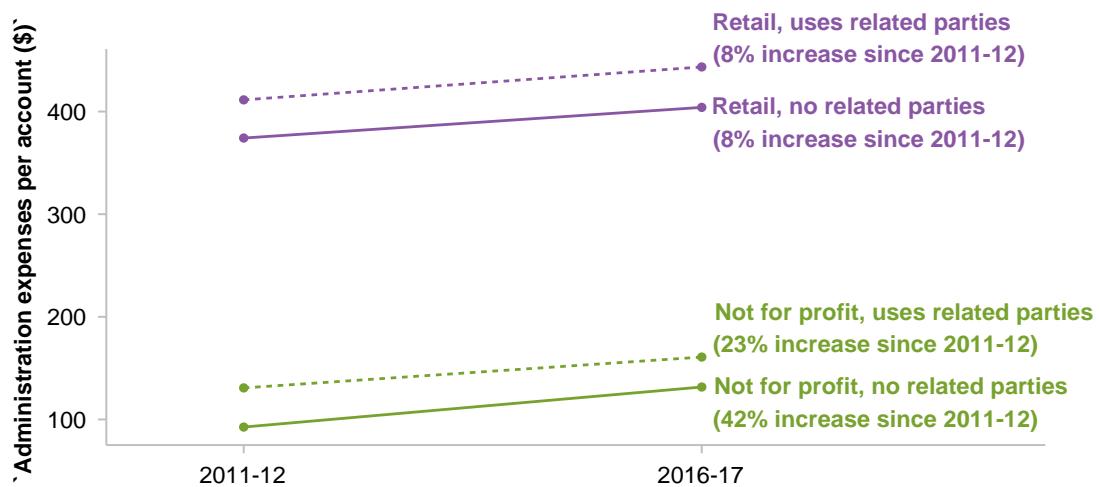
Source: PC analysis of unpublished APRA data.

That said, analysis of data from the Commission's supplementary funds survey also suggests that associated parties make for higher administration costs (figure 7.13) — particularly for retail funds.

While not a representative sample, FSRC case studies also provide some evidence of the many ways in which the financial interests of the members of retail groups have been preferred over those of the members of the funds run by those groups. This suggests that the results reflect reality, even if the data have holes (FSRC 2018b).

Figure 7.13 Funds using associated parties tend to have higher total administration expenses per account

Administration expenses per account by use of related parties, 2011-12 and 2016-17



Source: Supplementary funds survey.

Management of related-party arrangements needs to improve

Despite the regulatory protections in place, trustees' use of related parties is clearly too often not in the best interests of members. Vertical integration is contributing to inefficiency in the system. Regulatory protections need to be further strengthened to ensure that members are not disadvantaged if their fund chooses to use related-party service providers (chapter 9).

Data limitations relating to these arrangements are, of themselves, a red flag. The inability to examine investment management expenses is particularly problematic given they represent around 30 per cent funds' reported expenses, and of member fees. Deficiencies in the information reported should be addressed (chapter 10).

FINDING 7.3

There is a high propensity for funds in the system (particularly retail funds) to report using associated (or related) service providers — a form of vertical integration. Use of related parties is associated with higher costs, and weaknesses in contract review processes suggest some funds are outsourcing to related parties ahead of more efficient (but unrelated) service providers — constraining contestability and likely at the expense of member outcomes.

7.4 Are there unrealised economies in the system?

‘Economies of scale’ exist if a fund’s costs per member account (or per dollar of assets invested) fall as the fund gets larger. If such costs rise with size, a fund exhibits diseconomies of scale.

Evidence of a fragmented market with significant unused economies of scale could signal a lack of competitive pressure on funds to reduce costs, or that funds face impediments to gaining scale (for example, barriers to exits or mergers) — contributing to inefficiency. Evidence that economies of scale have been realised but the gains not passed through to members could also signal a lack of competitive pressure. That said, if funds adopt higher-cost, higher-return investment strategies as they grow (achieving increasing returns to scale), the benefits of scale might be seen in higher net returns rather than lower costs.

Multiple commentators and reviews have pointed to scale economies in the superannuation system as a potentially important driver of outcomes for members (Cooper et al. 2010a; Minifie, Cameron and Savage 2014; Murray et al. 2014; Wallis 1997). But robust evidence of the extent of to which these scale economies have been realised and passed through to members has been lacking, due in part to inadequate data.

Economies of scale can arise in both administration and investment management.

- On the administration side, for example, fixed costs involved in information technology systems, reporting processes, and general management functions (ASFA stage 1, sub. 42; IFAA, QIEC Super and Club Super, sub. 53) present an opportunity for lower average costs as a fund grows.⁷⁴ And size improves a fund’s bargaining position in the outsourcing market for administration (section 7.1).
- On the investment management side, the fixed costs involved in investment management teams represent one potential source of economies of scale. And larger size may make it easier for funds to more readily access lower cost approaches to investment (such as direct investments with in-house teams), improve their bargaining positions in securing lower investment management fees from third party investment fund managers (MLC,

⁷⁴ It has been estimated that fixed costs account for about one-third of the administration costs of an average superannuation fund (Minifie, Cameron and Savage 2014).

stage 1, sub. DR115; Mercer, stage 1, sub. 31), or move into unlisted assets (discussed below).

There is an important distinction between funds realising internal cost efficiencies because of the pressure to innovate or secure greater market share, versus scale benefits arising from organic growth. Only the former source is a strong indicator of competition and dynamic efficiency in the system.

More broadly, economies of scale can be realised at a system level when funds exit and members transfer to one of the remaining funds, particularly when those exiting are higher cost funds — the lived experience from 2005 (section 7.2). This has the dual impact of reducing duplicated fixed costs within the system, and making (at least some) remaining funds bigger. Scale realised due to funds exiting the system is also an indicator of competition.

But lower average costs with greater scale are not a given

The benefits of increased scale may have limits — beyond some size, diseconomies might emerge. For example, costs arising from the market impact of larger trades, along with the loss of investment flexibility that can come with larger mandates, have been associated with diseconomies for mutual funds invested solely in listed equity markets (and for the domestic equity component of US pension funds' investments) (cited in Cummings 2012). In a similar vein, some participants pointed to constraints on the size of investment mandates that will be accepted by local investment managers (CIFR, stage 1, sub. 10; Rice Warner 2014b).

And increasing size is not the only way to achieve economies of scale gains. Outsourcing provides an alternative channel. Cost savings could be accessed through scale gains derived by service providers; a conclusion drawn in some past studies and highlighted by participants (ASFA, stage 1, sub. 42; Higgs and Worthington 2012; Sy 2012). Against this, smaller funds may still have a purchasing power disadvantage in service provider markets (section 7.1).

Moreover, economies of scale may not always manifest in lower fees for members — for example, following average cost reductions in some business areas, funds might use the realised gains to cover expenditures that would otherwise have been funded by a fee increase — for example, member services, increases in reserves or to meet the cost of new regulatory requirements. And, as noted above, scale might be associated with higher-cost, higher-return investment strategies. Average costs might even increase with scale, but this outcome is not necessarily detrimental to members, a point made by several participants (box 7.2).

Previous studies find economies of scale but have some gaps

Several Australian researchers have attempted to measure economies of scale in superannuation, adopting various definitions of costs, potential explanatory variables and

estimation methods.⁷⁵ All found at least some confirming evidence. However, these analyses typically focused primarily on the nature of the relationship between average cost and scale. None considered whether any realised benefits had been passed through to members in the form of lower fees. And some key estimation issues were not addressed.

Box 7.2 Some participant views on economies of scale

Several participants cautioned against a narrow view of pass-through of scale benefits as they could flow through in the form of enhanced services rather than simply fee reductions. The Association of Superannuation Funds of Australia (ASFA, stage 1, sub. 42) noted that although scale economies may be realised, and reflected in downward pressure in some expense categories, this may be masked by higher expenses in categories not subject to economies of scale. First State Super (sub. 37) also indicated that cross subsidisation between funds that outsource to the same administrator may make it difficult to measure the benefits realised by size.

Participants noted that while benefits of scale may not necessarily be fully realised in the system, the right balance must be struck between the efficiency of large-scale operators, market concentration and competition (for example, BT Financial Group sub. 32; FSC, sub. 69). At a sub-fund level, some participants argued that excessive choice of investment options increases costs for funds overall with a severe lack of scale in the great majority of options. They also suggested that consolidation within funds is an important indicator of the realisation of economies of scale to the benefit of members, including by reducing excessive investment choice (for example, AIST, sub. 39).

None of the studies accounted for funds that have exited the industry. Evidence suggests that those funds were small and high cost (figure 7.7), meaning estimates of the relationship between fund size and costs generated using information only for remaining funds will be understated. Nor did these studies address the implications of gaps in the data — in particular, for investment expenses (costs). In approximately one quarter of all fund-year observations, reported investment expenses were \$0. Most of this can be attributed to retail and corporate funds.

The Commission has undertaken sophisticated econometric modelling to address these issues, enabling robust insights into the form and pass-through of economies of scale in super. A summary of the Commission's findings is presented below. Detail is presented in technical supplement 8 — *Economies of Scale in Superannuation*. Discussion focuses on scale measured in terms of assets, but similar conclusions apply for member accounts.

Overall, the Commission's findings are consistent with the observation from the Financial System Inquiry that:

The superannuation system is not operationally efficient due to a lack of strong price-based competition and, as a result, the benefits of its scale are not being fully realised. Substantially higher superannuation balances and fund consolidation over the past decade have not delivered

⁷⁵ Papers include Cummings (2012), Higgs and Worthington (2012), Minifie, Cameron and Savage (2015), Rice Warner (2014b) and Sy (2012).

the benefits that would have been expected; these benefits have been offset by higher costs elsewhere in the system rather than being reflected in lower fees. (Murray et al. 2014, p. 89)

Economies of scale are evident in the APRA-regulated system, with significant gains realised and marked potential for more

Inspection of plots of the APRA data reveals that smaller funds typically have higher average administration and investment expenses than larger funds (figure 7.14). However, many factors in addition to scale potentially drive costs — including, for example, rollover activity, the number of investment options offered by a fund, regulatory change and the types of assets in which members' balances are invested (that is, asset allocation). If any of these factors is related to scale, it is not possible through casual inspection of the data to determine whether it is scale, or these other factors, that account for the observed relationship. The Commission's econometric analysis controls for many of these potentially confounding factors, isolating the relationship between average costs and scale.

When other factors that influence administration expenses (as distinct from fees charged) are held constant, Commission modelling suggests a clear relationship with scale for all segments of the system. That is, average administration expenses are typically lower in larger funds, with corporate funds realising economies most rapidly.⁷⁶

A similar result exists on the investment side, where the evidence suggests the relationship is strong for the system as a whole; but more so for public sector and retail funds than for industry and corporate funds. As discussed further below, this may reflect the greater use of (higher-cost) unlisted assets by industry funds, with members (potentially) benefiting through higher returns, although data limitations preclude a firm conclusion on this point.

Overall, these observations are consistent with other studies that have found economies of scale at a system level. The potential impact of economies of scale is evident in estimates of how expenses might fall as funds grow. For example, the Commission's results imply that, on average, administration expenses (as a share of assets) for an industry fund starting at 65 basis points would fall to 50 basis points (or by 23 per cent) with an increase in size from \$500 million to \$1 billion.⁷⁷⁻⁷⁸ Similarly on the investment expenses side, on average, an industry fund starting at 40 basis points would experience a fall to 37 basis points (or by 7 per cent).

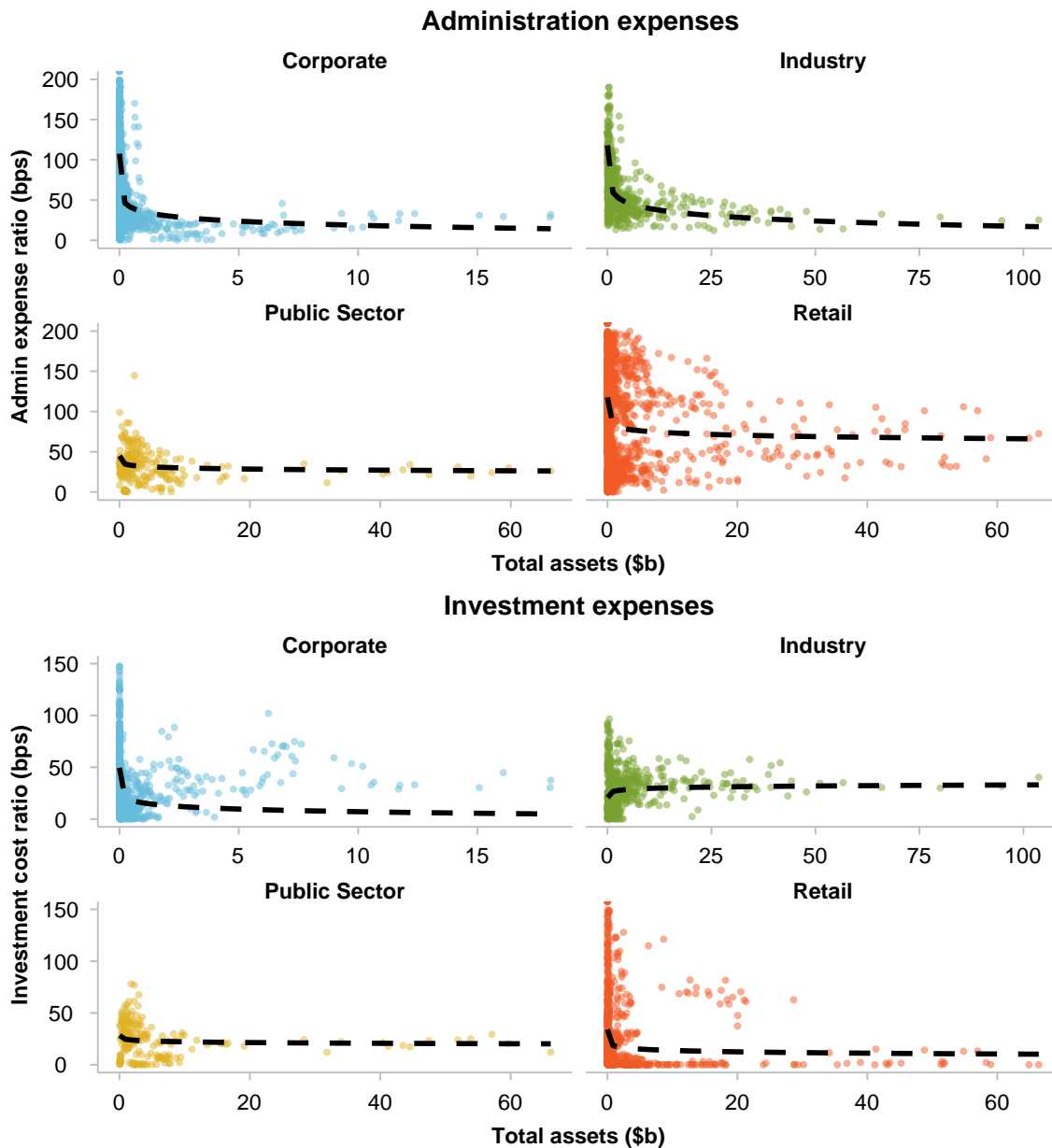
⁷⁶ Participants suggested that the result for corporate funds might reflect economies stemming from companies' use of their own human resources and payroll systems to administer super.

⁷⁷ A 'basis point' equals one one-hundredth of a one percentage point. So 50 basis points is equivalent to 0.5 per cent, or half of one per cent.

⁷⁸ The Commission's modelling approach (involving a Bayesian framework) delivered estimates for each measure of interest that span a range of values — reflecting the uncertainty involved in a modelling exercise of this type. All results reported throughout this discussion are median estimates, that is, the value from the midpoint of the range of interest. These estimates represent outcomes with a reasonable chance of occurring. Estimates from other points in the range for each measure are reported in technical supplement 8.

Figure 7.14 **Economies of scale are present in the raw data**

Average administration and investment expenses by fund size, basis points (bps), 2004–2016



^a The curves represent an estimated log relationship. The 95 per cent confidence intervals are not presented but sit very close to the estimated curves.

Source: PC analysis of APRA data.

The Commission’s modelling approach also sheds light on the relationship between costs and scale at a fund level. For both administration and investment expenses (as distinct from fees charged), at least half of all funds almost certainly have cost curves that exhibit economies of scale. Consistent with observations at a segment level, however, industry funds are less likely to be in this group for investment expenses.

This analysis is considerably more sophisticated than the preliminary work on economies of scale at a fund level that was presented in the Commission’s draft report. In particular, as noted above, the current work holds constant other factors that influence expenses to isolate the relationship between average costs and scale. The draft report simply looked at whether funds’ average expenses had risen or fallen (between 2004 and 2015). Results from the two bodies of analysis are not comparable but the findings are consistent.

Realised economies of scale translate to significant system savings

Over the period 2004 to 2017, abstracting from other factors that influence costs, the majority of funds realised economies of scale in administration and investment expenses (figure 7.15). In other words, if nothing else that impacts fund expenses had changed over this period, average expenses (as distinct from fees charged) would have fallen for most funds.⁷⁹ Larger realised gains are evident for administration than for investment expenses.

These realised economies amounted to significant system savings. Holding constant other factors that influence costs, *marginal* system savings (that is the incremental gains accrued from economies achieved from year to year) are conservatively estimated to have averaged about \$340 million a year between 2004 and 2017 — adding up to about \$4.5 billion for the period. For context, recorded expenses for APRA-regulated funds were about \$2.5 billion in 2004 and just over \$9 billion in 2017. *Cumulative* savings (scale benefits that persist beyond the year in which gains are first realised) were also achieved. Data limitations rule out their estimation, but there is no doubt they were material.

Unrealised economies of scale are large

Clearly, organic growth in the system will deliver further gains from economies of scale in the future. But gains can and should also come from consolidation — particularly the exit of higher cost funds. The Commission has estimated the potential system savings that would arise if higher-cost funds merged with the lowest cost funds **and** those lowest cost funds experienced economies of scale as they increased in size.

As for realised gains, estimated potential savings are significant (figure 7.16). For example, savings from a scenario where mergers occurred between the 50 highest cost and 10 lowest cost funds (agnostic of fund type) are estimated to be at least \$1.8 billion (with 50 per cent probability).⁸⁰ And even under some conservative scenarios where the lowest cost group includes some funds estimated to have diseconomies of scale in investment, the potential gains are still at least as large as \$750 million. (This analysis is consistent with the

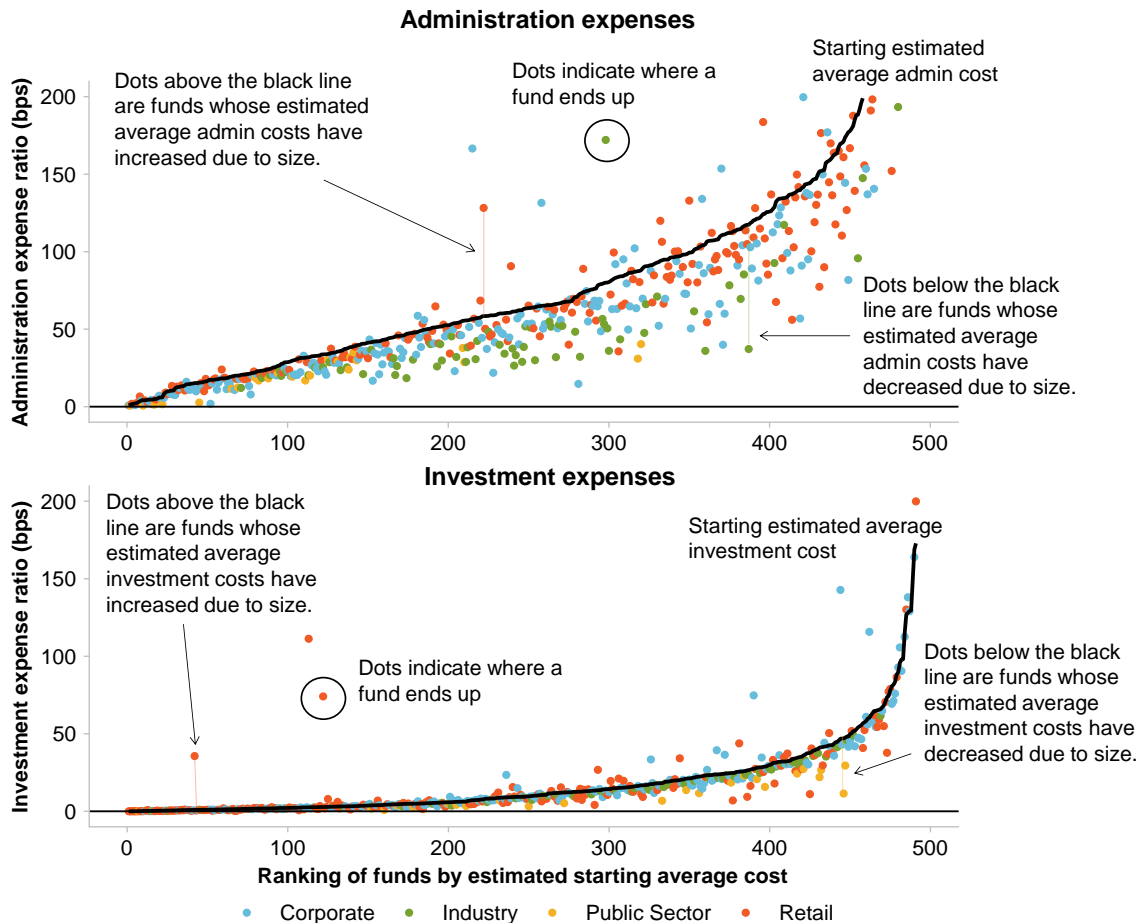
⁷⁹ The black line in each figure plots individual fund’s estimated expenses in 2004 (or whenever a fund first appears in the data), with funds ranked in order from lowest to highest expenses. The dots represent estimated expenses in 2017 (or whenever a fund exited the system for those no longer in the data in 2017). The majority of dots in both figures fall below the black line, illustrating realised economies.

⁸⁰ These estimates do not take into account transition costs, nor potential strategic responses by funds or changes in member behaviour — for example, increasing contributions to a lower cost fund.

observation in the draft report that unrealised economies likely exist, although here the focus is on high-cost funds, whereas in the draft report the focus was the large tail of small funds.)

Figure 7.15 Most funds have realised scale benefits in administration and investment expenses^{a,b}

Projected cost changes, basis points (bps), 2004–17

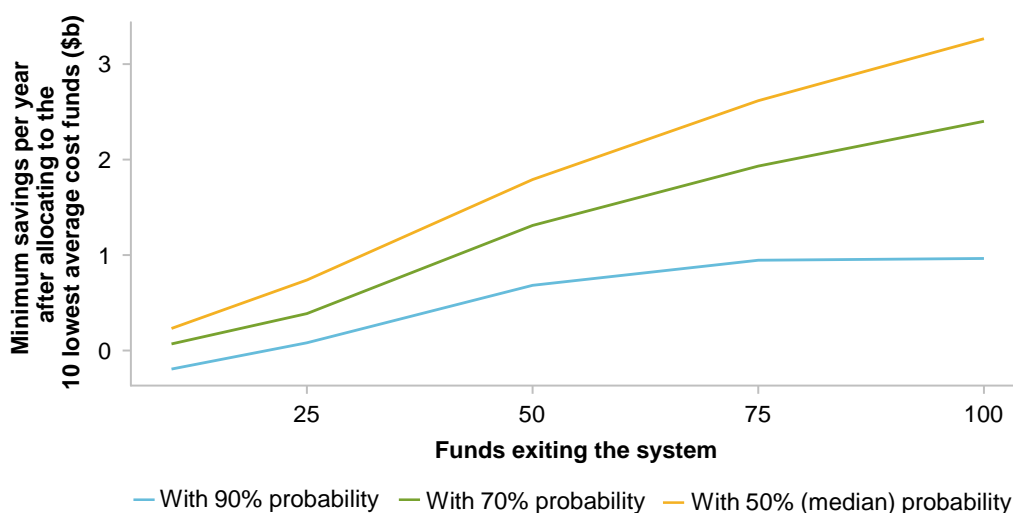


Source PC analysis of APRA data.
Coverage 494 funds representing 100 per cent and 91 per cent of the system by assets in 2015-16 and 2004-05 respectively. Excludes funds with less than two years of data.

^a The black line denotes the estimate average cost for funds in 2004 (or their first year of operation). The dots denote their estimated average costs with their assets and number of member accounts for 2017 (or their last year of operation). The vertical gap between the dots and the black line represent the fund's estimated average cost reduction or increase from scale. Funds are ordered by estimated average cost in 2004. ^b Starting estimated average costs close to zero for some funds are likely to be due to underreported costs (or imputed values that are estimated as larger than zero for zero expense reporting funds, but still small). The number of observations with low starting estimated average costs reinforces the problem of underreporting.

Figure 7.16 **Unrealised economies of scale — a source of large potential savings^{a,b,c}**

Estimated savings per annum, \$billion



Source	PC analysis of APRA data.	
Median coverage^c	By funds 107 (out of 180)	By assets \$705b (out of \$1532.7b)

^a Funds with estimated total average costs of less than 45 basis points were excluded from this analysis (to avoid allocating assets to funds with underreported expenses). ^b The 90 per cent probability curve shows a flattening of the savings because the group of lowest cost funds includes estimates for industry funds that exhibit diseconomies of scale. Similarly as funds are allocated to the lowest 10 at random, if industry funds have diseconomies of scale, then it is possible for the curves to start with losses. ^c Because funds with estimated total average costs of less than 45 basis points were excluded, the number of funds excluded varies across each posterior draw.

If the cost saving from these gains was passed through to *all* members as lower fees (a reduction of about 10 basis points) then, holding all other costs constant, an average member within the system would be \$22 000 better off in retirement. (This benefit to members may appear modest relative to Commission’s cameos in the draft report, but unlike in those cameos this benefit applies to all members.) Gains to members of higher cost funds would be markedly larger.

And even small falls in average costs for funds that have already achieved considerable scale (and are typically on a flatter section of their cost curve) would translate into material savings. For example, a one basis point reduction per year in administration expense ratios for funds with assets of over \$10 billion (currently about 35 basis points on average) would translate to around \$130 million in savings per year.

The presence of these potential gains, particularly from further consolidation, reflects a lack of effective competition in the system.

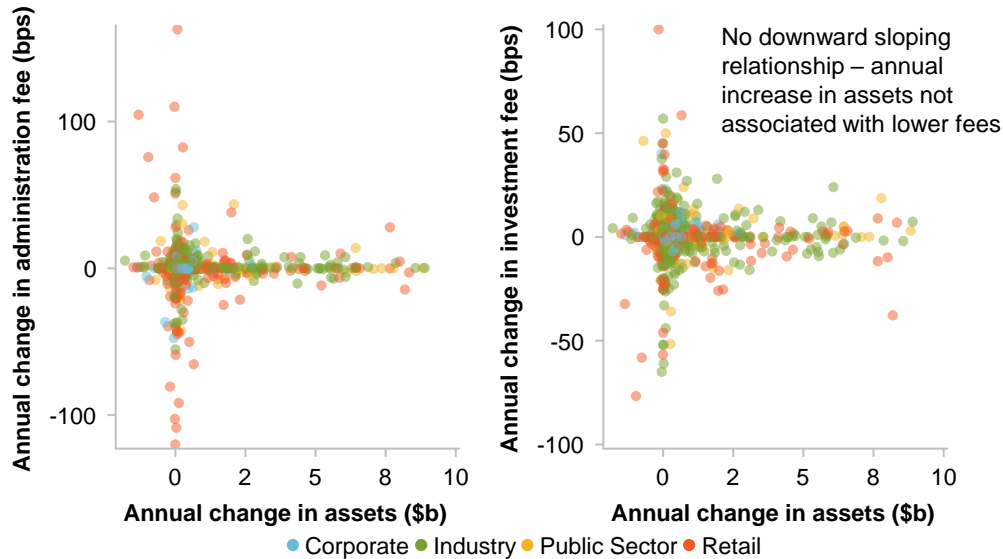
No evidence that economies of scale gains have been systematically passed-through as lower fees

Inspection of the raw data does not suggest a relationship between changes in funds size and changes in fees charged to members (figure 7.17). Nor is a relationship seen in the Commission’s modelling.

At a system level, average expenses *attributable to size alone* fell between 2004 and 2017.⁸¹ The median size of this fall was estimated at between 10 and 18 basis points for administration expenses, and between 0 to 4 basis points for investment expenses. In contrast, within the sample of funds used in the Commission’s analysis, administration fees rose by 1 basis point (for the median fund) and, for investment fees, by 3 basis points (again, for the median fund). Similar conclusions of a lack of pass-through are returned for each segment, with the exception of investment fees in the retail segment.

Figure 7.17 **Pass-through is not evident on casual inspection of year-on-year changes in expenses and fees over time**

Annual basis point (bps) changes in administration and investment fees by annual change in fund assets, 2004–2016



Source	PC analysis of SuperRatings and APRA data (2004–2016).
Coverage	118 funds representing 81 per cent and 39 per cent of the system by assets in 2015-16 and 2005-06 respectively for administration and investment. Excludes funds with less than two years of data.

⁸¹ Albeit these numbers are based on data for a sample of funds representing 81 per cent and 39 per cent of the system by assets in 2015-16 and 2005-06, respectively.

In other words, *the median fund* did not pass-through the lower average costs realised with greater scale to its members in the form of lower fees (confirming the preliminary result presented in the draft report). Underlying the average, however, some funds might have passed through at least some of the gains.

As mentioned previously, the result could be explained by funds: increasing the size of their operational reserves; investing in member services; or spending to comply with new regulatory requirements. Unfortunately, data that would permit analysis of the extent to which each of these outcomes prevailed, and the extent to which members are actually benefiting and whether in a form they value, are not available. On the investment side, some funds might have used economies of scale gains to invest more heavily in unlisted asset classes, which may then have led to higher net returns for members (this scenario is discussed next). Finally, it is also possible that data limitations (including underreporting of expenses and patchy fee data) are muddying the analysis.

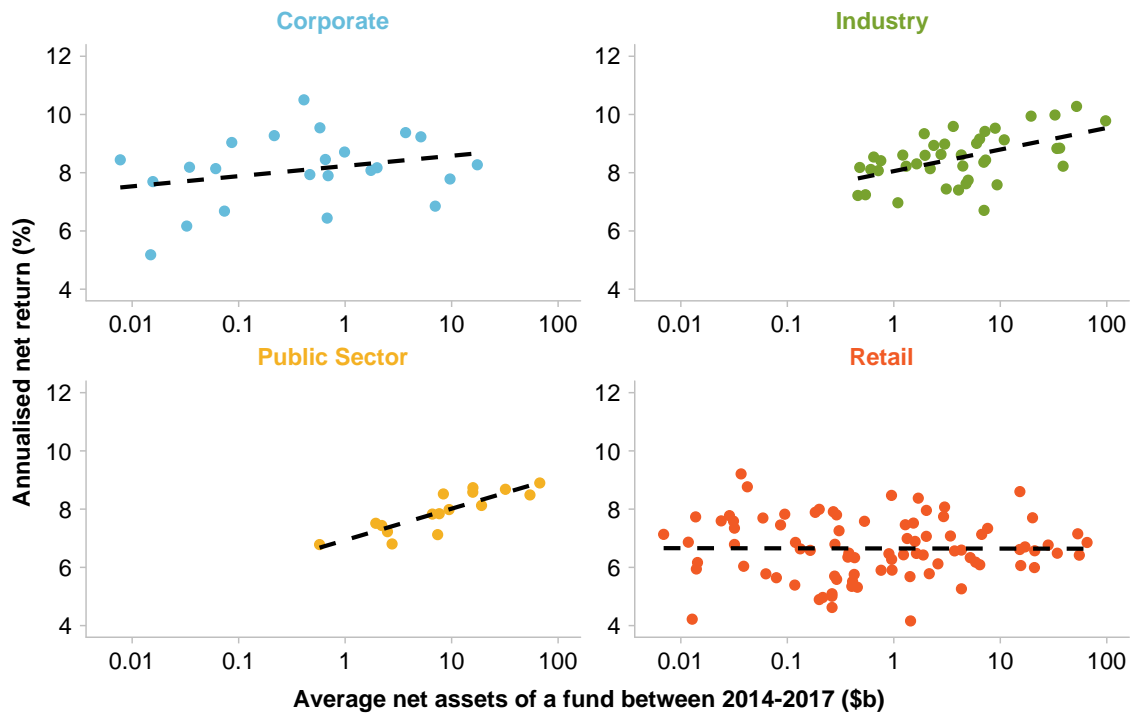
Economies of scale gains may have been passed-through as higher returns

Some participants suggested that increased investment in unlisted assets might account for the relatively weak relationship between investment expenses and scale for industry funds and, more broadly, the smaller realised gains from scale in investment expenses. Unlisted assets (which incur higher investment costs) typically obtain higher net returns over time (partly in compensation for their illiquidity) (tech. supp. 4). If increased investment in unlisted assets consumed some of the cost savings from increased scale, members may have ultimately benefited via higher returns — an efficient outcome from a member’s perspective.⁸² A relationship between unlisted assets and increased investment expenses could be attributable either to greater investment in this asset class among larger funds as they have grown, or a broader move across the system towards this type of investment.

The Commission’s analysis found that larger not-for-profit funds do obtain higher net returns, but no corresponding relationship exists for retail funds (figure 7.18). However, there is limited evidence that the stronger net returns recorded by larger not-for-profit funds are due to higher exposure to unlisted asset classes (data limitations rule out stronger conclusions). Indeed, there is no statistically significant evidence of larger funds investing more heavily in unlisted assets — at least in recent years (between 2014 and 2017). The evidence does suggest, however, that larger funds make better investment decisions (asset selection) within asset classes.

⁸² Technical supplement 4 on investment performance analysed survey data from funds and found that unlisted asset classes had higher net returns, but lower returns relative to benchmarks, between 2008 and 2017.

Figure 7.18 Net returns increase with scale for all segments except retail^a
 Annualised net returns (per cent) by average net assets, 2014–2017



Source	PC analysis of APRA data (2014–2017).
Coverage	178 funds representing 92 per cent of the system in 2013-14.
Survivor bias	Yes.
Selection bias	No.

^a Excludes eligible rollover funds and insurance only funds. This figure only includes funds that have been in operation in all years from 2014 to 2017. For each fund, net assets are taken as an average over the time period.

FINDING 7.4

Evidence of economies of scale is compelling — larger fund size is strongly associated with lower average costs in the Australian superannuation system.

Significant economies of scale have been realised over the past 13 years, particularly on the administration side. Holding constant other cost drivers, ‘marginal’ (or incremental) gains in system savings (accruing from increases in scale in any year) totalled an estimated \$4.5 billion between 2004 and 2017. Data limitations rule out estimation of realised ‘cumulative’ savings (scale benefits that persist beyond the year in which gains are first realised), but no doubt they have also been material.

Significant unrealised economies of scale remain. For example, annual cost savings of at least \$1.8 billion could be realised if the 50 highest-cost funds merged with the 10 lowest-cost funds. And a 0.01 percentage point reduction in administration expense ratios for funds with more than \$10 billion in assets could result in annual savings of about \$130 million. The presence of these potential gains, particularly from further consolidation, reflects a lack of effective competition in the system.

Scale benefits also manifest through increasing returns to scale. Net returns are positively related to size for not-for-profit funds. (No corresponding correlation was found for retail funds.) Stronger net returns among larger not-for-profit funds might be due to higher exposure to unlisted asset classes, but data limitations rule out strong conclusions. Larger funds do appear, however, to make better investment decisions within asset classes.

There is little evidence that realised economies of scale have systematically been passed through to members in the form of lower fees. Scale benefits may have been passed through in the form of member services or increases in reserves, or offset by the costs of meeting new regulatory requirements. And not-for-profit funds, on average, might have passed through some scale economies by investing more heavily in (higher-cost) unlisted assets and obtaining higher returns. Data limitations preclude firm conclusions about the form of pass through of economies of scale, and thus how members are actually benefitting and whether they are benefitting in a form they value.

8 Insurance

Key points

- About 12 million Australians hold insurance — for life, total and permanent disability, and income protection — through their superannuation, with about 80 per cent of these policies provided automatically (requiring members to opt out or amend cover if it is unsuitable). Total premiums collected increased by 35 per cent over three years to reach \$9 billion in 2016-17 (including an estimated \$1.9 billion on unintended duplicate policies).
- Current settings are more a function of history than considered policy design. The suitability of insurance relies on trustees balancing cover for members against the erosion of account balances for retirement — avoiding unnecessary balance erosion is a formidable task. Levels of automatic cover (and the premiums charged) vary widely across funds, and it is implausible that this can be fully explained by differences in member characteristics.
- Many members benefit from the lower costs and ready access of default group insurance in superannuation. But many entrenched problems remain (and insurance accounts for over a third of member complaints against their fund). These are exacerbated by a lack of awareness by (about a quarter of) members as to whether they have such insurance. Particularly for young workers — either with no dependants (in the case of life insurance) or low incomes (in the case of income protection) — insurance is poor value and does not meet their needs.
- Balance erosion can be excessive and highly regressive — having a disproportionate impact on members with low income, intermittent labour force attachment and/or multiple accounts with insurance (17 per cent of members). The reduction in retirement balances for many of these members could reach 14 per cent (\$85 000), and for some disadvantaged members could be reduced by over a quarter (\$125 000). Trustees should be required to annually articulate the ‘balance erosion trade-off’ for their members and publish it on their website.
- Some members have policies that are of little or no use to them — including ‘zombie’ policies that cannot be claimed against (income protection being the main and expensive culprit). Funds could better use member data (about 10 per cent of funds use no data, not even low cost imputed data) to inform product design and ensure offerings meet members’ needs. The lack of comparability across insurance products makes switching to better superannuation products difficult for members and limits competitive forces.
- The Government-prompted industry code of practice falls short of what is needed. Its ultimate success depends on it being universally adopted by funds, effectively enforced, and its provisions substantially bolstered — standardising key definitions and provisions is a priority. But these changes cannot be left to the industry. An ASIC-APRA taskforce should direct industry on how to bolster the code and monitor progress. Industry should be given a hard deadline of two years to make the bolstered code binding and enforceable. ASIC should ensure this happens. Adoption of the code should then be made an RSE licence condition.
- Further actions to cull poor value policies are necessary — insurance should usually only be provided on an opt-in basis to members under 25 years old, and cover should cease for all members on inactive accounts after 13 months, unless the member explicitly chooses otherwise. The Australian Government is already seeking to legislate these changes.
- An independent public inquiry into insurance in superannuation should be initiated within four years to review progress, evaluate the role of insurance in superannuation more broadly and determine whether further policy changes are needed.
- The fiscal impact of insurance in superannuation is complex with offsetting ‘swings and roundabouts’. Commission analysis suggests that Age Pension increases resulting from the erosion of super balances are not trivial and have the potential to materially offset any savings in social security payments that might otherwise be made to insurance payout recipients.

Insurance in superannuation is significant, both in terms of its share of the Australian life insurance market and relative to the total inflows into the superannuation system each year. This chapter examines whether the provision of this insurance is delivering value for money to members. The assessment is based on the criteria outlined in the stage 1 study, but expanded in areas to address the terms of reference for stage 3. The assessment does not consider the broader policy question of whether insurance should be opt in or opt out in superannuation. Such an assessment is beyond the scope of the current terms of reference, and is an inquiry in itself (requiring an assessment of underinsurance in Australia and the distributional and wellbeing impacts of that underinsurance). Rather, the focus of this inquiry, if the Commission finds that insurance is not providing value for money for all members, is to consider what changes to the current arrangements are warranted, without undermining the benefits insurance in superannuation provides.

Section 8.1 describes the framework used by the Commission. Section 8.2 provides some context about current arrangements. Section 8.3 examines the impact of insurance on members' account balances. Section 8.4 evaluates the value for money of insurance. Section 8.5 outlines recent initiatives by both industry and government, while section 8.6 discusses further changes that are required. Section 8.7 canvasses some findings on the fiscal effects of insurance in superannuation.

8.1 A framework for assessment

The broad objective of superannuation is to provide an income source in retirement. In some circumstances, there is some alignment between this objective and the objectives of insurance — life, total and permanent disability (TPD) and income protection (IP) — in superannuation.

- For TPD cover, insurance contributes to retirement income, as it insures against the risk that a member's accumulation phase is cut short.
- For life cover, the links are less clear, except to the extent that insurance payouts can fund the retirement of a dependent partner.
- For IP cover, there may be a link where a Superannuation Guarantee contribution component is deducted from the payment, or if the payment assists the worker to re-enter the workforce (for example, through facilitating rehabilitation programs).

There are a number of rationales that support the case for insurance in superannuation.

- Superannuation provides a pooling mechanism to facilitate group insurance policies that can be provided more cheaply than individually underwritten policies. The cost effectiveness of group insurance is primarily attributable to lower distribution costs (there is no need to pay commissions to insurance agents to sell the product given the

opt-out arrangements) but group insurance also has lower advice, administration and underwriting costs.⁸³

- Group policies can charge lower premium costs by pooling risk and reducing adverse selection, particularly under opt-out arrangements. This means that an individual with higher risk factors can access insurance at a substantially cheaper rate than under an individually underwritten policy.
- The default opt-out arrangements that facilitate group insurance assist in addressing reported problems of underinsurance.⁸⁴
- There are potential benefits to individuals from having life insurance through superannuation compared with purchasing it outside of superannuation. It allows members to pay for insurance using funds that cannot otherwise be currently spent and that are taxed concessionaly.⁸⁵

However, as the Commission noted in its previous work (PC 2016a, 2017d), the provision of insurance in superannuation is marked by conflicting objectives on fund trustees. Trustees are obligated to offer insurance on an opt-out basis in MySuper products, but must simultaneously ensure that the cost of this insurance does not inappropriately erode members' retirement incomes.⁸⁶

Also, insurance provided through superannuation, is just one of a multitude of arrangements in place that can assist workers and their families in the event of injury, illness or death (box 8.1). This mix of schemes, along with diversity across members' financial and household circumstances means that members' demand for insurance through superannuation is highly variable, even for people with similar observable characteristics such as age, gender, occupation and income.

Accordingly, the Commission's assessment of the efficiency and competitiveness of insurance in superannuation is designed to ensure that it delivers value for money to members within this broader context. While, there are potential efficiency and member wellbeing benefits from insurance in superannuation, there is also a range of potential 'leakages' that harm members and reduce value for money, including:

- excessive balance erosion — for some members, expensive insurance premiums (relative to contributions) can lead to a significant reduction in balances at retirement

⁸³ It is the opt-out nature of insurance, not the fact that insurance is contained in superannuation that delivers the group insurance benefits — alternative opt-out arrangements for insurance could be developed.

⁸⁴ Rice Warner (2016a) noted that default group insurance in superannuation goes some way to addressing the underinsurance gap in Australia (that is, Australians are typically insured for less than is required to meet their basic needs in the event of death or permanent disability). The Commission has not made an assessment of the underinsurance gap in Australia in this report, but rather considers whether policies represent value for money.

⁸⁵ This does not apply to income protection insurance premiums as these are typically tax deductible outside superannuation, or for individuals whose average tax rate is below 15 per cent.

⁸⁶ MySuper products are required to include life and TPD insurance on an opt-out basis. Trustees may also include IP insurance on an opt-out basis in MySuper products.

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- low-value policies — some members pay premiums for policies that provide them with little or no value. While some cross-subsidisation is necessary for group insurance to function, inappropriate cross-subsidisation should be constrained.

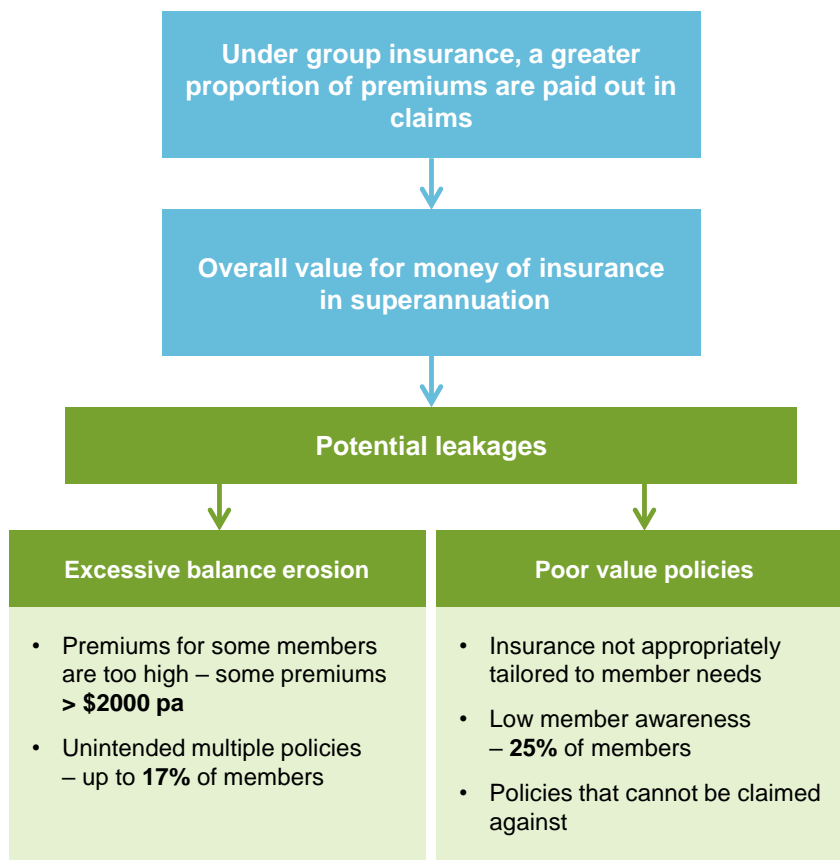
Box 8.1 There is a range of schemes to assist people unable to work

There is a multitude of schemes in place that provide varying levels of assistance to people, depending on the nature of their illness or injury or their personal circumstances.

- *Sick leave.* While typically used for short-term illness, some workers may have access to considerable amounts of sick leave that can provide longer-term assistance in the case of more serious conditions.
- *Social security payments.* People unable to work who meet income and asset tests may be able to access government social security payments, in particular the Disability Support Pension, which can provide ongoing income support until the recipient qualifies for the Age Pension. Even people who do not meet the disability eligibility requirements of the Disability Support Pension, may be eligible for Newstart Allowance, subject to meeting activity requirements.
- *Workers' Compensation schemes.* People with an illness or injury attributable to their employment may be covered under a workers' compensation scheme. These schemes vary in coverage and the quantum of payments across jurisdictions (Safe Work Australia 2017), but can provide income replacement payments for temporary incapacity as a proportion of pre-injury earnings, payment of medical and hospital costs and lump-sum payments for permanent impairment or death. To an extent, these schemes mirror the insurance offered through superannuation, albeit only for work-related conditions.
- *National Disability Insurance Scheme (NDIS).* The NDIS provides funding for reasonable and necessary supports for eligible participants with permanent disabilities (taking into account other compensation received for NDIS-type supports). Funded supports can include assistance with daily personal activities, household tasks and workplace help, as well as mobility equipment or home or vehicle modifications. It does not cover funding unrelated to a person's disability, including day-to-day living costs (NDIS 2018).
- *Other arrangements.* People may be able to access assistance or compensation in the case of illness or injury, such as through compulsory third party motor vehicle accident insurance schemes, and court action in other cases where a third party may be liable. The National Injury Insurance Scheme is intended to operate as a set of consistent state-based no-fault insurance schemes that would operate in parallel with the NDIS, providing cover for newly-acquired catastrophic injuries, including for both motor vehicle accidents and workplace accidents. Medical treatment injuries and general accidents were also intended to be included, but little progress has been made in developing these streams (PC 2017c, pp. 257–8).

The Commission's approach to assessing the value for money of insurance in superannuation is illustrated in figure 8.1. The suitability of these arrangements relies on trustees balancing provision of insurance cover for members today against the erosion of lower balances at retirement — avoiding unnecessary erosion is a challenging task.

Figure 8.1 **Assessing the value for money of insurance for members**



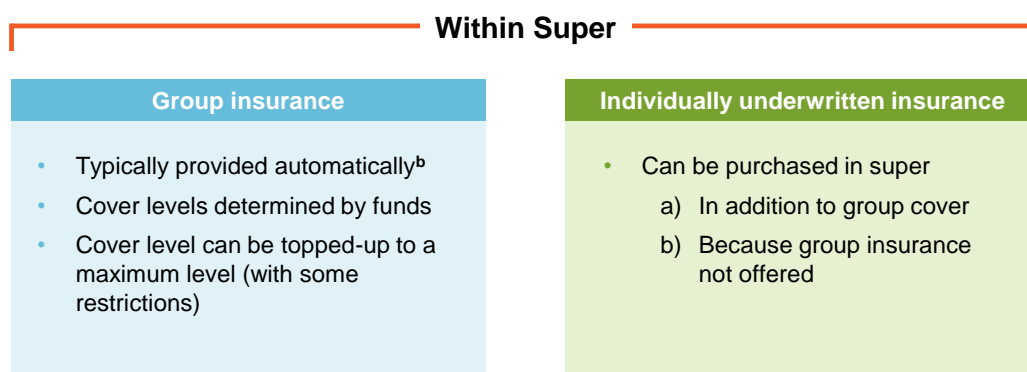
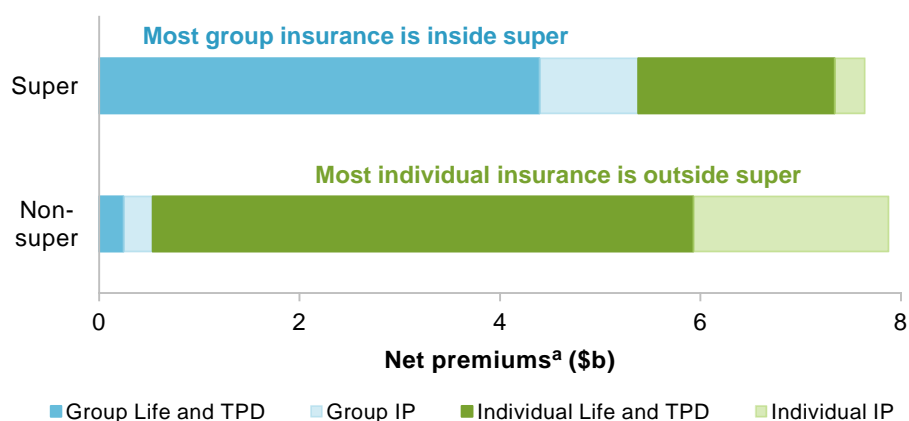
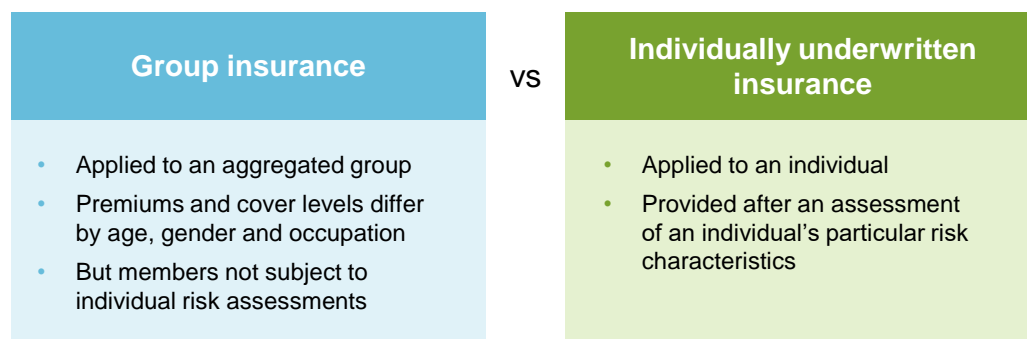
8.2 Some context

Life, TPD and IP insurance are permitted within superannuation, with premiums deducted from members' superannuation account balances. Insurance can be organised on either a group or individually underwritten basis. Most insurance in superannuation is group insurance and is provided on an opt-out basis (figure 8.2).

In determining their insurance settings, fund trustees are bound by their trust obligations to operate in the best interests of beneficiaries (the members). Section 52(7) of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act), among other requirements, requires trustees to only offer insurance if it 'does not inappropriately erode the retirement income of beneficiaries'. And, Prudential Standard SPS 250 requires registrable superannuation entity (RSE) licensees to have an insurance management framework. The framework must include how it will address the requirements set out in the SIS Act, processes for monitoring and reviewing insurance benefits, its approach to claims management and dealing with conflicts of interest.

Figure 8.2 Superannuation facilitates group insurance

Characteristics of group and individual insurance



^a Net premiums for the year to June 2016. ^b MySuper products are required to provide life and TPD insurance on an opt-out basis.

Source: APRA (2018h).

There appear to be few international parallels to default opt-out insurance in superannuation. A high-level assessment of seven other countries by KPMG (2017b) noted that only Chile and Canada had insurance within their pension schemes,⁸⁷ but these differed from the default arrangements in Australia because members were often unable to opt out.

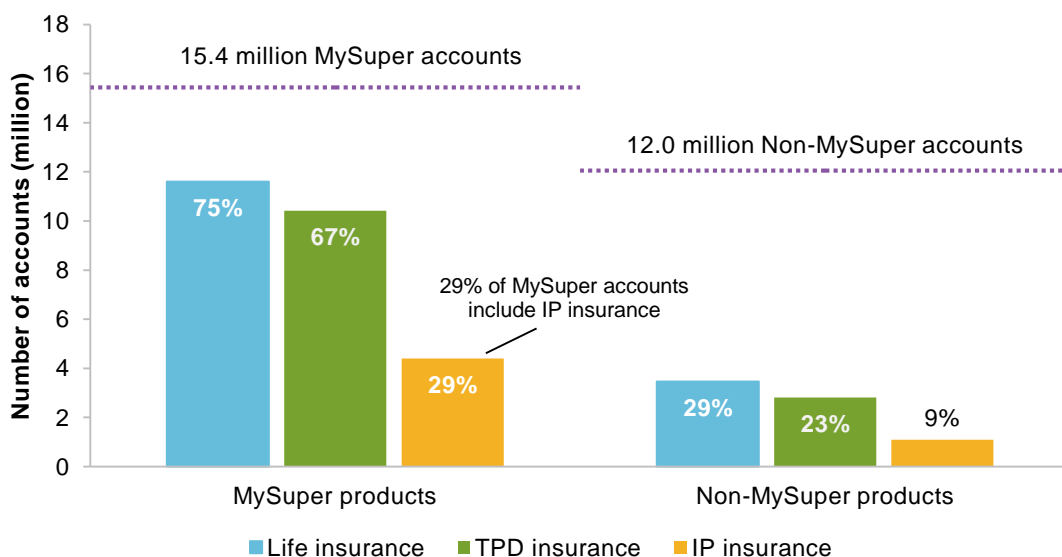
⁸⁷ The other countries examined were the United States, New Zealand, Sweden, the United Kingdom and France.

How big is the footprint of insurance in superannuation?

Insurance within superannuation accounts for just under half of the total market (in terms of net premiums) for life, TPD and IP insurance in Australia (figure 8.2). While difficult to pinpoint accurately, overall, there are about 12 million individuals with some type of insurance through their superannuation.⁸⁸

About half of all superannuation accounts (and three quarters of MySuper accounts) have premiums deducted for one or more insurance products (figure 8.3). Life insurance is the most commonly held insurance in superannuation, closely followed by TPD, with IP insurance held by a much smaller number of accounts.

Figure 8.3 Most accounts in MySuper have insurance^a
Superannuation accounts with insurance, June 2017



^a Total accounts is for all APRA-regulated funds. Non-MySuper accounts is the residual of total accounts less MySuper accounts and includes accounts where insurance is not available, including in accounts in the pension phase.

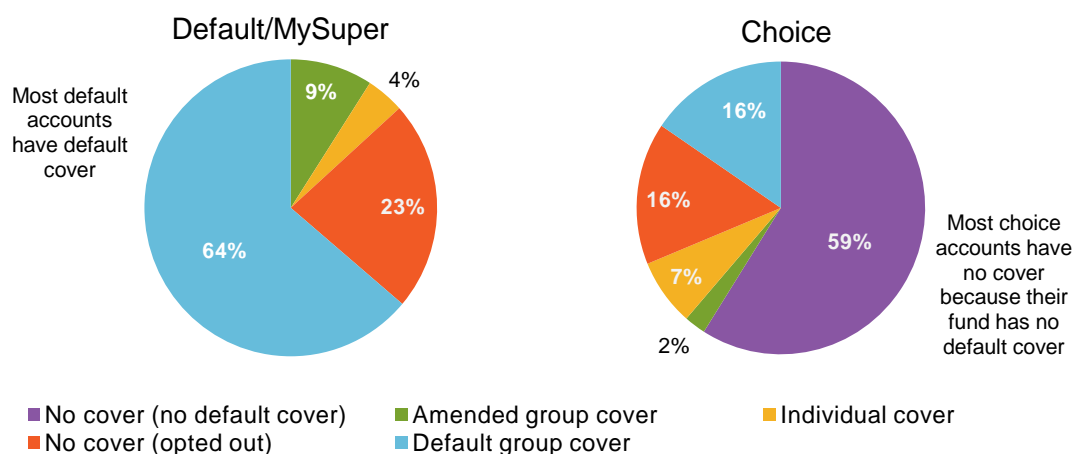
Sources: APRA (2018a, 2018b).

Most accounts with insurance (across both MySuper accounts and accounts in the choice sector) have automatic group cover rather than individually underwritten cover (figure 8.4). Overall about 80 per cent of policies within the superannuation system are provided through default group cover.

⁸⁸ This is an estimate using ATO data on accounts with insurance, although it is likely an underestimate, as it is based on member accounts with a tax file number attached. The number of unique individuals is not discernible from published APRA data as this counts total accounts with each insurance type.

Figure 8.4 Disparate insurance cover across MySuper and choice accounts^a

Per cent of accounts, 2016-17



^a 75 funds responded to at least one of the choice and default sections for 2016-17 for this question in the funds survey, representing 59 per cent of balances and 51 per cent of accounts. Data represents 2016-17 responses.

Source: Funds survey.

Default insurance premiums

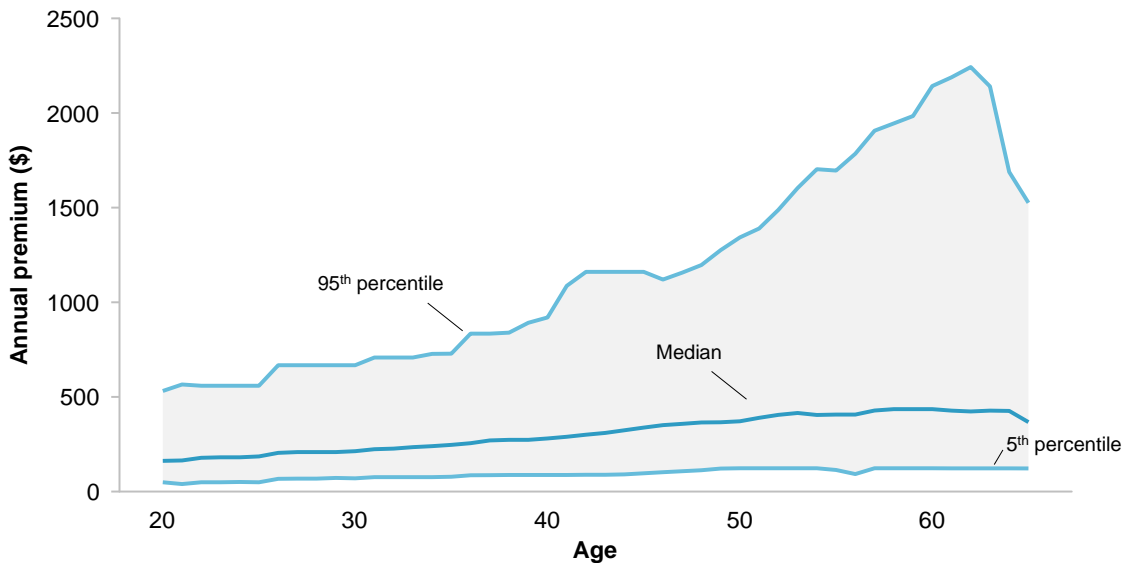
The default premiums that members pay vary widely — while the average hovers around \$300 per year, premiums can be as high as \$2000 per year (figure 8.5). One key factor is age — premiums tend to increase by age (reflecting increasing risk), but then decrease again at older ages as funds reduce the default levels of cover. But there are also other reasons why default premiums differ. For example:

- some members are subject to risk loadings to account for the risks associated with more manual and/or hazardous work — ‘light’ blue collar products are about 20 to 40 per cent more expensive than comparable white collar products, while ‘heavy’ blue products can be more than twice as expensive than comparable white collar products
- some funds include IP insurance in their default cover, while others do not. For example, a worker with a white collar rating will on average pay about \$250 per year more if their default cover includes IP insurance
- funds choose different levels of default cover and charge different prices per unit of cover.

To some extent, the variation in types and levels of cover and unit prices can be expected to reflect differences in member cohort characteristics and preferences (such as occupational risk, income levels and financial/familial obligations). Nonetheless, the wide disparity in premiums across offerings suggests that there may be other factors at play. Given the

limitations in the data about their members that funds can and do collect, it is implausible that the wide observed variation in default cover and premiums across funds is fully explained by these cohort differences.

Figure 8.5 Default premiums vary significantly between funds^a
Annual default premiums (\$), 2017



^a Default premiums for a male who is a non-smoker.

Source: PC analysis of Rice Warner data.

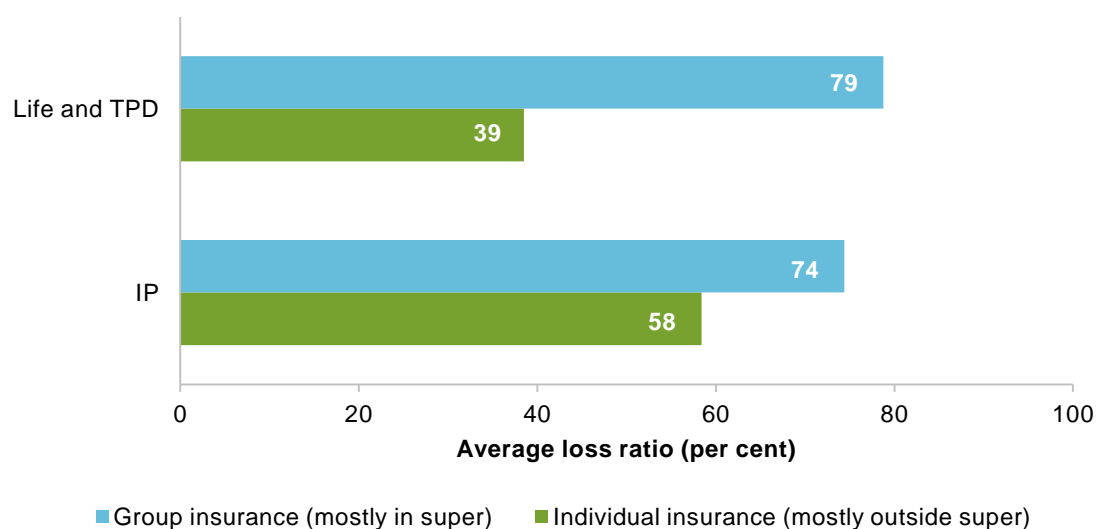
Insurance in superannuation pays out a relatively high proportion of premiums

Australian Prudential Regulation Authority (APRA) data indicate that insurance in superannuation has relatively high loss ratios (the proportion of premiums paid out as claims), although there are data limitations that impact their accuracy. While it is difficult to directly calculate loss ratios for insurance inside superannuation, this calculation can be performed for group insurance (which is mostly inside super) and individually underwritten insurance (which is mostly outside super).⁸⁹ Group insurance provides loss ratios of about 75 to 80 per cent, reflecting the much lower cost base of group insurance, compared with individually underwritten policies (40 to 60 per cent) (figure 8.6).

⁸⁹ Premiums and claims do not always occur in the same year, which means that to calculate loss ratios, data on the changes in the 'outstanding claims reserves' (reserves set aside for claims that are expected to still emerge in respect of that period) and the 'unearned premium reserve' (a reserve set aside for premiums paid in advance) need to be considered. Data on the changes in these reserves are not available for insurance inside superannuation.

Figure 8.6 Insurance in super pays out a higher proportion of premiums as claims^a

Average loss ratio, 2009-10 to 2016-17



^a Loss ratios are approximations because of data limitations. They are calculated as the total amount of claims plus any change in ‘outstanding claims reserves’ (reserves set aside for claims that are expected to still emerge in respect of that period) divided by the total amount of premiums less changes in the ‘unearned premium reserve’ (a reserve set aside for premiums paid in advance). Loss ratios are net of outward reinsurance. Average loss ratios are calculated as a simple average of annual loss ratios between 2009-10 and 2016-17.

Source: PC analysis of unpublished APRA data.

That said, loss ratios have been decreasing in recent years.⁹⁰ Premiums in the past three years have increased significantly, such that at the system level, premiums are accounting for an increasing share of the contributions into superannuation (table 8.1). This is likely to be an unavoidable but costly ‘pendulum swing’ following the significant losses experienced by insurers attributable to the under-pricing of the risk of the pool by insurers (Rice Warner 2016a). AIA Australia submitted that:

Pricing competition between group insurers was so significant that it contributed to reduced insurer and reinsurer margins and significant losses across the market for the years ending June 2013 to June 2014. Over the past three years premiums have risen to reflect the deteriorating claims experience and increased capital requirements. (sub. 76, p. 11)

The value of claims has also increased over this period (figure 8.7).

⁹⁰ The year-to-year variation in insurance claims means that multiple years of data are required before observing long-term changes in loss ratios.

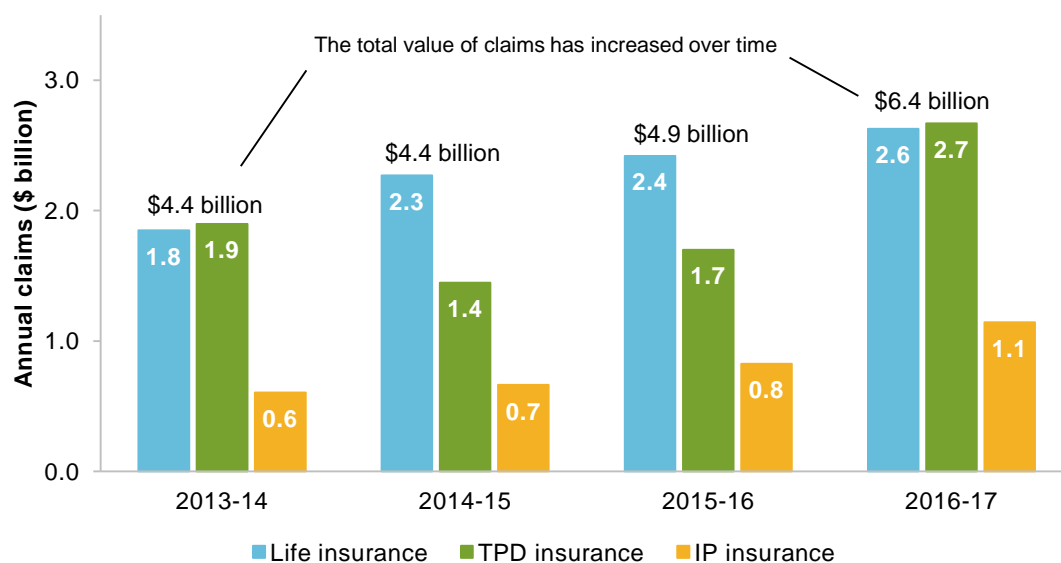
Table 8.1 Aggregate premiums increasing relative to contributions^a
2013-14 to 2016-17

	Units	2013-14	2014-15	2015-16	2016-17
Total insurance premiums collected	\$m	6 661	7 866	8 445	9 010
Total contributions ^b	\$m	95 246	104 080	104 181	116 972
— insurance premium share	%	7.0	7.6	8.1	7.7
Superannuation Guarantee contributions ^b	\$m	NA	53 521	55 701	59 041
— insurance premium share	%		14.7	15.2	15.3

^a APRA-regulated funds. ^b Contributions are for all members not just those with insurance.

Sources: APRA (2018b, 2018m).

Figure 8.7 Insurance claim payments have increased over time^a
\$ billion, 2013-14 to 2016-17



^a Data are for APRA-regulated funds. IP payments are commonly made for two years and so a single claim is likely to have payments spanning two to three financial years.

Source: APRA (2018b).

Current arrangements (and problems) have evolved over time

The nexus between insurance and superannuation goes back a long time (box 8.2). Current settings are arguably more a function of history than considered policy decision and design. Accordingly, there is no specific policy architecture governing how insurance should be delivered to members. Rather, the suitability of arrangements relies on the broad obligations of trustees acting in members' best interests and some degree of regulatory oversight.

Box 8.2 A brief history of insurance in superannuation

The connection between insurance and superannuation began in the 1950s with life insurance companies beginning to offer superannuation products (primarily to the public sector and to male professionals in large companies). Following the introduction of compulsory superannuation in 1992, insurance continued to be provided in most default products.

Legislative requirements to offer insurance were introduced in the 2005 Choice of Fund reforms. It specified that default funds must provide a minimal level of life insurance cover (but not TPD or IP insurance). Funds did not necessarily have to give members the choice to opt out.

The 2010 Cooper Review made the following findings on insurance in superannuation:

The Panel considers that life and TPD insurance strongly supports the principles of the superannuation system. The Panel believes that in the MySuper sector, where members are least likely to give consideration to their insurance needs, the trustee should be required to offer life and TPD insurance on an opt-out basis.

Requiring MySuper products to offer life and TPD insurance on an opt-out basis provides a safety net to members who might otherwise not consider their insurance needs; a view supported by many submissions. This will lower the cost of insurance for most members in MySuper, because there is pooling of risk between members who face different risks and financial circumstances. (Cooper et al. 2010b, p. 144)

In response, the Australian Government — under the 2013 Stronger Super reforms — made it mandatory for funds to provide life and TPD insurance, on an opt-out basis, in all MySuper products.

Since then, in response to concerns from government and regulators, the Insurance in Superannuation Working Group (ISWG) developed a voluntary code of practice, which contains provisions aimed at improving member outcomes with respect to insurance cover. Further iterations of the code with additional provisions are planned, but timing remains uncertain. This is because the focus to date has been on adoption (and development of transition plans) of the initial code, and that the priorities (including administrative processes and accountabilities) for future developments and how these will be resourced have not been announced.

These arrangements have led to a litany of problems, which is in part evidenced by insurance matters accounting for over a third of member complaints against superannuation funds.⁹¹ The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Financial Services Royal Commission (FSRC)) has also identified cases of misconduct affecting members holding insurance through superannuation. Broadly, the issues include a lack of awareness by members that insurance is included in their superannuation, the complexity and lack of comparability of insurance products, excessive balance erosion, and account proliferation resulting in many members holding multiple insurance policies, some of which they would be ineligible to claim against (so called ‘zombie’ policies). Increases in premium costs in recent years have magnified the magnitude of these concerns.

Notwithstanding some acknowledgment of instances of poor outcomes and scope for improvement, there is broad industry support for the presence of insurance in superannuation, including on a default, opt-out basis (box 8.3).

Other participants, including those representing member interests, were generally supportive of the role that insurance in superannuation plays in providing a safety net for members, but many raised concerns about the deficiencies inherent in the current settings (box 8.4).

8.3 How significant is balance erosion?

The deduction of insurance premiums over a member’s lifetime reduces their superannuation balance, resulting in less disposable income in retirement. This section assesses whether this trade-off is beneficial for all members, focussing primarily on the impact of default cover on account balances (because most members are disengaged and have not made a deliberate choice to expend their superannuation savings in such a manner). Earlier chapters analysed the effects of balance erosion as they relate to administration and investment fees (chapter 3) and unintended multiple accounts (chapter 6). The latter estimated the total systemwide premiums collected from unintended duplicate insurance policies to be about \$1.9 billion each year. It found that multiple insurance premiums are a key reason that a representative member with two superannuation accounts (from ages 25–45 years) would be over \$55 000 worse off at retirement compared with a member that has one superannuation account.

⁹¹ In 2016-17, the Superannuation Complaints Tribunal received 1376 complaints within its jurisdiction. Just over 50 per cent of complaints (694) were related to administrative matters, of which 195 complaints (28 per cent) were related to insurance matters, including the deduction of insurance premiums. Twenty per cent of complaints (273) were classified as disability-related, which covers complaints related to TPD and IP claims. A further 30 per cent of complaints were categorised (409) as death, which would also include complaints about insurance claims, but the bulk of these complaints (366) were about the distribution of death benefits (SCT 2017).

Box 8.3 **The benefits of insurance in super — industry views**

AustralianSuper stated that:

Insurance is an important part of the superannuation system. The purpose of insurance is to protect members' incomes and the future of those who matter to them. AustralianSuper believes that there is an opportunity to improve insurance within the superannuation system but strongly believes it is an important safety net for working Australians and helps alleviate pressure on social security. (sub. 43, p. 11)

REST Industry Super submitted:

REST is of the view that flexible and affordable insurance should be a core part of any default superannuation model. It should not be separated. (sub. 49, p. 12)

Mercer noted that:

... insurance cover represents an important part of the Australian superannuation industry. In fact, it has been considered critical by previous Governments and hence is a compulsory part of MySuper products. (sub. 57, p. 6)

ANZ submitted that:

It provides a safety net to those who would have otherwise not chosen, or not been able, to take out life insurance individually. It therefore plays a pivotal role in reducing costs to the Australian Government and providing economic and social benefits to Australians who may not engage or understand the importance of insurance. (sub. 73, p. 17)

Qantas Super said:

Not only does 'insurance in superannuation offer good value for many' members, it also provides insurance cover to superannuants who have risky occupations, or who have pre-existing conditions, who might not ordinarily be able to arrange for insurance cover on an individual basis – sometimes at any price. This is not just nice to have, but is of enormous benefit, and for those who need to claim, it is a life changing benefit for them or their family. (sub. DR137, p. 32)

Rice Warner submitted that:

... insurance in superannuation provides a valuable benefit for working age Australians and their families. If life insurance were not built into the design of a MySuper product, most members would not be covered. The growth of insurance within superannuation over the last 30 years has closed the gap significantly between the insurance needs for a member (and their family) and the amount of cover provided.

Further, life insurance is provided in a way that is efficient, competitive and offers benefits to the Government and economy by way of reduced social security payments and increased spending capacity for members and their families. (sub. 46, p. 2)

Chant West said:

The problem is that default and complexity don't mix! This has been the root cause of the much-publicised problems with insurance in recent years and has generated the impression that insurers, and the funds that provide this cover, are looking for ways to avoid paying claims. The quantum of claims paid and the payout ratios show this is manifestly not the case but it only takes a couple of members whose claims have not been paid due to some subtle terms and conditions that may seem innocuous to call into question the whole value of insurance, including insurance in superannuation. (sub. DR191, p. 24)

Box 8.4 Insurance in super — views from outside the industry

Some participants submitted that insurance benefits could be of great assistance to recipients. For example, MS Australia said:

... it is crucial that TPD and to a lesser extent income protection insurance benefits remain accessible under the current opt out regime. Any reduction in the availability of insurance benefits and in particular automatic acceptance eligibility would have significant consequences for people with chronic illnesses whose working lives may be cut short because of disability, such as MS. (sub. 44, p. 4)

Consumer Action Law Centre, Berrill and Watson Lawyers and the Chronic Illness Alliance submitted that:

Superannuation has delivered life insurance to millions of Australians in an efficient and affordable pathway. It has had its problems over the last five years, problems that are in need of rectification to protect the integrity of the retirement incomes system. ...

It is our strong submission that it would be throwing the baby out with the bathwater to move default superannuation to an opt in insurance model. It would put the retirement incomes of thousands of Australians at risk and add to the burden on the Australian taxpayer. (sub. 55, p. 9)

Slater and Gordon noted that:

Of the many injured or ill Australians that Slater and Gordon support in claiming upon their disability insurance entitlements each year, the majority of claims are made based upon default cover provided through their superannuation membership. This system has been fundamental in addressing the underinsurance issue, and allowing working Australians access to affordable and broader cover than would otherwise be available. (sub. DR178, p. 3)

Individual participants raised differing views about insurance in superannuation. For instance:

... this is the most tax effective way to get this cover. (Munro, sub. 31, p. 2)

... many would opt to take out disability insurance if that was available as a separate product. However, typically death cover is bundled with disability insurance in many main stream superannuation funds with no ability to take only one. (Rogers, sub. 2, p. 1)

... life insurance offered should be on a strictly opt in process and it should be very clear what the payment is before signing up. I do not understand why Life Insurance is a deduction from Super Funds, it should be totally separate. (Clapham, sub. 14, p. 1)

We strongly believe that insurance should be opt-in rather than opt-out. In the case of our daughter, she has intermittent work while completing a doctorate having amassed the sum of about \$600 over 3 years. She was unaware that she could opt-out of the insurance component that, together with fees, have eroded her contributions. (Hemming and Delliou, sub. 38, pp. 1–2)

Similarly, CHOICE raised concerns about complex and diverse policy terms and conditions:

Consumers need greater protection in the bundled life insurance market and this can only be achieved through standardisation of cover. In recent years some funds have attempted to control premium increases by making cover more restrictive. For consumers this is a zero sum game. More restrictive definitions may lead to a reduction in premiums for the membership as a whole, but will make it harder for those needing to make a claim. Meanwhile, the ever growing diversity of policies makes comparison between offers close to impossible for consumers. (sub. 71, p. 11)

Another perspective is that of other financial sector interests, such as financial advisers:

ClearView believes that a system which requires members to consciously opt-in for group insurance in super will result in a substantial improvement in understanding what they are, and aren't, covered for and how much cover they have. This will significantly reduce the number of workers who think they, and their loved ones, are adequately protected when they're not. Importantly it will lead to more workers seeking advice, either via their super fund or a third party, about the type, and level, of cover they need. (ClearView, sub. 48, pp. 5–6)

A broader question is whether insurance represents value for money for members — that is, is the value placed on the level of cover high enough to offset the premiums paid? An evaluation of the value for money of insurance in superannuation is provided in section 8.4.

There is a range of factors that can lead to significant balance erosion for many members.⁹² These can be categorised as factors that either lead to higher premiums or that reduce member contributions (and thus increase the relative impact of insurance premiums on balances at retirement).

On the premium side of the equation:

- some funds have higher than average default premiums (due to higher levels of automatic cover or higher costs per unit of cover)
- some members have multiple accounts with insurance cover, which means that they pay additional premiums
- many funds (about a third) include IP insurance — which can be quite expensive — in their default cover
- members in relatively hazardous occupations may have risk rating factors applied to their premiums to account for higher levels of risk
- members who choose individually underwritten insurance policies may have substantially higher levels of cover, and therefore premiums, than those who are covered by group insurance. Individually underwritten policies also tend to have a higher cost per unit of cover.

On the contributions side:

- members with low incomes are more susceptible to balance erosion (default premiums typically do not vary with income — although a fund may take into account income levels across its membership in setting cover levels)
- balance erosion can be particularly high for members who have periods out of the workforce because during those times there are no contributions to offset insurance premiums.

Balance erosion effects are not insignificant

The Commission has used its cameo model (chapter 1) to analyse the balance erosion implications of insurance under a range of scenarios (table 8.2). The base-case scenario shows that an individual who earns roughly the average annual total earnings over their lifetime could expect insurance premiums to reduce their balance at retirement by 4 per cent,

⁹² There is no widely-accepted definition of inappropriate balance erosion, but the recently released industry code of conduct has set out a benchmark of premiums not exceeding 1 per cent of average salary for the membership generally and/or segments of the membership. The Commission considers this to be a reasonable benchmark.

given the cameo model assumptions. These cameos only consider the impact of insurance premium deductions on account balances at retirement and do not take into account any offsetting benefits to members, such as a successful claim on their insurance, or the peace of mind from insurance, even when no claim is made.

Table 8.2 Balance erosion cameo scenarios^{a,b}

Scenarios	Contributions		Work history	Insurance cover	Premiums			Balance erosion at retirement	
	Starting wage	Average wage ^c			Risk loading	Multiple policies	Average premium	Real value	Share
	\$	\$					\$	\$	%
Average worker	50 000	63 000	Full time	Life and TPD	White collar	No	282	35 000	4.0
IP insurance	50 000	63 000	Full time	Life, TPD and IP	White collar	No	541	60 000	6.9
Low income	36 000	45 000	Full time	Life and TPD	White collar	No	282	35 000	5.6
Interrupted work history	50 000	51 000	Intermittent	Life and TPD	White collar	No	282	35 000	5.6
Multiple accounts	50 000	63 000	Full time	Life and TPD	White collar	Yes	409	55 000	6.4
Low income worker	36 000	45 000	Full time	Life, TPD and IP	Light blue collar	No	771	85 000	13.6
Cumulative impact	36 000	37 000	Intermittent	Life, TPD and IP	Light blue collar	Yes	995	125 000	28.2

^a The assumptions underpinning these cameos are set out in chapter 1. ^b Assumptions that are different from the 'Average worker' scenario are in bold. ^c This excludes the effect of real wage increases (all cameo scenarios assume economy-wide real wage growth of 1.5 per cent annually).

The results of the first three cameo scenarios (summarised below) suggest that insurance-related balance erosion can readily rise to 5 to 7 per cent of balances at retirement.

- *Higher than average premiums* — increasing the average lifetime premium from \$282 to \$541 (representing the inclusion of IP insurance) increases balance erosion from 4 per cent to 6.9 per cent at retirement.
 - There is significant variation in the default insurance premiums included in superannuation products (figure 8.8). (The inclusion of IP insurance is used as an example of a member paying higher-than-average insurance premiums.)
- *Low incomes* — an individual who enters the workforce on a full-time minimum wage (\$36 000) incurs balance erosion of 5.6 per cent at retirement.

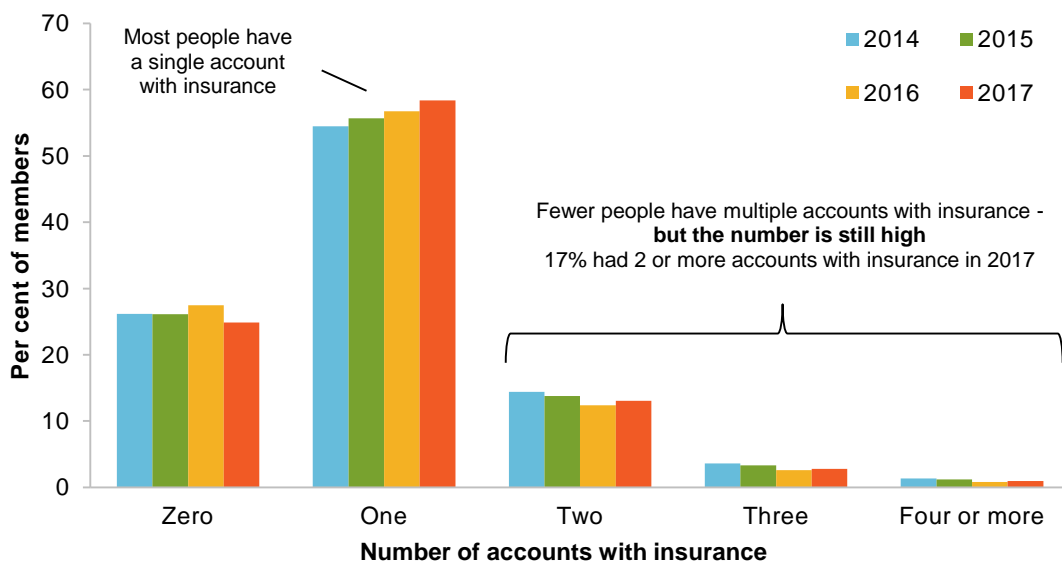
- The higher balance erosion occurs because a low-income member will make fewer contributions over their lifetime, leading to insurance premiums having a proportionally higher impact on retirement savings.
- *Interrupted work history* — a worker with an interrupted work history will experience balance erosion of 5.6 per cent at retirement.
 - This scenario assumes that an individual exits the workforce for five years at age 28 years (for example, on parental leave) and then works part time for five years from age 33 years before returning to full-time work. The worker does not receive any experience-based wage increases while they are out of the workforce.

Multiple accounts exacerbate balance erosion effects

The effects of balance erosion in superannuation accounts are exacerbated when members have multiple accounts with insurance. This erosion is particularly egregious because members may be overinsured, or unable to claim on multiple insurance policies (though this is predominately a problem with multiple IP policies — the least common type of cover).

Holding multiple superannuation accounts with insurance is relatively common. While there has been some improvement since 2014, in 2017 an estimated 17 per cent of members still had two or more accounts with insurance (figure 8.8).

Figure 8.8 Many members have multiple accounts with insurance^a
Number of accounts with insurance, 2014–2017



^a ATO data only include accounts with tax file numbers, and do not distinguish between the type of insurance in different accounts.

Source: PC analysis of ATO confidential data.

Most of the additional accounts that members hold are likely to be inactive (where there have been no contributions in the past 12 months). Rice Warner estimated that 25 per cent of accounts with insurance are inactive, while data from the Commission's funds survey suggest that there are at least 3 million inactive accounts that include insurance cover.

The Commission's analysis suggests that a member holding two accounts deducting insurance premiums between the ages of 22 and 41 years (and one account deducting insurance thereafter), would have a balance at retirement 6.4 per cent lower than if they had no insurance cover (but still had multiple accounts). These results are consistent with Rice Warner's analysis of inactive accounts:⁹³

Our analysis indicated that a large portion of the membership has insurance premiums deducted without any contributions being made. ...

We found a large impact on the retirement balance when insurance premiums continue after contributions cease. This is particularly evident for those at younger ages. For members with a Heavy Manual occupation, at younger ages the account balance is completely eroded; further, there is a significant impact at all ages, though cover reduces near retirement. (sub. 46, p. 15)

Balance erosion can be large and is highly regressive

The cameo scenarios presented here have each varied a single assumption. In reality, there is likely to be some correlation between factors that increase balance erosion (for example, low income workers who are less engaged with their superannuation may be more likely to have multiple accounts deducting insurance premiums).

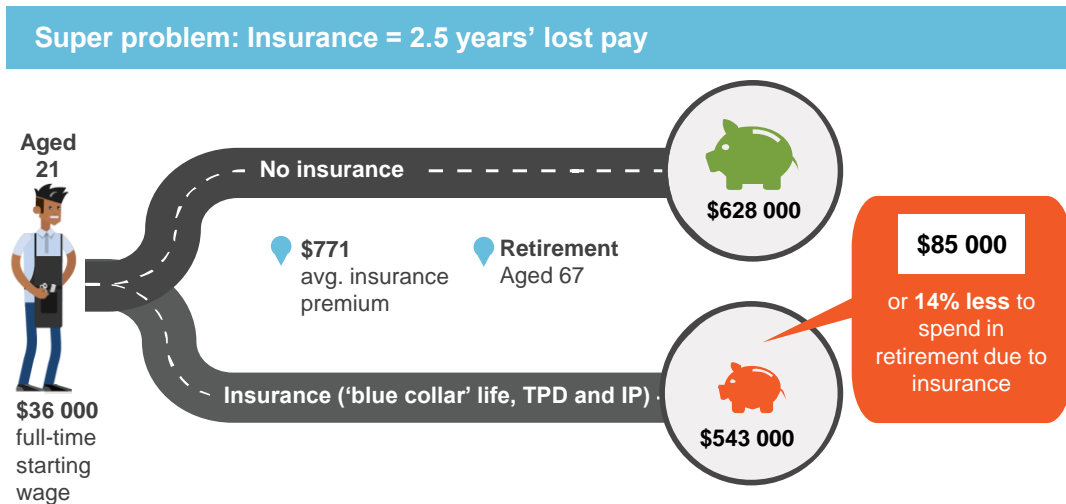
The Commission's final two scenarios are designed to highlight the impact of facing multiple factors that led to increased balance erosion.

- A 'typical' low income worker who attracts a light blue collar loading and is paying for IP insurance. This member's balance at retirement would be 14 per cent (\$85 000) lower at retirement than if they had no insurance (cameo 8.1).
- An 'extreme' low income worker who has an extended period out of the workforce, has multiple accounts deducting premiums, is paying for IP insurance, and faces a light blue collar worker loading. This member's balance at retirement would be 28 per cent (\$125 000) lower at retirement than if they had no insurance (cameo 8.2).

⁹³ KPMG (2017b) estimated that removing insurance from multiple accounts would only have a modest effect on the average level of balance erosion because it assumed that a large share of duplicate accounts were likely to be very small balances (less than \$1000) resulting in multiple insurance policies being limited by exhaustion (or triggering of a fund cessation rule). However, this assumption is implausible. First, ATO data indicate that in 2016-17, about 50 per cent of members with duplicate accounts had less than 90 per cent of their total balance in their main fund. This, coupled with data that show that members with multiple accounts on average have similar total balances to members with a single account (chapter 6), suggests that many multiple accounts have non-trivial balances. Second, the persistence of multiple accounts across all ages (figure 6.5) suggests that duplicate accounts are not being exhausted.

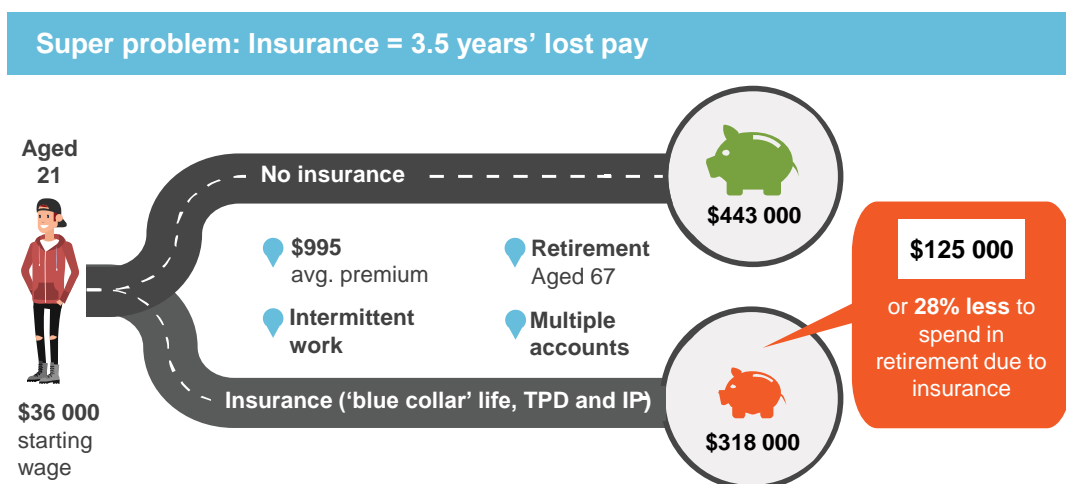
These scenarios demonstrate that the effect of insurance premium payments on members' account balances at retirement is regressive. This result is in line with other research on balance erosion (box 8.5).

Cameo 8.1 Insurance premiums can materially lower the retirement savings of low income workers^a



^a The assumptions underpinning this cameo are set out in chapter 1.

Cameo 8.2 For disadvantaged members, insurance's cumulative impact can be extremely high balance erosion^a



^a The assumptions underpinning this cameo are set out in chapter 1.

Box 8.5 Other work in this area**KPMG**

The ISWG recently commissioned KPMG to examine the effect of insurance on account balance erosion (KPMG 2017b). Overall, KPMG estimated that default insurance premiums would reduce retirement balances by 6.2 per cent. This was based on the projection from a current snapshot of the population (in terms of age, account balances and member contributions), rather than an estimation of the lifetime effect (the report notes the impact on younger members should be considered as more reflective of the likely lifetime effects). The analysis found that the impacts were higher for those with lower incomes (including women, because of their lower average earnings).

Rice Warner

Much industry commentary has focused on a benchmark of premiums being affordable (or in other words, having an acceptable level of balance erosion) if they are equal to about 1 per cent of salary (or approximately 10 per cent of Superannuation Guarantee contributions). Rice Warner analysis found that, insurance premiums were below 1 per cent of salary for the average member when only life and TPD cover were considered. When IP cover was added, premiums remained under the 1 per cent threshold at younger ages but substantially exceed the threshold at older ages (sub. 46, pp. 13–15).

FINDING 8.1

The deduction of insurance premiums can have a material impact on member balances at retirement. This balance erosion is more costly to members with low incomes. It also has a larger impact on members with intermittent attachment to the labour force, and those with multiple superannuation accounts with insurance (the latter comprise about 17 per cent of members).

Balance erosion for low-income members due to insurance could reach a projected 14 per cent of retirement balances in many cases, and in extreme cases (for low-income members with intermittent work patterns and with multiple income protection policies) could be well over a quarter of a member's retirement balance.

8.4 Do members get value for money?

Ultimately, what matters from a member's perspective is whether the insurance cover that they receive is sufficiently valuable to offset the premiums that they pay (and the inevitable superannuation balance erosion they will experience). This section assesses whether insurance in superannuation is providing value for money to members, including identifying any leakages or impediments that, if addressed, could improve the value of the current

arrangements. There are a number of aspects to answering this question, but the analysis draws broadly on the following criteria (and associated indicators)⁹⁴ as set out in stage 1.

Do funds offer value for money insurance products to members? (E11)

Are the costs of insurance being minimised for the level and quality of cover? (E12)

In most markets, the purchase of a product implies that consumers consider it to be value for money. However, this does not apply to insurance in superannuation because members are generally disengaged and are automatically signed up to insurance. Therefore, the Commission's assessment relies on examining a range of indicators:

- through the members lens — their level of awareness of, and engagement in, insurance in superannuation, and their preferences
- through the provider lens — the degree to which funds minimise costs and tailor default insurance products to meet members' needs.

Through the member lens — most do nothing

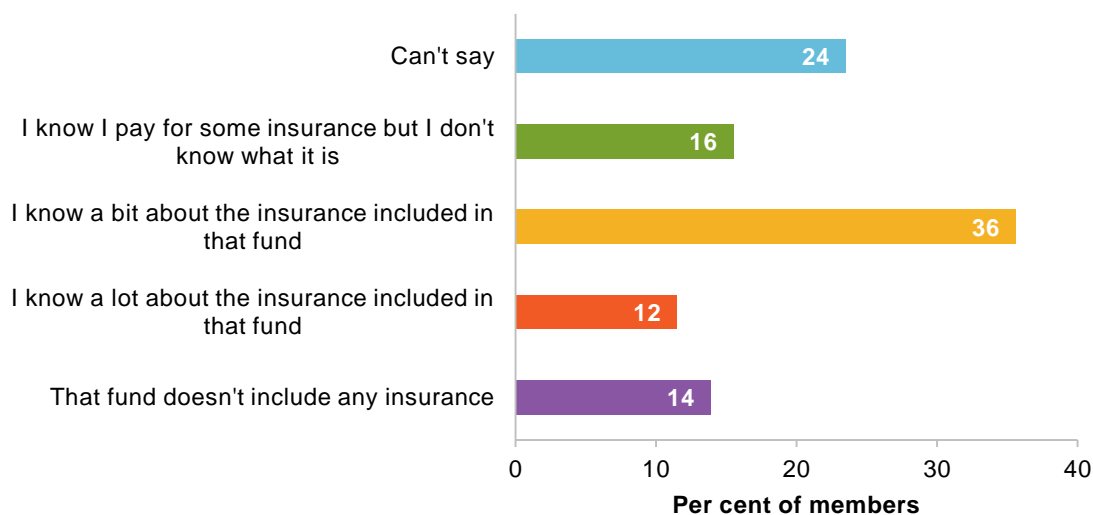
As mentioned above, members are relatively disengaged making it difficult to draw conclusions about their perceptions of the value for money of insurance in superannuation. This was confirmed by results from the Commission's members survey.

- While most members have some awareness of the insurance included in their superannuation, 24 per cent of members did not know if there was insurance in their fund and 16 per cent know they pay for insurance but do not know what it is. Few members (12 per cent) said they knew 'a lot' about their insurance (figure 8.9).
- Very few members amend or opt out of their default insurance cover. About 78 per cent of members have never made changes to their default level of insurance and only 6 per cent opted out in the previous 12 months.
 - The most common reasons given for not opting out of default insurance were satisfaction with the default product (31 per cent), lacking requisite knowledge (35 per cent) and assuming it is appropriate (35 per cent). Relatively few cited time (11 per cent) or difficulty (10 per cent), suggesting that ignorance or apathy are more significant barriers to people amending or cancelling their cover than the processes themselves (though these barriers are considered burdensome to members who do alter their cover — discussed below).

⁹⁴ Some of these indicators are common to other criteria discussed elsewhere in the report. Other indicators related to leakages from unintended multiple default accounts (discussed in chapter 6) are also relevant here.

Figure 8.9 **Many members have little understanding of insurance in superannuation^a**

What do you know about the insurance that is included in your fund?



^a Weighted using Commission weights.

Source: Members survey.

There are several imperfect methods for assessing whether members consider insurance in superannuation to represent value for money. The evidence derived from these methods is mixed.

- The choice experiment included in the members survey (which estimated accumulation members' willingness to pay for different features of superannuation) (appendix C), found that most members did not value insurance particularly highly and were willing to pay more for other features, such as member communications (for example, smart phone apps, online websites) and control over the choice of investments than for insurance in their superannuation. However, the roughly 30 per cent of members with low levels of financial literacy did value insurance relatively highly (this could be because they have relatively low savings, and thus cannot easily self-insure) (tech. supp. 1).
- MySuper accounts make up close to 80 per cent of accounts with insurance, but just over half of superannuation accounts in total, implying that when members are left to choose whether to purchase insurance in the non-default segment, the vast majority choose not to (though this could be partially explained by a lack of understanding of insurance).

Through the provider lens — mixed efforts

Under the SIS Act and Prudential Standard SPS 250, trustees must meet minimum requirements in setting and administering their insurance arrangements, including the

obligation to ensure that insurance does not inappropriately erode members' retirement incomes. Accordingly, they are required to obtain cover on a cost-competitive basis and ensure that it is appropriately tailored to meet the insurance needs of members. This should be reflected in trustees' decisions about the magnitude of cover and its broad design.

Group insurance the basis for lower costs and premiums through superannuation

As previously discussed, group insurance offers substantial cost advantages over individually underwritten cover, resulting in more favourable loss ratios and cover that is better value for money (figure 8.6). Participants provided evidence that this is still likely the case despite recent premium increases.

- Rice Warner gave examples where the price of group insurance cover relative to retail cover ranged between 20 and 60 per cent less (stage 1, sub. DR112, p. 25).
- MetLife submitted that '[i]nsurance in superannuation is generally regarded as being cheaper than insurance obtained outside of superannuation' (sub. 68, p. 4).
- Similarly, AIA Australia said that 'trustees are well placed to obtain cover for members on good terms and at a relatively low cost' (sub. 76, p. 11).

Selecting insurers

Participants have also submitted that the process of selecting insurers — usually conducted via a tender process — is competitive and minimises the costs of insurance to members. For example, MetLife said:

Insurance tenders are rigorous and highly competitive processes that help to minimise the costs of insurance for superannuation trustees. (sub. 68, p. 4)

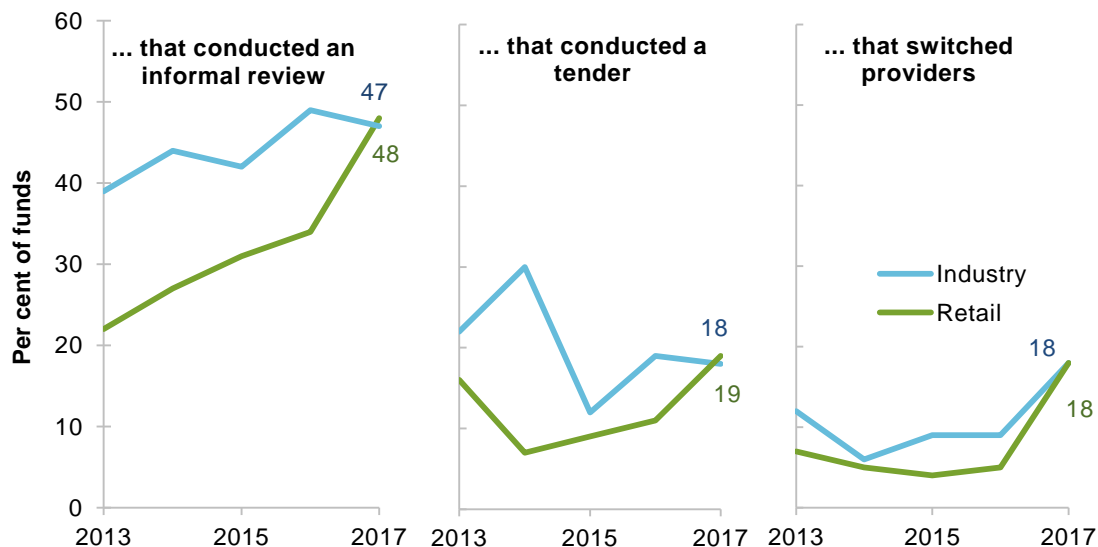
Similarly, AIA Australia submitted that:

... tendering of insurance has fostered competition for superannuation business for group insurers. (sub. 76, p. 11)

Data from the funds survey broadly support this view. It shows that for each year between 2012-13 and 2016-17, about 15 per cent of funds who responded to the question, put out a tender for the provision of the fund's insurance, with this number increasing in recent years (figure 8.10). The survey also indicates that the number of funds switching providers and informally reviewing the selection of an insurance provider each year has been increasing.

Figure 8.10 **Many funds appear to review their insurance arrangements^a**

Data on funds switching insurance providers, 2012-13 to 2016-17



^a 110 funds (including 33 industry and 57 retail) responded to this question in the funds survey, representing 88 per cent of balances and 84 per cent of accounts.

Source: Funds survey.

A potential issue is some funds receive rebate payments or other benefits (such as corporate hospitality) that can raise real (or perceived) conflicts, such as over the choice of insurer or incentives to reduce claim rates. The Australian Securities and Investments Commission (ASIC) recently found that of the trustees it surveyed, about 35 per cent have such arrangements in place, and of those whom it reviewed more closely, about 40 per cent said they had considered the effect of rebates on insurance premiums in selecting an insurer.⁹⁵ ASIC did not find any evidence that these arrangements had any impact on claims success, but nevertheless stated that trustees needed to be transparent about these arrangements and how they operate in members' best interests. It did note that adoption of the industry code of practice provisions on rebates would improve current practices (ASIC 2018f, pp. 15–16).

Another potential issue is where fund trustees engage a related entity as the fund's insurer. While the Commission has not identified this as a major driver in eroding the value of insurance to members (in part due to limitations in available data), the practice does create scope for a conflict of interest, as raised at the FSRC (2018c, p. 4). Trustees are already subject to obligations to act in the best interests of members under the SIS Act, with further obligations to manage conflicts of interest. However, Counsel Assisting the FSRC posed the question of whether this practice should be prohibited or subject to additional requirements

⁹⁵ The survey involved sending notices requesting information relating to the 2015-16 year to 47 trustees across retail, industry and corporate funds. Based on potential issues identified in the survey 18 of the original 47 trustees were requested to provide more detailed information and supporting documents on their insurance arrangements (ASIC 2018f, p. 5).

to demonstrate that it is in the best interests of members. The Commission's insurance recommendations to bolster the code and for funds to better articulate their balance erosion trade-off assessment go some way to addressing these concerns. Further, the Commission has also made some recommendations to improve fund and system governance generally (chapters 9 and 10) that would assist in addressing this practice, although further changes in enforcement practices or new regulation may prove warranted, pending the final outcomes of the FSRC.

What are the main value-reducing drivers?

Under current arrangements, there are some key drivers that reduce the value of insurance to members.

Duplicate insurance policies and policies on inactive accounts are often poor value

As discussed in section 8.3, paying for multiple insurance policies, or continuing to pay for cover while not working, exacerbates balance erosion. Further, these policies are more likely to be poor value for members, either because there is a lower likelihood that they will claim on the policies, or because they are unable to claim on them.

One reason for inactive members being less likely to make a claim is that the eligibility criteria can be dependent on the employment status of members. While these criteria vary across funds' policies, different tests are commonly applied depending on the work status of the member. For instance, to qualify for a TPD claim:

- a member who is working, or has been working within a previous prescribed period (such as 6 or 12 months), may be subject to a work test and required to demonstrate that they are unable to work — this may be specified as either in their own occupation (or an occupation for which they are suited), or any occupation
- in contrast, a member who has not been working within a previous prescribed period may be assessed against an 'activities of daily living' (or similar) test whereby they are required to demonstrate that they are unable to independently undertake a number of specified activities, such as bathing, eating and dressing.

While the latter eligibility criteria are arguably more restrictive, premiums are typically the same irrespective of work status. As such, TPD insurance will often be poorer value where a member ceases work.

Poor-value TPD insurance was highlighted by the FSRC in its examination of REST's previous insurance arrangements (which were modified as of December 2017). In some cases, members who had become totally and permanently disabled had their claims denied on the basis of an exclusion — their account balances were under a minimum threshold and they had ceased work — but insurance premiums had continued to be deducted from their account (FSRC 2018d, pp. 6485–9).

IP insurance is a particular problem in the context of duplicate or inactive accounts, as it is relatively expensive and appears to be the main culprit for members being unable to claim against a policy. This can occur because the member either:

- has multiple policies, but payments from one policy reduces their eligibility to claim against another, as total payments cannot exceed a given proportion of their pre-existing income
- is not working and thus does not have an income to offset.

Duplicate IP policies likely comprise a relatively small share of cases of members holding duplicate policies and some participants have suggested that very few claims are denied on this basis (TAL, sub. DR193, p. 9). Nevertheless, it is an egregious failure of the system where it does occur and it is critical to the integrity of the system that such policies are eliminated.

It can be difficult for funds to determine if insurance in an inactive account is unwanted, or if a member has other accounts with insurance. In the members survey, about 18 per cent of members with multiple superannuation accounts said that they kept multiple accounts because they either liked additional insurance, or one fund had a preferable insurance offering, but was lacking on other features.

On a related issue, as raised by participants (Australian Lawyers Alliance, sub. DR128, pp. 6–7; Berrill and Watson Lawyers, sub. DR176, pp. 6–7), there are some aspects of the taxation of superannuation benefits, including lump-sum insurance payments that could dissuade some people from consolidating multiple superannuation accounts due to increased tax liabilities in some cases (this is discussed further in chapter 6).

While it is difficult to determine the overall impact of ‘zombie’ policies on the erosion of members’ balances, it is clear that for some members, the effects are material (section 8.3). Accordingly, such erosion cannot be considered to meet trustees’ obligations to ensure that insurance does not inappropriately erode member balances.

Inappropriate cross-subsidisation still exists

Cross-subsidisation is an essential feature of group insurance. A key reason that group insurance is relatively cheap is that risk factors that are costly to collect information on can be averaged across the population without the risk of adverse selection occurring.

The question then is one of appropriate versus inappropriate cross subsidisation. Age is an example where premiums should differ to reflect clearly observable differences in risk between members of the pool. Many default group insurance policies already have age adjusted premiums, but these do not always fully reflect age-adjusted risks (this can be observed in the variation of premiums structures between funds and from the vociferous industry responses to the Australian Government’s policy to change insurance for members under 25 years of age to an opt-in basis (SELC 2018b, pp. 31–5)).

Flatter, less age-adjusted premiums might make little long-term difference to members when they join one fund at an early age and remain in that fund throughout their working lives, but it is not appropriate in an environment where members make more active and informed choices about their superannuation. (It is also not appropriate when members acquire multiple accounts, though policy changes to ensure members only default once should reduce this effect.) Accordingly, insurance should be value for money to members at a point in time and not rely on long-term membership to even out the swings and roundabouts.

Adjusting premiums by other risk-rating factors, particularly occupation (for instance, white or blue collar) or smoking status is also likely to be appropriate, but only where these characteristics can be identified consistently and reliably. However, this does not always occur, as ASIC recently noted in the context of default transfer arrangements:

When members are transferred from an employer plan to a personal plan within the same superannuation fund, some trustees automatically classify members as smokers or blue-collar workers unless specific information to the contrary is received from the member. If the member is not a smoker or blue-collar worker, these default transfer settings can unfairly increase insurance premiums and therefore significantly affect the size of the member's superannuation benefit. (ASIC 2018f, p. 17)

Such actions can lead to egregiously-inferior outcomes for incorrectly allocated individuals, given that the price differentials according to risk ratings can be substantial. ASIC (2018f, p. 17) has stated that trustees need to stop this practice and indicated that going forward it will seek confirmation from trustees that appropriate changes are implemented. ASIC should ensure that the appropriate action — including formal enforcement action where necessary — is taken if it subsequently finds that these practices persist (chapter 10 contains further discussion on ASIC's enforcement practices, including the need for improvement in strategic conduct regulation).

There is also likely to be cross-subsidisation from inappropriate cover, 'zombie' policies that members cannot use (for example, exclusions due to duplicate IP policies), or where they are subject to more onerous eligibility criteria. Anecdotally, claim rates are lower on inactive policies, which is consistent with the higher eligibility bar imposed on those members who are not working (and who account for many of the inactive policies).

Another broader cross-subsidisation issue is where benefits from paying for insurance (either from insurer rebates or tax deductions on premiums paid) are not directly and proportionally used for the benefit of the members who paid those insurance premiums, but used for wider purposes within the fund through allocation to fund reserves, including to pay for general administration costs.

- The FSRC (2018b, pp. 70–81) explored a case study where tax refunds collected on premiums paid were used to pay a related entity for administrative services. While a key feature of this particular case is that the link between the payment for, and provision of, the services was not transparent and indicated an issue with the use of related parties, another aspect is that the beneficiaries of any services are not restricted to those members who paid the premiums in the first place.

-
- Sunsuper (sub. DR197, pp. 6–8) also raised the issue that where funds do not pass on the benefits of tax deductions for expenses (including insurance premiums) directly to members, they can use this to promote artificially lower administration costs or subsequently boost returns through distributions back from fund reserves, and that this approach is neither transparent or equitable for members.

Such opaque use of member benefits is reflective of both inadequate disclosure and possible failures of fund trustees to act in some members' best interests. The Government's proposed outcomes test would go some way to addressing this issue, including through better disclosure of the use of fund reserves. Other enhancements to fund governance arrangements, including better definitions of what it means to act in members' best interests (discussed in chapter 9) may also improve outcomes for members with insurance. The code of practice could also provide additional transparency of insurance arrangements.

An appropriate level of tailoring by cohorts is still needed

The nature of group insurance places some inherent restrictions on product design — it is not possible to tailor products to each individual's needs. For instance, the risk of excessive erosion for lower-income members means that automatic levels of cover are unlikely to meet the preferences of higher-income members.

That said, poor tailoring of insurance can result in insurance that is of low value or causes excessive balance erosion for some cohorts of members. Funds need to use the information that they collect from members to develop insurance cover that limits these undesirable outcomes and best meets member needs.

Most funds do use some member information when setting their insurance cover. For example, AustralianSuper submitted that it:

... analyses its membership by age, gender, occupation and salary level.

Default insurance cover levels are set based on analysis, across these dimensions, of insurance needs, member preferences and affordability. ...

We conduct member research and broader community research into preferences for insurance, particularly relative to retirement savings. These vary by age, gender, income and occupation. (sub. 43, pp. 12–13)

Similarly, REST submitted that:

Our insurance design and policy definitions are developed to maximise the number of REST members receiving insurance cover that is appropriate to their life stage. Benefits are relatively low for young members with default cover increasing with age when financial commitments are usually higher and there is a greater dependency on income (and a greater capacity to afford). REST has attempted to minimise cross subsidies between different age groups and this should be a focus for the system. (sub. 49, pp. 12–13)

Indeed, there are some recent examples of funds significantly altering their cover to better meet needs of members (box 8.6).

Box 8.6 Examples of funds tailoring their insurance

Dealing with younger members

AustralianSuper announced that from November 2018, it will change its default life and TPD insurance to opt in for members aged under 25, noting that only about 10 per cent of its claims for these members have been paid to financially dependent partners and children. This change will align its default life and TPD cover with its existing settings for default IP cover. Members aged under 25 years will be able to opt in to insurance if they wish.

The relatively low prices of premiums for younger members mean that the projected reduction in premiums paid (at current prices) for a member joining at age 15 years are \$637, although AustralianSuper estimated this could increase balances at retirement by nearly \$9000.

HESTA also announced that from March 2018, its default insurance premiums (for life and IP cover) will vary by age. Prior to this, default members were charged a flat premium for insurance regardless of age, and life cover levels were constant until the age of 39 years, before decreasing as members got older.

Benefit design and affordability

Good benefit design can make insurance cheaper by helping claimants to return to work. For example, Sunsuper's TPD product 'TPD Assist' typically provides claim payments in up to six annual payments (rather than a lump sum) depending on whether claimants are assessed as being able to return to work. The product also limits waiting periods and provides support for rehabilitation to assist members to re-enter the workforce.

The product was changed from a one-off payment structure because many TPD claimants do not permanently leave the workforce. Sunsuper's survey found that 36 per cent of claimants had returned to work or were actively seeking employment. The product changes also reduced TPD premiums by about 30 per cent.

In a different vein, AustralianSuper has also introduced a 'Super Only' product that does not include any insurance. It is aimed at people with disabilities, working under the Supported Employment Services Award, and short term or intermittent employees working for less than six months.

Sources: AustralianSuper (2017a, 2017b); HESTA (2017); Sunsuper (2016).

However, not all funds use the member data that they collect. The Commission's funds survey found that about 9 per cent of responding funds that offer MySuper products indicated that they do not use information collected on the age or profession of members when determining their insurance arrangements.⁹⁶

⁹⁶ There were 68 funds (33 industry and 19 retail) that offer MySuper products and responded to this question in the funds survey, representing 76 per cent of balances and 74 per cent of accounts.

Furthermore, there is scope for the majority of funds to make further improvements to benefit design without the need for more (costly) data collection. It is apparent that some funds have successfully used broader research and data (such as census data) to cost-effectively impute the characteristics and preferences of the fund's membership.

Complex and incomparable policies impede member decision making

Complexity and lack of standardisation in insurance product offerings also impedes member engagement and decisions to retain, amend or cancel their cover, reducing the overall value of insurance to members. Issues include differences in the way products are bundled and priced, and differences in the terms and conditions to qualify for payment of a claim.

Variable eligibility definitions and exclusions are particular problems that make it difficult for members to understand what their insurance covers, which could also lead to a failure to claim entitlements. As ASIC recently found:

There is a high level of variation in the TPD definitions used in the insurance products offered through superannuation funds. The variations were based on a member's employment status, including whether the member was full time or part time, permanent or casual, unemployed or engaged in home duties. Variations were also based on the age of the member (e.g. whether they were older than 65). Although a high level of variation in TPD definitions used in insurance products is not prohibited by law, it poses significant challenges for members in understanding and comparing insurance cover. (ASIC 2018f, p. 14)

The problem of complex and variable terms and conditions of policies is compounded in cases where fund disclosure of insurance policies is incorrect. ASIC (2018f, p. 14) also found that '[t]here were some inconsistencies between the statements made by trustees about insurance cover in their disclosure documents and other materials, and the actual insurance policies'. As noted earlier, this problem has also been identified at the FSRC (2018d, pp. 6485–9), notably because the nature of the exclusions was not adequately explained in statements provided to members.

Bundling is another issue that can reduce the value of policies to some purchasers. For example, as one participant (Rogers, sub. 2, p. 1) submitted, the bundling of life and TPD insurance can disadvantage people without dependants who would value TPD cover, but not life cover. The bundling of life and TPD reflects both that the policies can be linked (for instance, a successful TPD claim may affect a subsequent payout in the event of death) and that funds are required to offer both types of cover in MySuper products.

A number of superannuation funds have submitted that while products are bundled by default — indeed, MySuper products are required to offer both life and TPD cover — there is scope for members to elect to amend their cover to only hold life or TPD insurance (for example, QSuper, sub. DR168; Sunsuper, sub. DR197). While the decision to offer the choice of unbundled cover is ultimately subject to commercial considerations, the Commission notes that such a choice would be of likely benefit to many members, although poor member engagement is likely to limit take up. More broadly, as noted by CHOICE (sub. 71, pp. 8–9), the bundling of insurance into superannuation compounds the difficulty in comparing

superannuation products more generally, as it adds another dimension to the task of comparing superannuation products. To this end, CHOICE submitted that:

A solution would be to create a single standard policy definition which applies across all default products. This would allow funds to compete on premium, benefit and customer service levels, while giving consumers certainty on policy cover. (sub. 71, p. 11)

This complexity and lack of product comparability could act as a constraint to product switching by members. Switching may also be constrained where a preferred insurance product in an existing fund dissuades a member from rolling over their balance to another fund that offers other advantages, such as better returns.

Some members find it difficult to interact with funds on insurance matters

The members survey indicated that some members making changes to their insurance experience difficulty, mostly in relation to opting out. While most of these members (almost 80 per cent) find amending insurance cover or taking out new insurance cover to be at least somewhat easy (figure 8.11), nearly half do not find it easy to opt out of insurance cover. (While claiming insurance is also challenging for many members, the Commission did not receive sufficient responses to assess the level of difficulty.) In (concerning) contrast, of those categories, funds responding to the funds survey indicated that their members were *most* satisfied with the process for opting out of insurance.

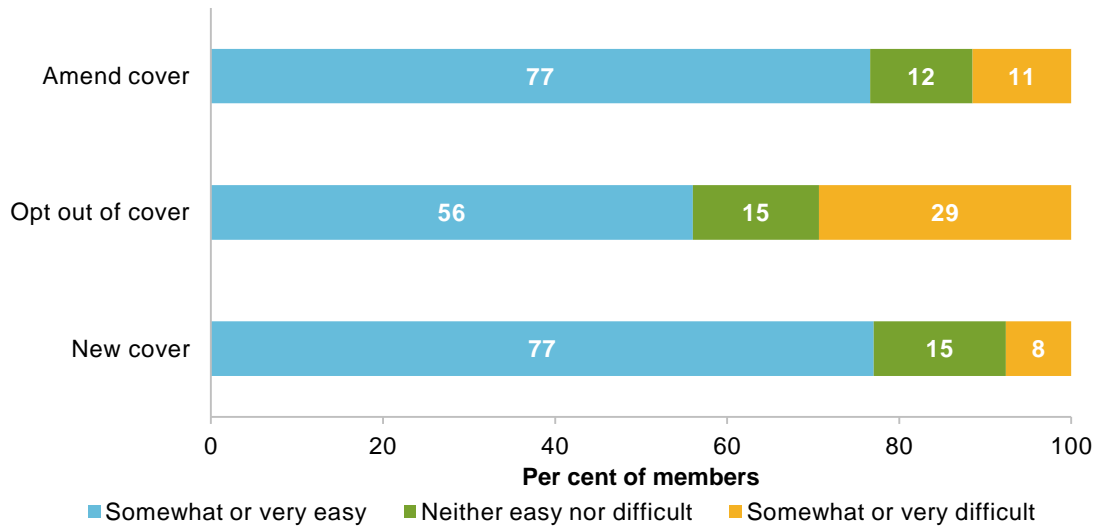
Difficulty in interacting with funds is also reflected in the substantial proportion of disputes about superannuation that are related to insurance, including the process of making claims. Similarly, findings by ASIC show that claims and complaint handling can be a particular area of vulnerability for members:

Claims and complaints handling processes can be difficult for members to navigate. Lodging a claim involves an awareness of the insurance cover available in superannuation, and the process itself can be time consuming and complex, particularly if someone is suffering from a medical condition. (ASIC 2017e, p. 20)

More recently, ASIC (2018f) has found that some trustees have been reviewing and revising their claim handling processes, potentially in response to factors, such as ASIC's earlier findings, recent adverse publicity and in anticipation of implementation of the industry code of practice.

Figure 8.11 **A substantial share of members do not find it easy to opt out of insurance**

How easy is it to make changes to insurance?



^a Weighted using Commission weights. ^b Responses are from members who have attempted to take one of these actions in the 12 months prior to the survey, where 'can't say' responses are excluded. ^c Responses on the difficulty of claiming insurance have been omitted due to a sample size below 30.

Source: Members survey.

So, is insurance value for money for members?

For some members, default insurance cover is undeniably good value. At an aggregate level, payout rates (loss ratios) are relatively high compared with life insurance provided through other channels. Further it can provide access to insurance for some people who might not be able to get individually underwritten insurance.

However, for other members, the blunt one-size-fits-all approach of group cover means that insurance is poor value and does not meet their needs and preferences, but because they are uninformed and disengaged they do not elect to opt out. While insurance needs vary across the spectrum, groups such as (typically young) workers with no dependants (in the case of life insurance) and low-income earners (in the case of income protection) are key cohorts where default cover can be poor value. Better tailoring of insurance to different member cohorts would improve the overall value for money of insurance to these members.

There are other systemic factors that further erode the overall value for money of the current insurance in superannuation arrangements, namely the problems associated with policies on multiple or inactive accounts, excessive complexity and lack of comparability, and, in some cases, deficient processes that can lead to poor outcomes for individual members, particularly in relation to claims handling.

FINDING 8.2

In terms of premiums paid, default insurance in superannuation offers good value for many, but not for all, members. For some members, insurance in superannuation is of little or no value — either because it is ill-suited to their needs or because they are not able to claim against the policy. Income protection insurance and unintended multiple insurance policies are the main culprits for policies of low or no value to members.

Younger members and those with intermittent labour force attachment — groups which commonly have lower incomes — are more likely to have policies of low or no value to them.

8.5 Recent initiatives fall short of what is needed

Both industry and government have undertaken recent initiatives that could improve the value for money of insurance to members, although there remains a need for further work to improve outcomes for members.

More work needed on the Insurance in Superannuation Voluntary Code of Practice

The recently developed voluntary industry code of practice is an initial step, but falls short of what is needed to effectively address deficiencies in the current arrangements for insurance in superannuation.

Initial development of the code

The Insurance in Superannuation Working Group (ISWG) was an industry group formed to develop an industry code of practice in response to concerns — from government, regulators, consumer groups and members — about the operation of insurance within superannuation. Following the introduction of the Financial Services Council Life Insurance Code of Practice, the Minister for Revenue and Financial Services called for further work on insurance in superannuation:

... the Government expects that the FSC and industry will continue to work towards expanding the coverage and scope of the Code to more fully cover group insurance arrangements within superannuation, and will take the necessary steps to ensure that the Code is enforceable across the whole industry, by gaining ASIC approval of the Code. (O'Dwyer 2016)

The first iteration of the code was released on 18 December 2017. Signatories to the code were to notify their intention to adopt the code on their website by 31 March 2018, with the code commencing from 1 July 2018. However, funds can undertake a staged adoption of the code, including the publication of a transition plan (to allow for the adjustment of existing

contractual arrangements) by 31 December 2018, with full adoption of the code to occur by 30 June 2021.

The total number of funds that have signalled their intent to adopt the code is reasonably high, covering most superannuation fund members. The Australian Institute of Superannuation Trustees (AIST, sub. DR130, p. 46) indicated that 41 of its member funds have stated their intent to adopt the code and estimates that 92 per cent of MySuper members will be covered by the code. The Association of Superannuation Funds of Australia (ASFA 2018b) published a similar (partially overlapping) list of its members, with the combined lists containing over 50 funds.

The code is owned by AIST, ASFA and the Financial Services Council. The code owners have undertaken to consult with stakeholders on an ongoing basis and commission formal independent reviews of the code no later than every three years. The code owners have established a transition committee to facilitate implementation of the code through the provision of guidance on matters such as compliance and interpretation of code provisions.

The code is voluntary and is intended to operate on an ‘if not, why not’ basis. The key elements of the code cover setting premiums in relation to income and approaches to cessation of insurance cover on inactive accounts. The code also contains provisions on areas such as information provision, claims handling and complaints (box 8.7).

Signatories are to publish an annual code compliance report that documents where the fund has failed to comply with the code, and where the fund has determined complying is not in the best interests of members.⁹⁷ The code also states that funds should remedy any instances where failure to comply with the code results in direct detriment to members.

What effects might the code provisions have?

While the development of clearer and more consistent member communications and the codification of processes (such as claims handling and complaints) should be beneficial, premium caps and cessation rules are likely to have the most impact for members.

⁹⁷ The code transition committee is developing a standard report template for fund trustees to use (sub. 99).

Box 8.7 Key features of the code

Premium limits

To address balance erosion, premiums are to be capped at an estimated 1 per cent of average salary for the membership generally and/or segments of the membership. Membership segments including younger members, members with low or infrequent contributions, and members nearing retirement are to be given particular attention. The code states that premiums and levels of cover are expected to be lower for younger members. If premiums exceed 1 per cent of salary, either for particular segments or the membership generally, funds are to publish the rationales for this.

Cessation of cover on accounts where contributions have ceased

To address balance erosion on inactive accounts and reduce the prevalence of 'zombie' policies, the code calls for the IP cover of 'automatic insurance members' to be cancelled 13 months from receipt of the last contribution. In the case of life and TPD cover, these will only be cancelled after 13 months if the member's account balance is below \$6000. Members with accounts that are not receiving contributions will be sent a number of communications prior to the 13 month mark inviting them to consent to cancellation of cover, or to elect to maintain it.

Other elements of the code

Other provisions in the code address various issues that reduce the value for money of insurance, such as low member awareness and the complexity and incomparability of insurance products.

- *Codification of the information provided to members.* Funds will provide a standardised 'key facts sheet' and a range of insurance specific information in a welcome pack to new members, along with an annual statement that provides information on the insurance cover (including the current premium). The code also includes standardised headings for TPD cover — funds to describe in plain language if their definitions have more requirements than the code, and if TPD definitions differ from the standard definition in the SIS Act for the release of superannuation benefits.
- *Codification of claims handling.* The code sets out the processes and timelines for: handling claims and how the fund will communicate with claimants; reviewing insurers' decisions; and lodging a complaint where claimants are dissatisfied with a decision.
- *Refund obligations.* Funds are to provide premium refunds (up to a maximum of six years) in cases where a member is unable to claim on a policy because the benefit is offset by a claim on another similar policy, or in cases where the member was never eligible to make a claim.
- *Premium adjustments.* The code requires all premium adjustments to be paid into the fund's reserve and used only for future premium adjustments or insurance administration.
- *Complaints.* The code sets out the processes and timelines the fund will follow in its internal complaints handling process and the options available for members to take their complaint to external dispute resolution.

Premium caps could reduce balance erosion, but have limitations

The premium cap could materially reduce the cost of insurance for many members and reduce the erosion of member account balances at retirement. The risk that balance erosion effects could still be highly variable between members based on their individual incomes

(because the caps are applied as an average across the fund or segment) is intended to be mitigated by an expectation in the code that various cohorts will be catered for differentially. As shown in box 8.5, funds that have acted in anticipation of the code have made design changes that accommodate specific cohorts, including younger members.

Implementing premium caps will likely result in reduced levels of cover for members and change the mix of insurance provided to members. For example, cutting relatively expensive IP insurance seems a likely strategy to meet the salary thresholds. Another potential approach by trustees to meeting cap rules might be to select cover with more restrictive conditions and exclusions. To prevent ‘junk’ insurance emerging, it is essential that the foreshadowed work on standard definitions be initiated immediately. Regulators — primarily ASIC — should provide guidance to industry in consultation with consumer representatives and insurance experts.

The premium cap proposals faced considerable opposition from some funds, either because more expensive cover is considered to be in the best interests of their members or the requirements are too burdensome to implement. In some cases, such as where members have particularly hazardous occupations, higher insurance expenditure may be appropriate, but a key risk is that caps will routinely be breached without sufficiently rigorous justifications.

Cessation rules are too narrowly targeted

Cessation of insurance on accounts where members are no longer making contributions should be an effective way to address two of the key problems with insurance in superannuation — excessive balance erosion and inappropriate ‘zombie’ insurance policies.

However, the code is very narrowly targeted. While it is likely to have an impact on IP insurance, it will have more limited effects on life and TPD insurance — the forms of insurance that are much more common because they are mandated in MySuper offerings — because deductions will still be permitted until account balances fall below \$6000.

A further shortcoming of the code’s cessation rules is that they do not apply to members who have purchased individual cover, or to members who have made any sort of amendment to their automatically allocated insurance. Low levels of member engagement (which exist even for choice products) suggest that many of these members do not remain sufficiently engaged to monitor and adjust their insurance cover over time, and so should be covered by the cessation arrangements. Accordingly, there is a case for cessation rules on inactive accounts to be a legislative requirement across the superannuation system.

Overall, the likely effectiveness of the code is uncertain

The code is a step in the right direction. It contains initiatives that go beyond current regulatory requirements that, if done well, would improve member outcomes. But it falls well short of what is considered best practice for an industry code of conduct. Under the

ASIC requirements for code approval set out in Regulatory Guide 183,⁹⁸ to be considered for approval by ASIC, a code needs to satisfy a range of criteria, including some key threshold criteria:

1. the rules contained in the code must be binding on (and enforceable against) subscribers through contractual arrangements;
2. the code must be developed and reviewed in a transparent manner, which involves consulting with relevant stakeholders including consumer representatives; and
3. the code must have effective administration and compliance mechanisms. (ASIC 2013d, p. 8)

While the current code clearly does not meet these standards, it was substantially diluted from the draft publicly released in September 2017 (which *was* intended to be binding and enforceable on participants). The draft also had more restrictive provisions and less scope for funds to justify noncompliance.

The deficiencies of the code resulted in widespread criticism, including from consumer advocates such as CHOICE, and calls for the code to go further. For example, the APRA Deputy Chair said:

... there is more to do, both to strengthen the enforceability and oversight of the Code and also to tackle some of the areas that the current Code has not fully addressed. These include looking at opportunities to clarify and standardise definitions for disability insurance, and dealing more fully with multiple accounts and unnecessary multiple insurance cover. (Rowell 2018, p. 6)

Many are now sceptical of its prospects for delivering material improvements to member outcomes. As such, further work is needed to bolster code provisions and implement appropriate administration and compliance mechanisms to make the code binding on participants. ASIC should be involved in these processes and issue guidance to industry on the steps required to bolster provisions and develop an enforceable code.

Government has announced recent insurance initiatives

In May, as part of the 2018-19 Budget, the Australian Government announced a number of proposed changes to insurance in superannuation arrangements, subsequently introduced in the Treasury Laws Amendment (Protecting Your Superannuation Savings Package) Bill 2018. These measures include changes to make insurance opt-in only for some key cohorts of members with:

- newly opened accounts and under 25 years of age
- accounts that have balances of less than \$6000
- accounts that have not received a contribution in 13 months.

⁹⁸ ASIC can approve codes of conduct in the financial sector under s. 1101A of the *Corporations Act 2001* (Cth). It is not mandatory for a code to be approved, but approval can provide a signal to give consumers confidence in the code.

The Australian Government has subsequently indicated that it will seek to amend the bill to provide some exemptions from the changes for young and low-balance members working in ‘dangerous occupations’, on the grounds that these members may face barriers in accessing insurance elsewhere (Robert 2018a).

The measures are intended to take effect from 1 July 2019.

These measures closely align with what the Commission recommended in its draft report, where the Commission made draft recommendations to make insurance opt-in only for members under 25 years of age and cease on accounts inactive for 13 months except where the member explicitly chooses to retain the cover.

The Commission did not make a draft recommendation on the change to opt-in insurance for low balance accounts, noting that there is a high degree of overlap between members under 25 years of age and those with balances under \$6000. Low balance accounts are also likely to account for a disproportionately large share of inactive accounts (which account for approximately a quarter of all superannuation accounts with insurance). Nonetheless, there are two broad remaining groups of members captured by the Government’s proposal.

- New workforce entrants (or those opening a new account who do not have an existing account with insurance) over 25 years of age who may experience a relatively short period without insurance before they reach the \$6000 threshold where insurance is automatically instated.
- Members over 25 years of age with very low superannuation balances due to low, but persistent, levels of workforce attachment. This could include those who have multiple active accounts as a result of working in multiple part-time jobs.⁹⁹

For the former group, there may be unintended and possibly perverse effects for some members, although these are likely to be small given the transitory nature of the opt-in arrangement. In the case of the latter group, their low workforce attachment and incomes suggest that even low levels of default cover may represent overinsurance and inappropriate balance erosion for many of these members.

Accordingly, there is a case for low balance accounts to be captured under an opt-in system, particularly in the absence of broader measures to ensure that people default only once and do not amass multiple unintended accounts with insurance.

⁹⁹ This could also affect people who maintain an additional low-balance account for insurance purposes (in the members survey, about 18 per cent of people with multiple superannuation accounts indicated that insurance was the reason they had not consolidated their accounts). Members in this position could also be affected by the criterion to cancel insurance on inactive accounts, but if the decision to maintain the account for insurance purposes is intentional they are more likely to make the election to retain their cover.

What impact might these changes have?

These initiatives can be expected to have considerable impacts on the landscape for insurance in superannuation. In the first instance, a substantial proportion of member accounts that currently have opt-out default insurance cover will be removed from the default pool. In announcing the changes, it was posited that:

... around 5 million individuals will have the opportunity to save an estimated \$3 billion in insurance premiums by choosing to opt-in to this cover, rather than paying for it by default. (O'Dwyer 2018a)

This suggests that about one third of insurance premiums and 40 per cent of members will be affected by the changes.

Others have also estimated effects of these measures.

- KPMG's (2018) estimates suggest that the changes will have large impacts on the group insurance market in superannuation. It estimated that the changes could reduce the total amount of group cover by 50 per cent overall (and the total premiums collected by 42 per cent). It also estimated the effects for each of the three components, illustrating that many affected accounts would be captured by more than one of the criteria.¹⁰⁰
- AustralianSuper (trans. pp. 141–2) told the Commission that it expects the Australian Government's changes will remove insurance for an additional 30 per cent of its members, accounting for some 18 per cent of premiums.¹⁰¹ AustralianSuper has already shifted to opt-in insurance for members under 25 years of age — affecting approximately 4.5 per cent of their members but only 1 per cent of total premiums.

The changes will clearly remove a significant share of the group insurance pool in superannuation, and indeed this is intended, but another expected effect is that the removal of insurance from these members' accounts will result in premium increases for the remaining members with default group insurance cover.

Estimates of likely premium increases vary. KPMG (2018) contended that premiums for remaining members could rise by 26 per cent. Rice Warner (2018e, p. 5) pointed to a smaller expected increase in premiums of about 5 to 10 per cent, but notes that this would likely vary dramatically across funds, depending on their existing fund demographics and arrangements, and the approaches they put in place to deal with the changes. The Australian Government Actuary (2018) has also estimated that premiums would rise as a result of the changes. For members over 25, it estimated increases in the order of 10 per cent, but it also noted that this

¹⁰⁰ KPMG estimated that the reduction in total group cover from each of the criteria on a stand-alone basis was 46 per cent from inactive accounts, 45 per cent from accounts with balances under \$6000 and 18 per cent from removal of cover for members under 25 years of age.

¹⁰¹ AustralianSuper already has measures that target some of these cohorts, so the effects on this fund from the initiatives may be of lower magnitude than for funds that do not already remove insurance from portions of these groups. It recently changed to opt-in insurance for members under 25 years of age and already cancels life and TPD insurance on inactive accounts with balances under \$10 000.

could be significantly higher for some groups, such as members under 25 who opt into insurance cover, reflecting the higher risk of those who choose to opt in (depending on how insurers choose to pool these members).

While the likely extent of premium rises is uncertain, there are a few points to note.

- Some modest premium increases would be expected as fixed administrative costs are spread over a smaller pool.
- The removal of often inappropriate cross-subsidisation from zombie policies, inactive policies with more onerous eligibility criteria and where age-based risk is not fully reflected in premiums will result in premium increases for some members, but only to better reflect these members' risk factors.
- Overall, the total insurance premiums collected across the superannuation system will fall, resulting in lower average total premiums paid per member and boosting members' balances at retirement. This will particularly benefit members with multiple accounts that have premiums deducted for insurance cover.

Other measures could also partially address problems with insurance

There are other initiatives in train that could improve insurance outcomes for superannuation members.

Making opting out of insurance easier

In July 2017, the Minister for Revenue and Financial Services announced, as part of a broader suite of proposed reforms, that APRA would undertake actions to make it easier for members to opt out of superannuation-based insurance. APRA has subsequently indicated that it 'proposes to amend *Prudential Standard SPS 250 Insurance in Superannuation (SPS 250)* to require an RSE licensee to provide simple and straightforward opt-out processes for all insurance products' (APRA 2017g, p. 24). These changes are yet to be finalised.

Design and distribution obligations and product intervention powers

The Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 proposes additional disclosure obligations on financial products and powers for ASIC to proactively intervene in relation to financial products by making orders prohibiting specified forms of conduct. These arrangements are yet to be implemented, so their impact on conduct in the superannuation industry is not clear, particularly given that conduct is already regulated under the SIS Act. It is likely that the intervention powers would only be used in extreme cases where a product was unequivocally of no value to all consumers, not just where it was unsuitable given a particular individual's own circumstances.

Outcomes test

As discussed in chapter 10, recent proposed reforms by the Australian Government include an outcomes test designed to improve the quality of MySuper products. It would include the requirement for trustees to make an annual written determination, including on the appropriateness of the insurance offering and whether it inappropriately erodes the retirement income of beneficiaries.

APRA is also proposing changes to improve member outcomes, including the introduction of *Prudential Standard SPS 225 Outcomes Assessment* that would require all RSE licensees to annually assess the outcomes to members, including the impact of insurance benefits. However, the additional assessment requirements are intended for the internal use of RSEs to assist in continual improvement of their processes and there is not a public release requirement.

The Commission considers that the publication of annual explicit written statements about the trade-off between the provision of insurance cover and the erosion of members' account balances that trustees make in determining their default insurance settings *is* an important discipline on funds. It will help to ensure that trade-off assessments are rigorous and give appropriate consideration to different cohorts of the fund's membership.

Australian Financial Complaints Authority

Effective dispute resolution arrangements are important given that insurance is a major source of superannuation-related disputes. As discussed in chapter 10, following the Ramsay review of financial system external dispute resolution (Ramsay, Abramson and Kirkland 2017), the Australian Government is introducing a new dispute resolution framework, with a single body, the Australian Financial Complaints Authority (AFCA), which will replace the functions of existing bodies, including the Superannuation Complaints Tribunal (SCT).

The Ramsay review noted that complaint resolution by the SCT took a long time, but this could be attributed to chronic underfunding. The new AFCA model could improve outcomes, if appropriately funded.

Importantly, the bill — Treasury Laws Amendment (Putting Consumers First — Establishment of the Australian Financial Complaints Authority) Bill 2017 — also contains amendments to allow ASIC to publish aggregate and firm-level data on internal dispute resolution, which may encourage improvements in complaint handling. This will provide for much needed transparency and accountability for insurance in superannuation.

A potential co-regulatory model for industry codes

As part of the ASIC Enforcement Review, the panel has recommended a co-regulatory model in appropriate parts of the financial sector, such as those covered by the AFCA regime

including the provision of insurance in superannuation, which would provide ASIC with greater regulatory oversight (ASIC Enforcement Review 2017).

Under the model, it would be mandatory for industry participants to subscribe to an ASIC approved code, and in the event of noncompliance, individual customers would be able to seek redress through internal and external dispute resolution. Code compliance would be overseen by a code monitoring body and report to ASIC on code adequacy and compliance periodically. Content of the code would largely remain a matter for industry, but with broad criteria set by ASIC.

Such a mechanism would address some of the key deficiencies with the insurance in superannuation code as it currently stands, including both its voluntary nature and lack of enforceability — mirroring the Commission’s recommendations with respect to the insurance in superannuation code — but would apply across the financial sector more broadly, thus resulting in a more consistent approach to the role and effectiveness of codes across the sector.

Some participants have expressed support for such an approach, with CHOICE (sub. DR184, p. 21) submitting that the co-regulatory model should be adopted by the Australian Government. The Australian Government (2018, pp. 5–6) has responded that it agrees in principle with the ASIC Enforcement Review’s recommendations on industry codes, but has indicated that it will defer any implementation in order to take into account any findings arising from the FSRC about industry self-regulation.

8.6 Further actions are required — by industry and government

The prospects of recent insurance-specific initiatives, as they stand, to address the deficiencies of insurance arrangements in superannuation, while welcome, are limited. Accordingly, further concerted action is required — by both industry and government. This includes efforts by industry to adopt and improve on the code of practice, complementary action by government and regulators to drive code adoption, and other actions by government to mitigate adverse outcomes from current insurance in superannuation arrangements. In this context, the measures announced as part of the 2018-19 Budget go a considerable way to reducing the incidence of low or no-value policies. Table 8.3 summarises the Commission’s perspective on some of the key issues, improvements in train and what further actions are required.

Table 8.3 Issues and responses

<i>Causes</i>	<i>Improvements in train</i>	<i>Further action needed</i>
Problem: Account balance erosion		
Premiums for some members are too high	<ul style="list-style-type: none"> The code of practice includes a premium cap of 1 per cent of the salary of members (as a whole and by segment). Outcomes test annual written determination requirements for MySuper products 	<ul style="list-style-type: none"> Funds should adopt the industry code. ASIC/APRA taskforce to monitor code adoption, compliance and development (including providing guidance). Industry should make the 'bolstered' code binding and enforceable within two years (rec. 17) Require funds to publicly document rationales on the appropriateness of cover and the balance erosion trade-off (rec. 16)
Multiple accounts	<ul style="list-style-type: none"> See below 	<ul style="list-style-type: none"> See below
Problem: Unintended multiple policies		
Low member awareness and engagement	<ul style="list-style-type: none"> Industry code of practice includes measures to improve communication with funds 	<ul style="list-style-type: none"> Funds should adopt the industry code. Adoption of the code should be made a condition of offering insurance (rec. 17). Industry code should be strengthened and annual member statements refined
Multiple accounts	<ul style="list-style-type: none"> ATO account consolidation initiatives (chapter 6) 	<ul style="list-style-type: none"> Change default arrangements so members only default once (chapter 12, rec. 1) Further account consolidation initiatives (chapter 6, rec. 5)
Inactive accounts	<ul style="list-style-type: none"> Code of practice provisions for cessation of cover on inactive accounts Government proposed changes for cessation of cover on inactive accounts 	<ul style="list-style-type: none"> Cessation of insurance on accounts without contributions for 13 months should be made mandatory, unless members expressly choose otherwise (rec. 15)
Problem: Policies not value for money		
Poor data	<ul style="list-style-type: none"> Some funds imputing member characteristics from broader datasets 	<ul style="list-style-type: none"> The code should be amended to facilitate adoption of industry best practice Funds should ensure they use latest contact details from ATO — include in code On-going work to improve data collection and dissemination
Principal-agent problems	<ul style="list-style-type: none"> ASIC product intervention powers to address grossly inappropriate policies APRA making changes to help members to opt out of insurance Changes to dispute resolution processes under AFCA Government proposed changes to opt-in only cover for under 25s and low balance accounts 	<ul style="list-style-type: none"> Improvements to superannuation fund and system governance (chapters 9, 10) Legislate making insurance for young members (aged under 25) opt in, as young members rarely need life insurance (rec. 15)
Complexity and incomparability	<ul style="list-style-type: none"> Code of practice provisions to enhance communication and information provision 	<ul style="list-style-type: none"> Standardisation of definitions and short form annual statements in next iteration of code need to happen promptly
Reassessing extent of problems with insurance in superannuation		
Concerns about prospects for changes		<ul style="list-style-type: none"> An independent inquiry should be commissioned within four years to evaluate initiatives to that date, evaluate insurance in super more broadly and consider further necessary policy changes (rec. 18)

What should industry do?

Proactive and pre-emptive actions to self-regulate can address concerns in a more efficient and less burdensome manner than through government regulation. There are two broad areas where funds need to focus attention to increase the value of insurance to members.

- There is scope for funds to improve benefit design, including better tailoring of insurance products to meet the needs of different cohorts and ensuring members are not allocated to unsuitable products or charged on the basis of inappropriate risk ratings, while ensuring that full consideration is given to the effect of insurance premiums on account balance erosion. It is apparent that there is scope to use available data to do this better, with funds able to impute the likely characteristics of their own membership from generic data sources.
 - Complexity and lack of comparability across product offerings is an obstacle that makes switching to better superannuation products difficult for members and limits competitive forces.
 - Development of standard definitions, including removing opaque and inequitable exclusions, is a crucial step in reducing this problem, although it should be done in a way that does not unnecessarily inhibit better tailoring of products to members' needs — such as the redesign of TPD products to have staged payments, rather than a single lump sum.
- Engagement with members is another key area for improvement by funds, including ensuring members are aware of their insurance cover and making it easier to opt out, amend cover, elect to retain cover where it might otherwise be cancelled (such as when they go on extended leave) or make claims.
 - An important aspect of this is having as up-to-date contact details for members as possible, and all funds should work with the ATO to ensure that they have the latest available contact information for their members.

In both of these areas, it is apparent that there is currently a diverse range of approaches by funds, so there is scope for many funds to adopt approaches in line with industry best practice. The code of practice is a potentially good vehicle to enact these changes.

Funds should adopt the code

It is the Commission's view that funds should adopt and implement the provisions of the industry code of practice, as this is a transparent and consistent way for funds to make improvements to insurance arrangements that increase value to members.

Ultimately, the Commission considers that adoption of the code should be mandatory for all funds providing insurance to their members to ensure that the protections afforded to members apply universally (notwithstanding that adoption to date is relatively high). In the interim, those funds that do not adopt the code should be prepared to face additional scrutiny from regulators on their insurance arrangements, and be able to explain why adopting the

code is not in the best interests of their members. Even where funds choose this course of action, they should adopt elements of the code that would benefit their members.

The code should be strengthened through its subsequent iterations

While future iterations of the code have been flagged, it is important that the unwarranted flexibility and carve-outs of the current version are unwound. In particular, the code provisions should be enhanced in the following areas.

- *Standard definitions.* Given generally low levels of financial literacy among members, understanding and comparing insurance offerings will always be difficult given the different mixes of insurance types and levels of cover, but this is exacerbated by differences in eligibility and exclusion definitions for insurance types (particularly in the case of TPD insurance), making it difficult for members to make comparisons on a like-for-like basis and contributing to inequitable outcomes for members across the superannuation system. It is therefore critical that standardised definitions and exclusion clauses are introduced to increase transparency and ensure that members are able to compare insurance offerings purely on the mix of benefits and premiums. Implementing standard definitions and making insurance offerings as uniform as feasible would also combat residual impediments to mergers occurring (chapter 10) and the potential use of unreasonable exclusions — such as for members deemed to be working in certain higher risk occupations — to address cost pressures.
- *Tailoring benefit design.* While the code requires participants to consider member characteristics in designing benefits, further prescription in the code could increase the adoption of industry-leading benefit design practices (such as imputing member needs using ABS data).
- *Communications.* The code contains extensive provisions on communications, including an annual member statement. However, the risk is that without further direction, the statement will end up long, excessively detailed and unread. Similar to the key fact sheet, the annual statement needs to be a short form document that contains only key details on the level and type of cover, annual premiums, the likely projected balance erosion for the member, and links to additional information on the fund's website (including the fund's balance erosion trade-off determination and a calculator for assessing balance erosion for individual members).
 - Ensuring communications actually reach members is a necessary precondition to be effective, but this does not always occur — the code should also require all signatories to regularly access updated contact details from the ATO.

A key objective should be to strengthen the code to the standard necessary for ASIC approval. Beyond bolstering provisions of the code, another critical task for the code owners — with appropriate regulator guidance — is to make the code binding and enforceable on participants. This needs to include having an appropriately resourced independent body to oversee code administration and enforcement. ASIC should also be given an enforcement role under the code.

Some participants have suggested implementing arrangements similar to that for the FSC Life Insurance Code of Practice, which is administered by a Code Compliance Committee with a secretariat housed with the Financial Ombudsman Service (Berrill and Watson Lawyers, sub. DR176, p. 11). The FSC (sub. DR186, p. 32) also supported this outcome, albeit through a suggestion that the code could be merged with the Life Insurance Code of Practice. Importantly, deficiencies have also been identified in the current iteration of that code, including at the FSRC (2018d, p. 6439) with respect to failure to cover direct selling of life insurance by third parties, so merging the codes would not be sufficient to address the concerns with respect to the insurance in superannuation code — these provisions would still need to be bolstered.

ASIC needs to work closely with industry on an appropriate timetable, with documented interim milestones, to ensure that progress remains on track. Given, the nature of progress to date, it is difficult to comprehend how these improvements can be made without regulator direction and mandatory code adoption and compliance.

What should government do?

In broad terms, government should focus on measures to bolster and leverage the work of industry and to intervene in areas where industry efforts are unlikely to be effective. Measures announced as part of the 2018-19 Budget are welcome steps in the right direction.

Policy responses to address broader systemic issues affecting superannuation will also be important in addressing problems related to insurance. For example, addressing superannuation account duplication will also reduce unintended multiple insurance policies — thereby reducing the incidence of one of the most egregious sources of balance erosion (chapter 6). The Commission is proposing initiatives to modernise the default system by ensuring members only default once, which should halt further creation of duplicate accounts. However, this measure would have some implications for providing default group insurance — in particular, the provision of insurance to high risk workers — and procedures will need to be put in place to ensure that all members receive suitable automatic insurance cover (this issue is discussed in chapter 12). The Commission is also recommending changes to assist in consolidating the legacy stock of unintended multiple accounts.

Better fund and system-level governance, as discussed in chapters 9 and 10, would also enhance outcomes for members with insurance in superannuation. In particular, trustees do not always act in ways consistent with their duty to act in the best interests of members or interpret this too broadly, which could disadvantage some cohorts of members (such as where there are inappropriate insurance cross-subsidies).

Ongoing efforts to improve data collection and dissemination will also be important. The need for better data is indeed a common theme across this inquiry and the Commission is recommending the creation of a cross-regulator working group to identify avenues for improved data collection and access.

In addition, there are also some specific insurance-related measures that the Australian Government should adopt. These are detailed below, although the subsequent recommendations are contained in chapter 13.

Joint regulator taskforce to bolster code, monitor code adoption and compliance

While the code currently falls well short of where it might ideally be, it would be a missed opportunity if it fell by the wayside. Regulators should leverage the code by undertaking activities that require funds to adopt and comply with code provisions, and provide guidance to assist the code owners in bolstering the provisions and administrative arrangements of the code to an appropriate standard.

To coordinate efforts across regulators, the Australian Government should establish a joint regulator taskforce (recommendation 17). It should include both ASIC and APRA to ensure that there is coordination between the regulators, given that some instances of inappropriate activity may require a response by both regulators. Further, there is a close link between many elements of the code and other requirements (or proposed requirements) imposed on funds, such as requirements concerning opt-out procedures.

Participants have suggested that such a taskforce should liaise closely with, or even formally involve, consumer and industry organisations (for example, AustralianSuper, sub. DR150, p. 9; CHOICE, sub. DR184, pp. 20–1; Berrill and Watson Lawyers, sub. DR176, p. 11). While the taskforce itself should consist only of the regulators (that can be held to account), it should establish extensive consultation processes — potentially including the establishment of ongoing consultative committees — with the focus being on consumer organisations and insurance experts, and with industry on an as needed basis only.

The taskforce should provide guidance on priorities for bolstering the code and direction on what is needed to meet ASIC’s requirements for an enforceable ‘approved’ code of conduct. Industry should be given a hard deadline of two years to make the bolstered code meet this standard before alternative regulatory approaches are considered.

The taskforce should also determine and set an appropriate timetable and interim milestones to ensure that the necessary enhancements to the code occur in time. This should ideally ensure some of these enhancements, such as the development of standard definitions, occur before the hard deadline mentioned above. This could allay some participants’ concerns that the suggested timeframe is too long, although on balance, sufficient time will be required to fully implement all the necessary changes.

In the interim, as an additional check to ensure code development remains on track, the taskforce should monitor and publicly report on the adoption and implementation of the code by funds, and progress in implementing the necessary enhancements to the code — including implementation of standard definitions and moving to a short form annual insurance statement. The taskforce should make findings on where industry is failing to make sufficient

progress and further government action is warranted. These findings should be considered as part of the Commission’s proposed future independent public inquiry (discussed below).

Also, where the taskforce finds that funds have not yet adopted the code or adequately complied with key provisions, this should be used as a catalyst for additional scrutiny from the regulators.

Make the code an RSE licence condition

Ultimately, the Commission considers that adoption of a binding and enforceable ASIC-approved industry code of practice should be a mandatory requirement for all funds offering insurance to members, not only for automatic cover to members in MySuper products, but also in the case of funds that provide insurance in choice products. While most members will be covered on the basis of voluntary adoption of the code, this is of no comfort to those members stuck in recalcitrant funds. Making the adoption of the code mandatory (in addition to making the code binding and enforceable on members) is also in line with the proposed co-regulatory model that the Government has agreed in principle to, and which, if adopted, would result in these requirements applying to a range of codes across the financial sector more broadly.

Regulators expressed some concerns about making adoption of the code a condition of MySuper authorisation. APRA (sub. DR204, p. 9) noted that the code may change over time; while ASIC (sub. DR.206, p. 18) contended that code deficiencies may need to be addressed first to ensure the code is robust and effectively monitored.

The Commission notes these concerns and the risk that such a requirement could lock in (and potentially give undue credence to) a code that proves to be of little worth. Accordingly, code adoption should be made an RSE licence condition once the code has been bolstered and is enforceable (recommendation 17).

Require funds to publish their balance erosion trade-off assessments

More broadly, fund trustees need to more clearly articulate the trade-offs they are making when entering and designing group insurance arrangements for their members. The Commission acknowledges that fund trustees are already obligated to make these trade-off assessments, including under the SIS Act and prudential standards, but a lack of public transparency makes it difficult to gauge compliance, or for engaged members to make informed choices.

While the proposed annual written determinations in the outcomes test for MySuper products, the requirements under the new SPS 225, and initiatives in the industry code are all steps in this direction, the Commission considers that explicit publication requirements are a ‘must have’ for members to make informed decisions and should apply to all funds providing automatic insurance cover.

APRA should immediately require trustees of all APRA-regulated funds to articulate and quantify the balance erosion trade-off they have made for their members and make it available on their website annually (recommendation 16).

Funds seeking inclusion on the ‘best in show’ shortlist will need to also articulate this trade-off for prospective members (in addition to other activities to ensure that insurance is suited to a broader cross-section of members). This is because while more expensive insurance arrangements in some funds may be appropriate to the existing membership, they could be unsuitable for prospective new default members. These new members might be better served (on average) by a more basic default insurance offering.

In addition, funds should have a simple calculator on their website that automatically inputs a member’s balance, contribution and insurance premium information, so that those members who wish to do so, can estimate how various insurance choices would impact on their retirement balances. Enabling members to estimate the lifetime effect of premium deductions from their accounts can assist them in evaluating the balance erosion trade-off, given their own situation and preference, against the benefits they may receive for a given level of cover. The cost of implementing such a calculator should be immaterial in the context of the total premiums collected from members.

Opt-in insurance for members aged under 25 years and cessation of insurance on inactive accounts

As noted earlier, the Australian Government has already introduced legislation as part of its Protecting Your Super package to make insurance opt-in only for new members under 25 years of age, and cease insurance on accounts that have not received a contribution for 13 months, unless the member has elected to retain the cover. The package also includes insurance being made opt-in only on low-balance accounts (under \$6000). The first two of these criteria mirror the recommendations from the Commission’s draft report.

The Commission has concluded that there is a strong case to generally make insurance for members under 25 years of age.

- Overall, young workers are likely to receive less value from having insurance through their superannuation, given their typically lower incomes and financial commitments. This means that they are more likely to be overinsured and hold policies that are of low value to them. Automatic life insurance cover for young members without dependants is perhaps the most difficult to justify, but the bundled nature of insurance (due in part to the requirements to offer life and TPD insurance in MySuper products) means that insurance cover for these members overall is of lower value.
- Making insurance for members under 25 years opt in could also assist in reducing the number of unintended insurance policies across multiple accounts given that much account duplication occurs in the age range of 18 to 25 years (chapter 6), although changes to ensure members default only once should do most of the work in addressing this issue.

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- Some funds have argued that the characteristics of their membership base mean that insurance is of value to their members. The Commission acknowledges that, particularly in the case of TPD (and IP) insurance, cover for some younger member cohorts may be arguably in their favour. And where this can be compellingly made to the APRA, an exemption from this age cut-off may be warranted — on a case-by-case ‘if not, why not’ basis.

Likewise, cancelling insurance on inactive accounts (including both default group and individual cover), unless the member expressly elects to retain it, should address a number of the legacy problems from the existing arrangements, including:

- reducing the stock of unintended multiple insurance policies (beyond what may be addressed through initiatives to reduce the proliferation of new accounts)
- reducing the stock of policies that are of no value to members because they are ineligible to claim on them
- removing potential barriers to the consolidation of inactive duplicate accounts.

The 13 month contribution inactivity period in the Australian Government’s changes (mirroring the Commission’s draft recommendation, and that in the voluntary industry code) is a reasonable compromise between excessive balance erosion and cancelling value cover. It allows sufficient time, given the delays in receipt of contributions and the need for funds to establish contact with members prior to cessation. Some have argued that this will unreasonably affect members on long-term unpaid leave (such as parental leave), but who remain employed with an intention of returning to work (and recommencing contributing to the same superannuation fund). While a longer inactivity period or an exemption may suit some people in such a situation, for others, it will just increase the erosion of their balances for cover that is of less value to them than if they were in active employment. Accordingly, the best approach for these members is to rely on enhanced member awareness and engagement to facilitate these members making the choice to continue their cover while on leave. There may be an additional role for employers here that should be explored by industry and regulators.

The Protecting Your Super package also includes the removal of default insurance on low balance accounts. While there are some potential adverse outcomes of this measure, under current policy settings, the measure will help address unnecessary insurance (and excessive balance erosion) on low balance accounts, including in cases where members amass multiple accounts. However, the case for this measure is less compelling if policy changes are enacted to ensure that members default only once, as the Commission has recommended.

Accordingly, the Commission recommends that the Australian Government should seek to legislate the insurance initiatives contained in the Protecting Your Super package. Any exemptions from the criteria to provide insurance on an opt-in basis to younger members should be limited in scope to cases where funds can make a compelling alternative case to APRA (for example, by drawing on directly pertinent actuarial modelling) that it would be in the interests of a specific cohort of members (recommendation 15).

Future public inquiry into insurance in superannuation arrangements

While initiatives taken by industry to date are a step in the right direction and the industry code of practice offers some limited prospects for improving member outcomes, more work is needed. As such, the likely effectiveness of these initiatives is difficult to gauge today. Further, the recommendations put forward in this report, if implemented, would take some time to translate into measurable outcomes for members.

As such, an independent inquiry into insurance in superannuation arrangements should be initiated within four years from the completion of this inquiry report (recommendation 18). This should allow sufficient time for slated changes to be implemented and take effect. However, the timing should be determined by the progress made in making the code enforceable, and occur sooner if the code is not made enforceable within two years.

This would provide an opportunity to review progress and the need for further policy interventions in the absence of meaningful remediation of unnecessary balance erosion and inappropriate insurance products for members. The inquiry should also provide scope to examine the potential for broader changes to insurance policy settings that could enhance member outcomes. Without being exhaustive, potential issues that should be examined by the inquiry include the following.

- The appropriateness of insurance provision in superannuation products generally, including on an opt-out basis in default MySuper products.
 - This should take a broader view than has been possible in this inquiry and should examine insurance in superannuation in the context of the broader policy settings and arrangements in place to provide assistance to people in the event of illness and injury, including the purchase of life insurance through other channels outside the superannuation system and the extent and consequences of levels of underinsurance, and the intersection of life insurance with other schemes, such as workers' compensation.
- Whether more prescriptive regulation of insurance in superannuation is needed.
 - This could include examining if there is a case to further expand opt-in only settings to other specific cohorts, or if there are other approaches that could mitigate inappropriate erosion of members' superannuation balances.
- The scope for other changes to policy settings that might enhance the value of insurance to members.
 - For example, AustralianSuper has argued that IP insurance can be a more valuable benefit to members than TPD and that there should be greater flexibility given to trustees in designing insurance cover.
 - The inquiry could also assess if there is a case to expand the capacity (which is currently available to employees under some industrial instruments) for individuals to sue their employer in cases where they could make a claim, but do not have insurance because their employer did not pay their superannuation contributions. It

should be noted, however, that other initiatives and recommendations by the Commission should further reduce the incidence of non-payment of contributions by employers.

8.7 Fiscal effects

The terms of reference ask the Commission to consider the effects of insurance on social security outlays. These effects, while important to government and ultimately taxpayers, are not the primary rationale for improving the arrangements for insurance in super.

The effects on social security outlays are complex and mixed

One argument made by some to support the case for having insurance in superannuation is that it leads to a net fiscal gain to government by reducing social security outlays (box 8.8).

Box 8.8 Fiscal estimates by others

KPMG estimated that removing insurance from superannuation would lead to a net increase to government outlays of between \$0.65 billion and \$1.85 billion over 10 years. They considered the effects of: savings in Disability Support Pension payments (\$3–\$4.2 billion); additional tax revenue from tax on insurance benefits (\$2.9 billion); and offsetting tax concessions of \$5.25–\$6.4 billion.

Rice Warner also found that removing insurance from superannuation would result in a cost to government — they estimated increased social security payments from removing default insurance at about \$1.66 billion each year (it also estimated lost tax and spending capacity due to reduced insurance claim payments of \$4 billion each year).

The two approaches illustrate the difficulty with calculating such estimates. It is also important to note that neither analysis considered the effects of account balance erosion from the deduction of premiums on Age Pension eligibility.

Sources: KPMG (2017b); Rice Warner (sub. 46).

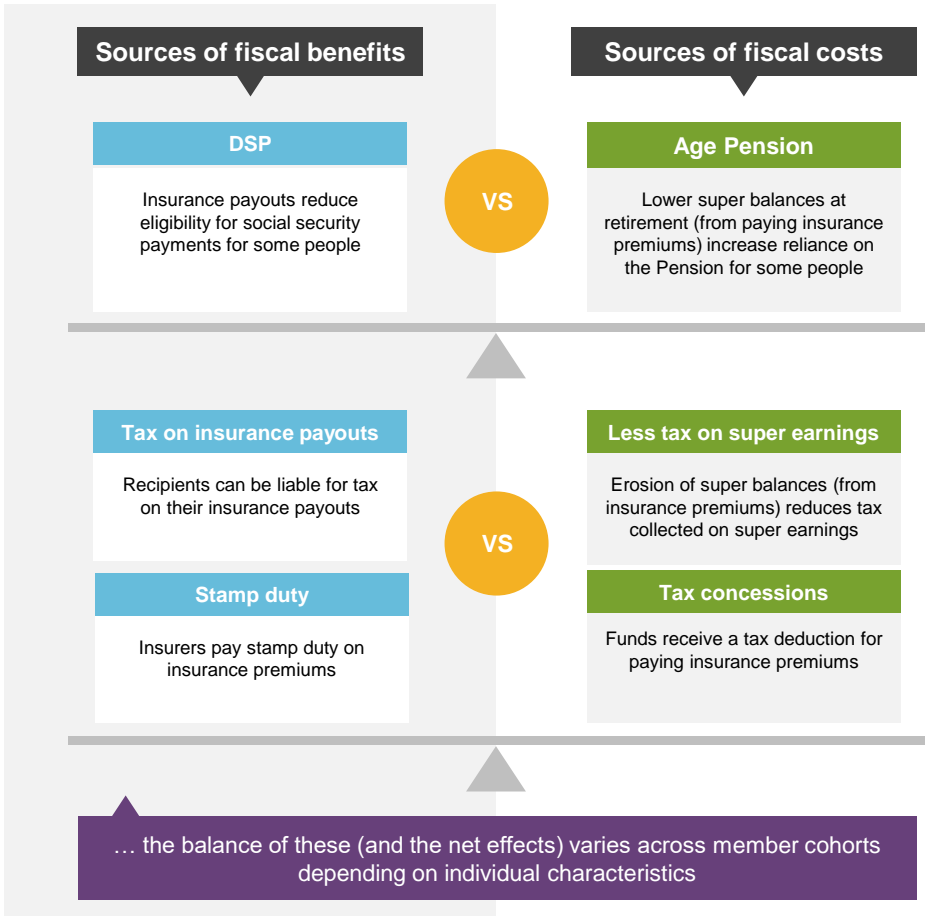
However, there are complex and opposing fiscal effects with respect to social security outlays — primarily the Age Pension and Disability Support Pension (DSP) — as well as taxation considerations, as illustrated in figure 8.12. The balance of these opposing effects will determine the net fiscal effects of insurance in superannuation.

The Commission has modelled a range of cameo scenarios for a new workforce entrant today to explore the potential fiscal impacts of insurance in superannuation across an individual's lifetime. The model takes an individual (or couple) aged 21 years with a range of assumed characteristics and calculates their lifetime savings, social security payments and taxes paid for the different possible claim outcomes. The results of this analysis are (unsurprisingly) heavily assumption-driven and thus should only be considered illustrative. The

Commission’s analysis does not estimate a total net fiscal impact of insurance in superannuation.

Full details on the Commission’s approach are documented in tech. supp. 9.

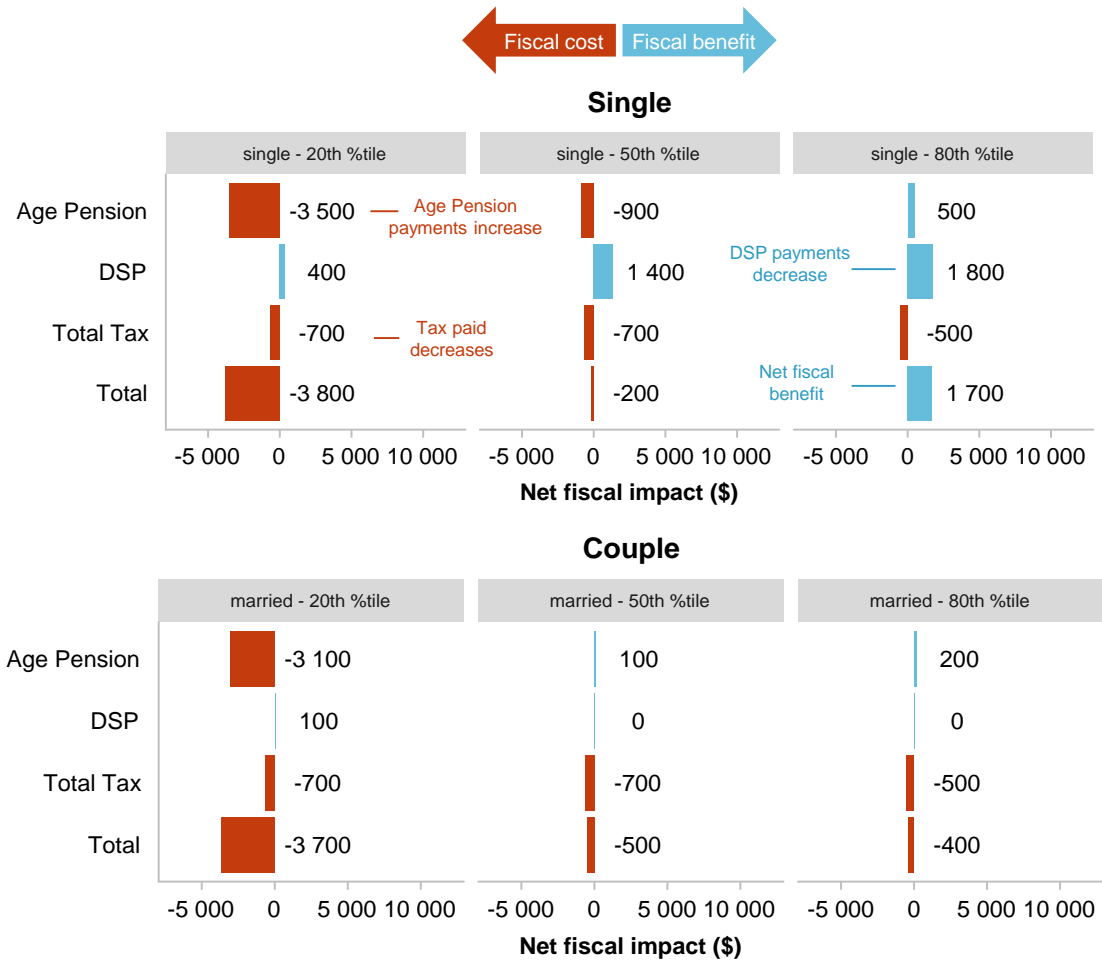
Figure 8.12 Fiscal impact of insurance in super — a world of swings and roundabouts



Cameo results

The Commission has used multiple cameos to illustrate the effects of combinations of couple status and income for TPD insurance (figure 8.13) and IP insurance (figure 8.14). These results illustrate that the fiscal effects for a given individual vary widely depending on their income and household characteristics — for some individuals insurance results in a net fiscal cost to government, but for others a net fiscal benefit. For example, in the case of TPD insurance for a single individual with an income at the 20th percentile, there is an expected net fiscal cost of \$3800, which consists of an increase in Age Pension payments (\$3500) and a decrease in tax receipts (\$700), partially offset by a reduction in DSP payments (\$400).

Figure 8.13 **Net fiscal impacts of TPD insurance^a**
Selected cameos

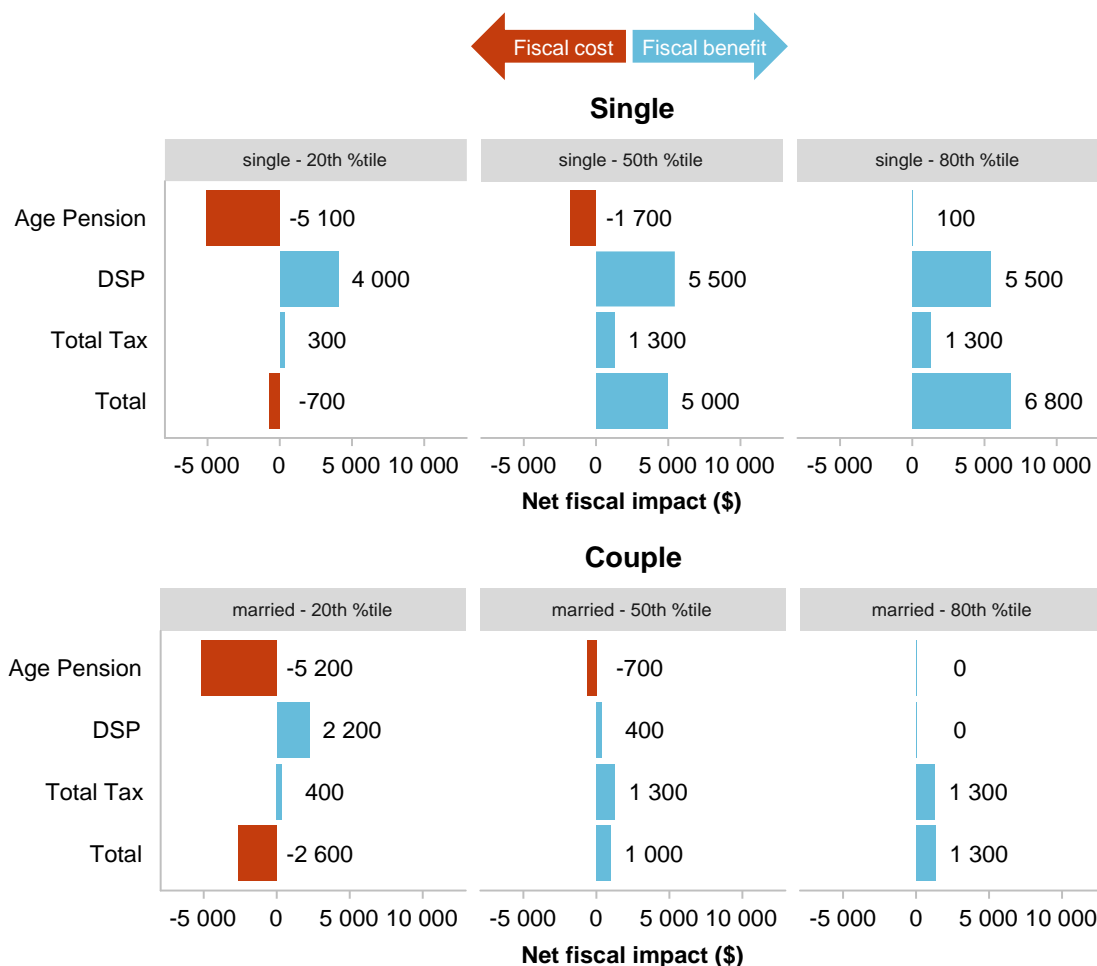


^a All results are presented as net present values and represent the weighted sum of all the possible outcomes (that is, never claiming, claiming at 22 years old, etc.) that an individual can face.

Source: Productivity Commission estimates.

Figure 8.14 **Net fiscal impacts of IP insurance^a**

Selected cameos



^a All results are presented as net present values and represent the weighted sum of all the possible outcomes (that is, never claiming, claiming at 22 years old, etc.) that an individual can face. Cameo modelling is for an IP policy with a two year benefit.

Source: Productivity Commission estimates.

Some concluding observations on fiscal impacts

The Commission's cameo modelling suggests that the fiscal cost of insurance from increased Age Pension payments (arising from the erosion of superannuation balances) is likely to be material for some cohorts. This casts doubt on the earlier estimates of others of a net fiscal benefit of insurance in superannuation.

The Commission's analysis also suggests that single individuals with IP insurance is the cohort most likely to generate a net fiscal benefit to government, although the absolute fiscal impact will be constrained by the relatively low incidence of IP insurance (about 30 per cent of default member accounts).

Further analysis — undertaken with a more comprehensive model — would be required to determine whether there are aggregate net fiscal benefits or costs associated with insurance in superannuation. The Treasury would likely be best placed to undertake such work — it has expertise in this area and could draw on the assumptions underpinning Age Pension reliance used for Intergenerational Report modelling.

Finally, it is important to remember that net fiscal impacts are only one component of a broader assessment of the total net impacts of insurance in superannuation.

FINDING 8.3

The fiscal impact of insurance in superannuation is complex and multifaceted. The effect on Age Pension outlays of the erosion of superannuation balances by insurance premiums is not trivial, and could materially offset any savings to government in social security outlays (that would otherwise have been paid to members that become insurance payout recipients).

9 Fund governance

Key points

- Fund members are heavily reliant on the conduct and actions of others — trustees, financial advisers, regulators and ultimately government. High quality governance arrangements are needed to ensure members' interests are not only protected but championed. This needs:
 - robust fund governance — quality stewardship and management of each fund by a board of singularly member-focused trustees
 - diligent system governance — holding the system to account through effective supervision and confident enforcement by the key system regulators, ASIC and APRA.
- Super funds exist solely as a vessel for members. Members' outcomes — more than process or intent — must be the key focus of governance arrangements and trustee endeavour.
- Fund governance has improved in recent years (albeit off a low base), but governance practices for many funds fall well short, working against members' best interests. For example:
 - not all funds employ satisfactory practices for appointing adequately skilled and qualified board members, and some sponsoring entities do not take this process seriously (only 55 per cent of CEOs strongly agree that their board has the right mix of capabilities)
 - many boards employ ineffective processes for evaluating board performance and capability
 - conflicts are poorly managed, especially in vertically integrated structures — as reflected in the trustee misconduct uncovered through the Financial Services Royal Commission
 - some funds have inadequate processes in place for managing related-party arrangements
 - not all funds undertake high-quality performance attribution
 - many funds mimic (at least to some degree) the strategy of rival funds for fear they will otherwise exhibit poor short-term performance relative to their peers ('peer risk')
 - benefits provided to employers by funds unduly influence employers' choice of default fund.
- While vertical integration is not a problem per se, contract management, disclosure and reporting need improvement. Conflicts of interest raised by use of related parties need to be managed by trustees and, where found to be poorly managed, redressed decisively by confident regulators.
- One of the most costly manifestations of poor fund governance is the failure of funds to merge where this would benefit members.
 - The proposed member-focused outcomes test would help foster beneficial mergers, but needs elevation to stem persistent underperformance. Introducing competition for the default market (as recommended by the Commission through best in show) will also deliver much needed fund consolidation.
- The considerable body of evidence of trustee misconduct, and conduct inconsistent with community standards and expectations, suggests the best interests duty merits better definition.

High quality governance is integral to a well-functioning, efficient and competitive superannuation system. It is an essential prerequisite for ensuring that members' interests are not only protected but championed in a system where they are: compelled to save; often reliant on the actions of others; and often disengaged, meaning demand-side competitive (and conduct-disciplining) pressures are not felt as strongly as in many other areas of the economy.

High quality governance rests on:

- robust fund governance — quality stewardship and management of each fund by a board of singularly member-focused trustees
- diligent system governance — holding the system to account through effective supervision and confident enforcement by the key system regulators, ASIC and APRA, of system and fund performance; trustee and financial adviser conduct; product appropriateness (including for insurance in super); and licensing arrangements.

This chapter focuses on governance within funds from a system-wide perspective — in the main, individual funds are not singled out for comment. Governance of the system and, in particular, the role of regulators is the focus of chapter 10.

In essence, good fund governance boils down to the characteristics and character of the trustee board members and how well they do their job. The assessment of the performance of Australian trustee boards in this chapter reflects this.

Among other evidence, this chapter draws on a survey of Australian fund CEOs and their equivalents undertaken by the Commission. Most CEOs (80 of a potential 94, representing around 95 per cent of member accounts and 94 per cent of assets in the system) participated in the survey. The Commission is mindful of the potential for bias to be generated from self-reported performance, and has observed optimism in the aggregate results. However, the results still provide insights into fund governance. More details about the survey and a summary of responses are presented in appendix C and tech. supp. 3, respectively.

The chapter also provides an assessment, in whole or part, on the following criteria identified in the Commission's stage 1 report.

- Are there material anticompetitive effects of vertical and horizontal integration? (C5)
- Are principal–agent problems being minimised? (E8)

9.1 Fund governance: what is it, why does it matter and why is it regulated?

Fund governance is not dissimilar to governance for corporations

The description of 'corporate governance' used by the Australian Securities Exchange (ASX) Corporate Governance Council aptly captures the focus of this chapter; governance:

... describes ‘the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled within corporations. It encompasses the mechanisms by which companies, and those in control, are held to account.’ (ASX 2014, p. 3)

But characteristics of super set it apart

Governance arrangements for corporations predominantly focus on the need to ensure that shareholders’ interests are protected; governance arrangements for super funds seek to ensure that the interests of members prevail over those of others. The others include (fund owner) shareholders, trustees and other ‘agents’ who make decisions on behalf of members.

As distinct from banking, where institutions promise that deposits will not fall in value, in super, nearly all members (in defined contribution products) bear the risks associated with any drop in the value of their assets — trustees proffer no binding promise on future returns. As a consequence, prudential regulation, with a focus on inputs to ensure risks are managed, is particularly applicable to banks (RBA 1996); product-based regulation, with stringent disclosure rules, is particularly applicable in super. And, given the absence of a promise to members, regulation of super needs to tie authorisation of the trustee (acting in members’ best interests) not simply to their actions and inputs, but to their outcomes. Super funds exist solely to act as vessels for members; members’ outcomes — more than process or intent — need to be regulators’ key focus.

Super funds also have characteristics akin to mutual funds — money is pooled and invested on behalf of members. But, unlike mutual fund investors, super members are compelled to invest (and their ‘equity’ is not afforded governance rights), and many default into products rather than actively choosing them. As a consequence, super merits more stringent regulation.

Reflecting the distinctive characteristics of super, the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act) ‘reinforces the common law’s orientation of trustees towards the best interests of members and emphasises that the sole purpose of the superannuation system is generally to provide retirement benefits to members’ (Cooper et al. 2010b, p. 45). For example, a trustee must: perform their duties and exercise their powers in the best interests of beneficiaries (s. 52(2)(c)); give priority to its duties to and the interests of beneficiaries over any duties to others and any interests of the trustee itself or its associates (s. 52(2)(d)(i)); and ensure that the interests of beneficiaries are not adversely affected where any conflicts of duty or interest arise (s. 52(2)(d)(iii)). Trustees must also ensure that a fund is maintained solely for the provision of benefits to members (or the beneficiaries of their estate) (s. 62).

Good governance is central to fund performance

In essence, good governance promotes better decision making on behalf of members, greater transparency and accountability, stronger management of risks and, overall, superior performance on behalf of members. The Cooper Review highlighted that:

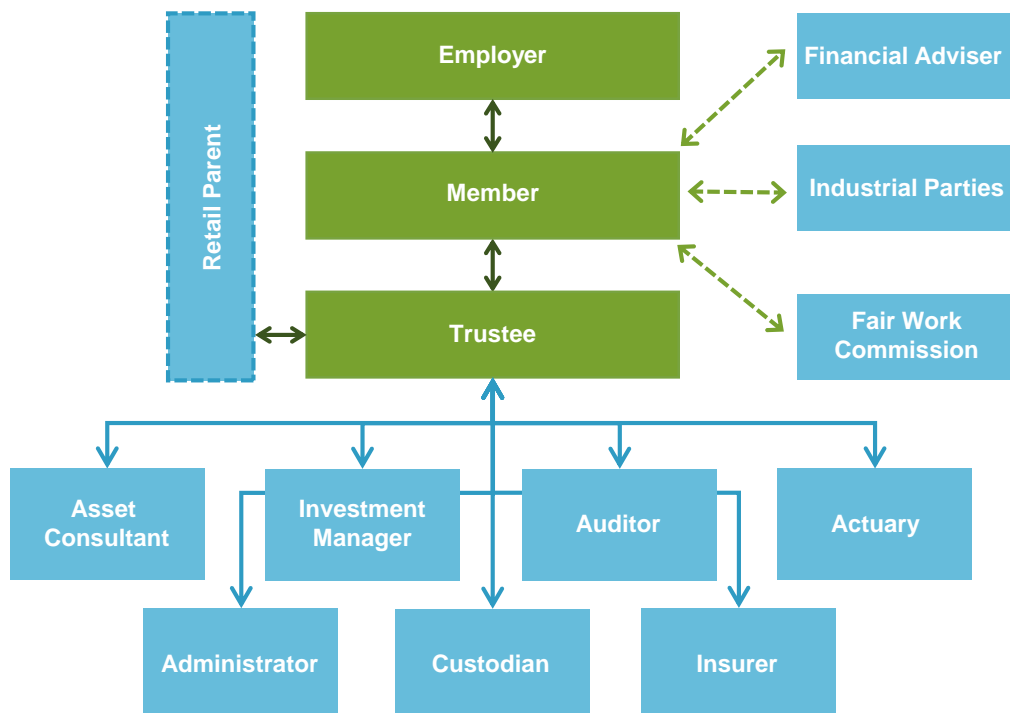
In superannuation, just as in other areas of corporate activity, good governance plays a major role in promoting better decisions, greater accountability and in reducing unintended operational and investment risks. (Cooper et al. 2010b, p. 44)

And APRA, following a thematic review of super governance, noted that ‘RSE [registrable superannuation entity] licensees with a strong focus on delivering quality member outcomes also tend to have in place robust governance practices that go beyond minimum regulatory requirements’ (APRA 2018d, p. 3).

Principal–agent risks drive regulation of fund governance

Principal–agent relationships, that is, relationships in which other parties (agents) make decisions on behalf of members (principals), abound in super (figure 9.1). Risks arise when the interests of members and agents are not aligned that agents will make decisions that benefit themselves but cause detriment to the member (box 9.1). These risks, coupled with the compulsory nature of super, an understandable lack of member engagement (chapter 5) and super’s preferential tax treatment, contribute to an expectation that the government will regulate to ensure that members’ interests are protected.

Figure 9.1 Principal–agent relationships abound in super



Box 9.1 Risks in key principal–agent relationships

Employers and members

Employers are required to nominate a default fund for employees who do not choose a fund, and may face incentives to make a decision that is not in the best interests of their employees. For example, they may choose a fund on the basis of less onerous administrative requirements. Or they might be offered benefits by super funds to sway their choice (chapter 7). A recent ASIC survey of trustees highlighted that super funds commonly provide benefits to employers such as educational materials, tickets to sporting events and corporate hospitality (ASIC, sub. 90). And the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Financial Services Royal Commission (FSRC) (2018b, pp. 87–9)) heard evidence from HostPlus that it has to use corporate hospitality to retain employers. Despite its strong performance record, HostPlus perceived that it faces competition from lower performing funds because of their spending on benefits for employers.

Trustees and members

Super fund trustees have a fiduciary responsibility for managing and investing the contributions of members. However, this does not make the relationship immune to conflicts. The FSRC (2018b) revealed multiple instances where the interests of shareholders in for-profit funds' corporate groups were placed ahead of those of members. Fees were levied for no service. Transfers to MySuper products were delayed, meaning advisers continued receiving commissions. Members were prompted to remain in higher-fee products rather than have their funds transferred to MySuper products where, most likely, they would receive higher net returns.

Not-for-profit funds can also be subject to conflicts of interest. For example, sponsoring entities might seek to influence investment decisions. In 2012 and 2013, the Construction, Forestry, Maritime, Mining and Energy Union (CFMEU) (a sponsoring entity of Cbus) expressed concern that Cbus had entered into a contract with Grocon, a company with which the CFMEU was involved in a heated industrial dispute. Subsequently, the CFMEU required the creation of a 'Building Industry Group Consultative Forum' to influence 'which building companies would win work from Cbus, and on what terms' (RCTUGC 2015, p. 468).

Financial advisers and members

Whether employed in-house (possibly as part of a vertically integrated entity) or by third parties, financial advisers have traditionally received commissions or other remuneration benefits from product providers for placing clients with particular products. Evidence suggests that these arrangements encourage some advisers to sell particular products rather than give unbiased advice focused on their clients' interests (ASIC 2018e; FSRC 2018b). Advisers also face conflicts where provision of particular advice to clients results in ongoing payments to the adviser. For example, while SMSFs generally avoid principal–agent issues (because the members are also the trustees) (chapter 10), there might be incentives for advisers to recommend setting up SMSFs to clients based on potential ongoing fee revenue to the adviser rather than because it is in the client's best interests.

(continued next page)

Box 9.1 (continued)

Industrial parties and members

Industrial parties have traditionally played a major role in determining which super funds are listed in awards and therefore eligible for default contributions. There is potential for conflicts around which funds are supported for inclusion in an award, given industrial parties are often sponsors of industry funds (Drew and Stanford 2003). Commercial agreements that see funds pay sponsoring entities to promote them reflect this risk (for example, the Energy Super and Electrical Trades Union Queensland and Northern Territory Partnership Agreement 2017-18 (exhibit 5.132.1), the Hostplus and United Voice Partnership Agreement May 2016 (exhibit 5.322.1) and the Hostplus and Australian Hotels Association National Partnership Agreement November 2015 (exhibit 5.322.22) provided in evidence to the FSRC).

9.2 Trustees' skills are key to better governance

A stronger focus on trustees' skills would support better governance

APRA's Prudential Standard SPS 510 *Governance* requires boards to have a framework that includes 'at a minimum ... policies and processes that achieve appropriate skills, structure and composition of the Board' (APRA 2016c, p. 1). SPS 510 also mandates a written policy setting out requirements for the nomination, appointment and removal of directors. And Prudential Standard SPS 520 *Fit and Proper* requires an RSE licensee to 'clearly define and document the competencies required for each responsible person position' (which includes trustees and senior managers) (APRA 2013b, para. 17).

APRA (sub. DR204) reported that industry practices have improved over the past five years off the back of significant effort in implementing standards. And there is evidence of boards focusing more on the fit of candidates nominated by sponsoring entities, along with succession planning (Rowell 2017c). However, APRA's thematic review of governance found that:

Very few boards had formally documented, or were able to articulate, what their optimal board (and committee) composition should be ... In particular, there was limited documentation of aspects of board composition such as the target size, optimal skills mix, ideal number of independent directors, workload considerations, or the connection between director skills and experience and the RSE licensee's strategy and business plan. (APRA 2018d, p. 3)

Further, the review found that some boards with an equal representation structure:

... had experienced challenges in appointing quality candidates with the necessary capabilities (particularly superannuation and financial expertise), in part due to the limitations imposed by constitutions [that reflect equal representation]. (APRA 2018d, p. 5)

The results of the Commission’s CEO Governance Survey echo these findings. Of responding CEOs, only:

- a little more than half (representing around 60 per cent of assets and members accounts in the system) strongly agreed that their board examines and improves its mix of capabilities over time
- 55 per cent (representing around 65 per cent of assets and 62 per cent of member accounts in the system) strongly agreed that their board has the right mix of capabilities
- 59 per cent (representing 66 per cent of assets and 68 per cent of member accounts in the system) strongly agreed that their boards have effective processes for selecting, developing and terminating directors. And some of the confidential comments accompanying the survey highlighted concerns over inadequate board control over the appointment process and the appointment of nominees with skills and experience that were not well suited to the board’s needs.

The ASX recommends that publicly listed companies ‘have and disclose a board skills matrix setting out the mix of skills and diversity that the board currently has or is looking to achieve’ (2014, p. 15). As of 1 July 2018, a Governance Code places a similar requirement on Australian Institute of Superannuation Trustee (AIST) members (sub. DR130) (although a board can deviate from this, and other code requirements, provided it ‘has had appropriate [internal] dialogue about the matter’ (AIST 2017, p. 8) and considered the appropriateness of any alternative approach adopted).

Skills matrixes represent best practice for making board appointments. Matrixes should: be informed by external evaluation of board performance and members’ skills, knowledge and experience (discussed below); detail the collective skills of directors; and enable identification of gaps in both a board’s current skills mix and future requirements. Gaps should be addressed through professional development and board appointment processes (as recommended by the ASX for listed companies).

While best practice would see diversity in the backgrounds and strengths of new appointees, all, at a minimum, should have a mature understanding of the super system, investment decision making and a high level of financial literacy — gained either through industry experience or formal training (for example, the CFA Institute Investment Foundations Program (CFA Institute 2018)). This should be a regulatory requirement.

The use of skills matrixes would also provide boards and CEOs with greater ability to pushback against substandard or unsuitable board nominations by sponsoring entities — and the appointment of such people to boards is simply no longer tolerable. It runs counter to members’ best interests and at escalating costs to members and future taxpayers with the size and significance of the super system.

In its draft report (PC 2018d), the Commission proposed that the Superannuation Industry (Supervision) Regulations 1994 (Cth) be amended to require boards to annually publish a consolidated summary of their completed skills matrix. In response, the Australian Institute

of Company Directors (AICD, sub. DR164) argued that it would be preferable to implement this measure through standards rather than legislation — standards have the force of law, but are more readily amended; APRA processes for the review of standards enables greater industry participation; and consolidation of all governance-related requirements in the same place would avoid the fragmentation and potential confusion inherent in multiple instruments.

The AICD (sub. DR164, p. 2) also noted that ‘[o]rdinarily, it would not be appropriate to prescribe specific governance practices on a mandatory basis’ but saw merit in the more prescriptive approach suggested by the Commission, given the unique characteristics of super and governance issues in the sector. The Association of Superannuation Funds of Australia (ASFA, sub. DR148), on the other hand, argued for a principles-based approach, with APRA able to encourage trustees to use a matrix while also permitting boards to use other mechanisms for making determinations about skills needs.

The Commission sees clear merit in prescription. Sparrow (2014) argues for prescription where a regulated entity has an incentive to avoid implementing risk controls. Both evidenced and potential future weaknesses in trustee skills and board composition fit that criterion. And the findings from APRA’s thematic review are a testament to some boards’ reluctance to focus on these matters. Funds have been able to adopt policies and processes of their choice in the five years since SPS 510 was first implemented, and APRA already encourages boards to use matrixes (sub. DR204). Clearly, this approach falls short of what is needed in securing better outcomes — prescription through standards is clearly warranted.

The Centre for Law, Markets and Regulation (CLMR, sub. DR141) noted that matrixes will be ineffective if implemented in a tick-the-box manner, and suggested that APRA should use its licensing power more decisively, with appropriate governance processes and structures being seen as an essential precondition of a license. However, a stronger regulatory focus on outcomes and more active prosecution of wrong-doing, discussed in chapter 10, should encourage RSE licensees ‘to meet the spirit and intent, and not just the letter, of the prudential requirements’ as APRA (2018d, p. 3) observed among funds with a strong focus on quality outcomes.

A number of inquiry participants (including APRA, sub. DR204; Governance Institute of Australia, sub. DR152; Mercer, sub. DR175) argued that boards should not be required to publish assessments of individual directors’ skills. As they suggest, such a requirement might reduce the rigour of assessments if directors (and boards) are reluctant to see gaps in their skill sets on the public record. And individuals might be unwilling to take on board positions if they face that consequence. As APRA noted:

What is most important is boards having in place a robust process that seeks to ensure the board as a whole has the requisite skills and experience and being able to demonstrate that process is effectively implemented. (sub. DR204, p. 13)

Arguing only about independent directors loses sight of what matters

The value add of independent directors is strongly contested

In relation to improving skills and experience on super fund boards, much recent debate has focused on the merits of independent directors. Both the Cooper and Murray Reviews recommended mandating a minimum share of independent directors on boards. And the Australian Government has been seeking to mandate that at least one third of board positions be held by independent directors (O'Dwyer 2017a). Media commentary (Coorey 2018), however, suggests the relevant bill has been put aside following revelations about retail fund misconduct at the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Financial Services Royal Commission (FSRC)). APRA submitted that it:

... continues to support the Government's proposed amendments ... [on the grounds that they] will allow the appointment of directors from a broader pool, so that boards have the necessary skills, capabilities, experience and diversity of views to enhance decision-making and better meet the current and future needs of their members. (APRA, sub. DR204, p. 12)

Results of the Commission's governance survey suggest that about one quarter of directors, or an average of two per board, are independent. But boards vary markedly. Twenty-two CEOs (representing 6 per cent of assets and 4 per cent of member accounts in the system) responded that their boards have no independent directors, and 18 (40 per cent of assets and 47 per cent of member accounts) reported a majority of independents.

These responses, however, must be viewed with caution. Liu and Ooi (sub. 92) found that almost all non-executive directors on retail boards were reported to be independent, but nearly 80 per cent were 'affiliated' directors — that is, executives, employees or directors of a related entity. Liu and Ooi (sub. 92, p. 15) concluded that 'trustee director independence is, in fact, a scarce commodity in retail funds' — some directors are independent in name only.

The debate over mandating independent directors has become highly polarised. Retail funds have generally supported the idea; many industry funds have been resistant.

Advocates of a mandated approach argue that the requirement for equal representation of employer and employee representatives on boards in the industry fund segment is less relevant than when originally introduced, due to: the move away from defined benefit funds; the perception that individual trustee-directors are dictated to by the organisations that appointed them; and concerns that equal representation can leave some groups 'unrepresented', such as pensioner members or members who have joined the fund because they exercised choice.

Opponents of mandating independent directors typically point to the outperformance of the not-for-profit segment relative to for-profit funds, and argue that independent directors are not required in the not-for-profit segment because conflicts between the interests of shareholders and members do not exist.

Empirical evidence on the relationship between board composition and fund performance is sparse (Donald and Le Mire 2016). And while a large literature exists for listed companies, the findings are mixed. In large part, this reflects analytical issues. Many studies test correlation, not causation, and the problem of endogeneity plagues the research. As Guo and Masulis note ‘[a] key challenge in studies examining the relationship of board composition and board decisions is whether particular board attributes lead to certain decisions or whether boards that make certain decisions tend to have particular board attributes’ (Guo and Masulis 2015, p. 2771). A number of recent studies have addressed the endogeneity issues using suitable data and methods. This work finds a positive relationship between board independence and a range of company outcomes.¹⁰²

Some anecdotal evidence also supports a positive relationship between independent directors and performance in the super sphere. Sunsuper, in evidence to the FSRC (2018b), considered that the engagement of three independent directors had enhanced its governance. Equisuper (2017) reported that the appointment of three independent directors to its board had enriched its capacity for improved decision making. And preliminary APRA analysis (Rowell 2017b) has found that trustees with better outcomes, on average, had some independent or non-affiliated directors. Evidence also suggests that a larger number of affiliated trustee directors is associated with significant fund underperformance (Liu and Ooi, sub. DR139).

Despite the sparse empirical evidence, standards making bodies around the world, tasked with establishing best practice, typically set a requirement of majority independence. And many developed countries are moving to increase the number of independent directors on pension funds (Governance Institute of Australia, sub. DR152), either by mandating an increase or by elevating required director competencies to professional standard, ‘with the result that boards may well need to consider the appointment of independent directors in order to meet the standard’ (Mercer 2015, p. 4).

Skills and experience should be the key focus ...

In the Commission’s view, ensuring that funds have thorough processes in place to recruit highly skilled and experienced board members is more important than focusing on the number of independent directors on a board.

In a similar vein, the AICD (2018, p. 3) submitted to the FSRC that:

The AICD has previously supported independent directors ... but has emphasised that independence, on its own, is not sufficient to promote good governance. Rather, the collective qualifications, education, experience and skill-set of a board play a critical role.

¹⁰² Guo and Masulis (2015) found that greater independence leads to more rigorous monitoring of CEOs. Knyazeva, Knyazeva and Masulis (2013, p. 1561) documented that ‘board independence has a positive effect on firm value, operating performance, fraction of CEO incentive-based pay, and CEO turnover’. Lie and Yang (2016, p. 1) concluded that ‘greater board independence improves decisions related to the spending and accumulation of cash’.

A focus on skills would naturally see boards seeking to recruit from as wide a ‘gene pool’ as possible — leading to more independent directors and the benefits they embody including wisdom from other contexts and a willingness to ask difficult questions and challenge decisions.

... but the barrier to independent director appointments needs to be removed

A number of inquiry participants including the AICD (sub. DR164), AIST (sub. DR130) and Industry Super Australia (sub. DR162) supported the Commission’s observation that SIS Act restrictions on the appointment of independent directors for non-public offer employer-sponsored (corporate and industry) funds should be removed. Where funds consider that their governance would be enhanced by the presence of additional independent directors, they should be free to appoint them, and not have to approach APRA for approval, as the Act currently requires.

More external assessment of board skills and performance is needed

Board performance and capability assessments are recognised internationally as best practice for detecting gaps in performance and determining whether boards are appropriately skilled. Under SPS 510, boards must have procedures for assessing their performance — and that of individual directors — at least annually. Additional guidance (SPG 510) sets out APRA’s *expectation* that an external party will be engaged at least every three years to do a board assessment (covering both board performance and director capability).

APRA looked at board performance assessment in its thematic review of governance, concluding that it was ‘a notably weaker area of governance practice’ (2018d, p. 7). While the majority of boards met APRA’s expectations of annual reviews and an external assessment every three years, many processes were inconsistent with effective performance management. Some boards did not assess the capability and performance of individual trustees. Few boards had clearly articulated objectives (beyond meeting fitness and propriety criteria) against which performance could be assessed, or performance measures. About half did not assess performance against the RSE licensee’s overall strategy. Many lacked processes for dealing with underperformance (beyond a breach of fitness and propriety criteria). Self-assessment was often the sole assessment method adopted. And most external assessments were based on information provided only by board members.

APRA also observed that the use of independent experts on board committees sometimes signals a skills deficiency that might be better met through appointment of a director with the requisite skills and experience.

APRA’s findings suggest that many boards take a tick-the-box approach to assessments. Recent research undertaken by CLMR (sub. DR141) staff reached a similar conclusion.

While the majority of respondents to the Commission’s governance survey reported that their boards seek independent review of trustee capabilities to ensure they are optimal, 22 per cent (representing 25 per cent of assets and 30 per cent of member accounts in the system) either disagreed or only slightly agreed that this was the case. And only around 60 per cent of responding CEOs (73 per cent of assets and 70 per cent of member accounts) ‘strongly agreed’ that their boards examine and improve their effectiveness on a regular basis — not a reassuring result.

As effective board performance assessments are an activity that underperforming trustees have an incentive to avoid, SPS 510 should be tightened to explicitly *require* trustees to have, use and disclose processes to:

- *effectively* assess, at least annually, the board’s performance relative to its objectives and the performance of individual directors
- seek external third party evaluation of the performance of the board (including its committees and individual trustee directors) and capability (against the skills matrix) at least every three years. The assessment should consider whether the matrix sufficiently captures the skills that the board needs (and will need in the future) to meet its objectives, and highlight any capability gaps. APRA should be provided with the outcomes of such evaluations as soon as they have been completed.

Qantas Super (sub. DR137) suggested that boards would not conduct genuine appraisals, drawing on fiercely honest observations from directors and management, if the results have to be shared with APRA. This suggests a continuation of the form of conduct revealed by the FSRC — where misleading or inadequate information is provided to a regulator by a regulated party. As such, the Commission views this more as a disappointing revelation than a legitimate point of rebuttal. Moreover, and as the governance thematic review illustrates, APRA can detect the difference between tick-the-box assessments and best practice. As APRA focuses more closely on outcomes (chapter 10), funds with poor board assessment processes will come under greater scrutiny and regulator direction to improve.

FINDING 9.1

Board processes to recruit highly skilled and experienced directors, and to effectively evaluate board performance and capability, are an essential prerequisite for best practice governance. Although there have been improvements to trustee board processes to better ensure boards have the necessary skills and experience, there is still much room to do better. Many boards are not employing effective assessment processes.

Use of a skills matrix (informed by external evaluation of board performance, skills, experience and knowledge) to guide the appointment process should be considered best practice by superannuation trustee boards. A focus on skills would likely lead to more independent directors as boards recruit from a wider ‘gene pool’.

9.3 Conflicts must be better managed

Evidence presented to the FSRC (detailed below) clearly reveals the impacts on members of poorly managed conflicts of interest, particularly, but not only, in retail funds. Conflicts of interest raised by use of related parties need to be managed by trustees and, where found to be poorly managed, redressed decisively by confident regulators.

A number of recommendations at other points in this report would remove, or prompt better management of, these conflicts. Key among these is elevated outcomes assessments for both MySuper and choice products (chapter 10). The assessments would put pressure on trustees to ensure they are delivering good outcomes for members. And, by stemming persistent underperformance, would sever the link between poor conflicts management and material member harm. Implementing assisted employee choice in the default segment (chapter 12) would remove employers and industrial parties from the default allocation process. Strategic conduct regulation (chapter 10) would increase the penalties for poor conflicts management. And comprehensive and informative dashboards (chapter 5) and better data (chapter 10) would contribute to better disclosure, helping members (and their agents) evaluate which products best suit them. Further steps that would improve conflicts management are detailed below.

Contract management processes need to improve

A number of regulatory measures stemming from the Stronger Super reforms seek to mitigate against the use of related parties that is not in members' best interests:

- SPS 231 (APRA 2012) requires that boards are able to demonstrate to APRA that outsourced arrangements are: conducted on an arms' length basis; in members' best interests; grounded in a business case; and decided through a 'tender or other process'. Funds must notify APRA when an agreement is entered into, ceased or changed
- SRS 331 (APRA 2015b) sets out reporting requirements related to associated parties
- legislative changes passed in 2013 under the *Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Act 2013* (Cth) mean that RSE licensees can no longer be bound by trust deeds that might require them to engage particular service providers
- SIS regulation 2.38 (set in July 2014 and overseen by ASIC) requires funds to publish 'the name and Australian Business Number of each outsourced service provider who provides a service which may affect a material business activity of the entity'.

APRA (2015c) identified areas of weakness in funds' approaches to dealing with related parties during a 2015 thematic review of conflicts of interest. A recent review of related-party arrangements (APRA 2018q) found improvements since 2015, but also remaining areas of weakness. For example, some contracts lacked triggers for review; some funds, in choosing related parties, lacked credible processes for ensuring that those parties offered terms and pricing in line with the market; poorly performing related-party investment managers were unlikely to be terminated; fund practice in identifying the materiality of an

arrangement (a trigger for heightened prudential and reporting requirements) varied widely; and some funds were unable to demonstrate, as required under SPS 231, that arrangements were conducted at arms' length and in members' best interests.

Taking into account additional evidence that related parties, on average, appear to be higher cost, related-party transactions are underreported and that many contracts have not been reviewed for some years (chapter 7), it is clear that trustees' management of related-party arrangements is manifestly not always in members' best interests.

Participants have some concerns about related-party regulation

Some participants highlighted potential benefits to funds in using related-party arrangements (for example, Mercer, sub. DR175; QIEC Super and Club Super, sub. DR157); others expressed concerns. Industry Super Australia (stage 1, sub. DR106) argued that there is no obligation on RSEs to ensure that all related-party transactions are conducted on terms no more favourable to the related party than would be reasonable if the fund were dealing at arms-length. AIST advocated for conflicts of interest reporting to be strengthened in line with principles outlined by ASIC (2016c). Hartley argued that the transparency on fees paid to related parties is deficient and should be rectified (stage 1, sub. DR82).

Recent regulatory changes are a step forward but should be further strengthened

The prudential standards and changes to the legislative and reporting framework introduced in 2012 and 2013 represented a step forward in seeking to mitigate the risks to members' best interests potentially posed by related-party outsourcing. However, the current requirement that funds demonstrate to APRA that they have undertaken a 'tender or other selection process' for selecting the best service provider could conceivably cover a range of processes of varying robustness. It does not explicitly require trustees to demonstrate that they have paid a market-equivalent price for related-party services. Nor is the fact that only 57 per cent of contracts have been reviewed in the past three years (chapter 7) reassuring.

Given the lack of demand-side pressure on funds to ensure related-party services are provided on a truly commercial basis, the Commission recommended in its draft report that prudential standards should be strengthened to require funds using related parties to conduct formal due diligence of related-party outsourcing arrangements every three years to ensure arrangements provide value for money, and to provide the results of this testing to APRA.

A number of participants supported this proposal, including AiG (sub. DR181), ASFA (sub. DR148) and AustralianSuper (sub. DR140). (ASFA noted the requirement should only apply for material business activity.) Cbus (sub. DR177) was also supportive, but suggested review after five years to line up with the typical duration of administration and insurance contracts. And REST (sub. DR171), while supportive, suggested criteria should be developed for materiality and 'value for money'.

On the other hand, QIEC Super and Club Super (sub. DR157) strongly disagreed with the proposal, on the grounds that that triennial due diligence would be costly, of little benefit to members and is not required. And Mercer (sub. DR175) suggested that due diligence reporting might prevent the use of longer-term arrangements.

Given the issues identified with related-party arrangements, the Commission maintains its proposal. Due diligence should only be conducted for material activity, and demonstrate that arrangements continue to be in members' best interests.

Conflicts inherent in integration need better management

Best practice governance would require that the trustee boards of *all* super funds avoid conflicts wherever possible, and then manage any unavoidable conflicts of interest that remain. Consistent with this, since 2013 funds have been required under SPS 521 to have a conflicts management framework that 'must provide reasonable assurance that all conflicts are being clearly identified, avoided or prudently managed' (APRA 2013c, p. 4). However, evidence from the FSRC (box 9.2) highlighted many instances in which the financial interests of employees and shareholders of vertically integrated retail groups have been preferred over those of the members of funds run by those groups. As AIST (2018a, p. 15) observed:

The hearings also laid bare a worrying lack of insight among many retail trustees about what it really means to have a fiduciary duty to members. Instead they talked of the need to balance the interests of members against those of the shareholders and related parties, demonstrating ignorance of the law requiring them to put members first ... In the very worst instances, trustees and fund staff had complete disregard for members, regulators and the law.

The evidence uncovered led Counsel Assisting the FSRC (2018b) to ask if structural change of entities with certain structures is desirable.

CLMR (sub. DR141, p. 3) noted that the historical position of the law on conflicts of duty and conflicts of interest is that 'they have to be avoided by all fiduciaries unless specifically excused by the fully informed consent of a legally-competent principal'. Asher (sub. DR151) also noted the prohibition against conflicts, and called for regulation to reduce them.

An extreme option for dealing with conflicts in vertically integrated entities would be to require structural separation. But, as the Commission (2018a) argued in its inquiry into competition in the financial system, integration is not a problem per se. It can deliver benefits through economies of scale and scope; it can act as a competitive check on the market power of unrelated service providers (chapter 7); and consumers might draw utility from engaging with one entity. The Commission argued that 'incentives towards poor behaviour are better dealt with directly, by credibly enforcing standards' (2018a, p. 249). In a similar vein, APRA submitted to the FSRC that, 'with care and diligence on the part of trustees, many potential conflicts of interest can be appropriately mitigated' (2018r, p. 23) — a view echoed by the ANZ:

ANZ acknowledges that potential conflicts of interest can arise for superannuation trustees in vertically integrated structures, such as those involving integration of superannuation trustees with advice businesses, or those involving the investment of funds in insurance policies issued by related party insurers. ANZ considers that those conflicts, or potential conflicts, of interest can be appropriately managed, and that so long as they are, [vertically integrated] structures ... can serve the interests of members. (2018, p. 9)

In the case of super, more needs to be done to better manage conflicts in integrated entities. One response to the misconduct revealed in the retail segment might lie in changes to the regulation of trustees. At a minimum, independent directors should be truly independent (which they are not when they are associated with related parties) — a legislated definition of independence would assist. And measures that would help address conflicts wherever they emerge could be effected through contracting arrangements. Further, more is needed to address the particularly egregious issue of conflicted financial advice (addressed below).

Box 9.2 FSRC revealed many examples of poor conflicts management

Among the many pointers to misconduct or conduct falling below community standards and expectations revealed at the Financial Services Royal Commission were:

- fees levied for no service, fees charged to deceased member accounts, retention of trailing commissions and delays in transferring members to lower fee MySuper products (entities associated with Nulis, Suncorp, Colonial First State, the ANZ, BT Funds Management and Mercer engaged in one or more of these practices)
- a decision not to automatically extend lower pricing for a product to existing members and use of members' money (held in reserves) to compensate members for errors made by the trustee (subsidiaries of IOOF Holdings)
- payment of a tax surplus accrued on members' funds to a related entity, and failure to ensure that services outsourced to a related party were demonstrably in members' best interests (Suncorp)
- insurance premiums levied by a related-party provider that were considerably above industry medians, with no distinction between white and blue collar workers, nor smokers and non smokers (entities associated with Colonial First State)
- branch selling of related-party super products without provision of appropriate (financial) advice to customers (Commonwealth Bank and the ANZ)
- an inability or unwillingness to address the high fees and poor investment underperformance of related-party providers (AMP Limited).

Source: FSRC (2018b).

The definition of an independent director needs attention

In evidence to the FSRC (2018f, p. 4421), Nicole Smith from National Australia Bank observed that 'the more control the trustee has over where and how money gets spent and profit gets made, the better the trustee is able to manage conflicts'. That control would have to

be easier to exercise if independent trustee directors are not permitted to be affiliated with parties related to a fund. To that end, the definition of an independent director needs tightening.

The SIS Act definition relates only to directors in equal representation structures and provides retail funds with considerable latitude.

The definition included in the Financial Services Council (FSC) Governance Policy, a product of industry self-regulation, stipulates that a parent company director cannot be treated as independent on a subsidiary RSE licensee board under any circumstances. However, an independent director on the board of a related entity (but not the parent company board) may be treated as an independent director of the RSE licensee if a ‘no conflicts’ rule is satisfied (that is, if this does not give rise to any real or perceived conflicts or the possibility of such conflicts) (FSC 2013, p. 11).

The Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017 contains a detailed definition (box 9.3) of independence, which would preclude current and recent directors and executive officers of related parties (table 9.1) from sitting on a trustee board as independent directors.

The AICD (sub. DR164), however, argued for a principles-based definition rather than fixed criteria on the grounds that considerations of independence need to go beyond the formal relationships captured in the Bill. Donald (Sydney hearings, trans., p. 101) similarly argued that the definition would permit the appointment of some directors who were not sufficiently independent. The AICD suggested adoption of an amended version of Principle 2 of the ASX corporate governance principles:

An independent director is a director who is free of any interest, position, affiliation, or relationship that could influence, or could reasonably be perceived to influence, in a material respect their capacity to bring an independent judgment to bear on issues before the board and to prioritise the interests of beneficiaries as a whole. (sub. DR164, pp. 5–6)

A principles-based definition has the attraction of covering all potential board appointees, but leaves open the possibility that boards use the lack of prescription to appoint trustees who are not sufficiently independent. And the board discretion inherent in a principles-based approach would complicate monitoring and enforcement for a regulator. The Commission, therefore, prefers a prescriptive approach. Adoption of the definition laid out in the Bill can be achieved by APRA issuing a prudential standard to reduce the scope for conflicted board members. (To allow this, the current definition in the SIS Act would need to be repealed.) Concerns that the coverage of the definition is inadequate could be addressed by APRA retaining discretion to determine that a director was not independent on grounds other than those listed.

Box 9.3 The Strengthening Trustee Arrangements Bill has proposed a more comprehensive definition of independence

(1) A person is **independent** from an RSE licensee of a registrable superannuation entity unless the person:

- (a) if the RSE licensee is a body corporate that has a share capital — has a shareholding interest in 5% or more of the share capital of the RSE licensee; or
- (b) if the RSE licensee is a body corporate — has a shareholding interest in 5% or more of the share capital of a body corporate that is related to the RSE licensee; or
- (c) if the RSE licensee is a body corporate — is, or has been at any time during the preceding 3 years:
 - (i) an executive officer (other than a director) or an employee of the RSE licensee; or
 - (ii) a director or executive officer of a body corporate that is related to the RSE licensee; or
- (d) has, or has had at any time during the preceding 3 years, a business relationship:
 - (i) with the RSE licensee; or
 - (ii) if the RSE licensee is a group of individual trustees — with any of the trustees; that is, or was at the time, material to the person or to the RSE licensee (or trustee); or
- (e) is, or has been at any time during the preceding 3 years:
 - (i) a director or executive officer of a person paragraph (d) applies to; or
 - (ii) a person who, in the capacity of an employee of a person paragraph (d) applies to, is or was involved in the business relationship referred to in that paragraph; or
- (f) if the RSE licensee is a trustee of a regulated superannuation fund — is, or has been at any time during the preceding 3 years, a director or executive officer of:
 - (i) an employer-sponsor of the fund who is a large employer in relation to the fund within the meaning of section 29TB; or
 - (ii) an organisation, representing the interests of one or more employer-sponsors of the fund, that has the right to appoint, or nominate for appointment, directors or trustees of the RSE licensee; or
 - (iii) an organisation, representing the interests of members of the fund, that has the right to appoint, or nominate for appointment, directors or trustees of the RSE licensee;
- (g) is a person to whom circumstances of a kind prescribed by regulations made for the purposes of this paragraph apply.

Source: Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017.

Table 9.1 Who is considered independent under the Strengthening Trustee Arrangements Bill?

<i>Circumstances of proposed director</i>	<i>Considered independent in the Bill?</i>	<i>Considered independent in SIS Act?^a</i>
Board member of the parent company of RSE licensee	No	..
Director or executive officer of a company owned by the RSE licensee's parent company	No	..
Director or executive officer more than 3 years ago of a company owned by the RSE licensee's parent company	Yes	..
On the board of an insurance provider to the RSE licensee	No	Yes
Employee of the RSE licensee where the licensee is a body corporate	No	..
Small shareholding (less than 5% of share capital) in RSE licensee	Yes	..
Larger shareholding (5% or more of share capital) in RSE licensee	No	..
Executive officer of a trade union with right to appoint or nominate board members to an RSE licensee that is fund trustee	No	No
Director of an employer group with right to appoint or nominate board members to an RSE licensee that is fund trustee	No	No
Executive officer of a trade union that does not have the right to appoint or nominate board members to an RSE licensee that is fund trustee	Yes	No
Director of an employer group that does not have the right to appoint or nominate board members to an RSE licensee that is fund trustee	Yes	No
Member of a trade union that has the right to appoint or nominate board members to an RSE licensee that is a fund trustee	Yes	Yes
Had undertaken consultancy work for an RSE in past 3 years	No	Yes
A director of an employer-sponsor of the RSE that is fund trustee	No	No

^a Does not consider whether person is a fund member which is a consideration under the SIS Act. .. Not applicable as SIS Act provisions related only to equal representation funds. Self-regulation applies to retail funds.

Source: Commission analysis.

Conflicts could be better managed through contracts

One proposed way to better manage the conflicts inherent in vertically integrated arrangements would be to extend trustees' best interests duty to all service providers through contract. (In a related vein, Counsel Assisting the FSRC (2018b, p. 221) asked if the duty should be extended to shareholders of trustees and related bodies 'in respect of any conduct that will affect the interests of members of the superannuation fund'.) But this would blur responsibility for the duty — and it needs to steadfastly rest with trustees. Another concern might be that this would open providers up to the risk that a trustee might use members' best interests as grounds for breaking a contract for other commercial reasons.

A better potential option would be for trustees to include a clause in all contracts with providers (of material business activities) that they will not take any action that would work against members' best interests. Combined with more rigorous auditing requirements on funds, this

should help trustees to break contracts where members' interests are being harmed, but without diluting the trustee's ultimate responsibility to act in the best interests of members.

Further effort is needed to address advice conflicts

Despite the Future of Financial Advice (FoFA) reforms, conflicted financial advice remains an egregious problem (chapter 5). Linkages between advisers and retail funds (chapter 7) are one contributor.

In a recent study of vertically integrated financial advice providers, ASIC stated that it:

... strongly support[s] the FOFA reforms and believe they have gone a long way to addressing some of the problems in the financial advice industry. While the FOFA reforms prohibit certain types of conflicts of interest in the financial advice industry (i.e. conflicted remuneration), they allow the conflict of interest that arises from a vertically integrated business model. Importantly, this conflict of interest is addressed through requirements such as the best interests duty and the obligation to prioritise the interests of the client over the interests of the adviser and related parties. (ASIC 2018e, p. 15)

But ASIC also determined that advisers had not demonstrated compliance with the FoFA best interests provisions of the *Corporations Act 2001* (Corporations Act) in 75 per cent of the customer files reviewed through the study. Ten per cent of the files raised particular concerns. Affected customers had, on advice, switched to a new super platform with either inferior insurance arrangements and/or a significant increase in ongoing product fees (without compensating benefits).

And, after considering evidence on the relationship between retail groups, trustees and advisers, Counsel Assisting the FSRC observed that:

It is a fair inference from the evidence that management of most of the retail funds that gave evidence ... are cynical about the extent to which the majority of financial advisers will comply with their best interests duty. It is also a fair inference that this cynicism reflects the informed view of experienced market participants. (2018b, p. 201)

Given that the FoFA reforms are still relatively recent, and that poor practices were heavily entrenched in parts of the financial advice industry, it is likely that a cohort of financial advisers are yet to change their practices to reflect the FoFA requirements.

It is noteworthy — and appropriate — that ASIC is likely to more aggressively pursue what it perceives to be breaches of the FoFA requirements over time as the FoFA reforms become more entrenched. Enforceable undertakings entered into by the Commonwealth Bank (for inappropriate provision of personal advice through branch selling of a super product) and the ANZ (for charges for advice but no service) (ASIC 2018o), are indicative of steps in this direction. Further, a major test case of the FoFA reforms is awaiting judgment (box 9.4).

Removing grandfathered trailing commissions (chapter 3) would minimise the conflicts they promote. And lifting the quality of products across the board via an elevated outcomes test (chapter 10) would remove the risk of a member switching to a persistently poor product.

The proposed creation of a shortlist of ‘best in show’ super products as part of the Commission’s recommendations to improve default arrangements (chapter 12) would further assist regulators in dealing with conflicts of interests. While there would be no requirement for advisers to recommend funds from the shortlist, the list would provide information on quality products that would be suitable for many clients, and put pressure on advisers to clearly justify recommending any product that was not shortlisted.

Box 9.4 ASIC civil action against Westpac

ASIC commenced civil penalty proceedings in the Federal Court in December 2016 against two Westpac subsidiaries (Westpac Securities Administration Limited and BT Funds Management Limited) alleging a number of contraventions, including failures of the ‘best interests duty’ introduced under the Future of Financial Advice reforms.

The proceedings stem from an ASIC investigation into telephone sales campaigns targeting super fund members. ASIC alleges that during the two telephone campaigns, the entities provided personal financial product advice to customers, specifically recommending that customers roll out of their other super funds into their Westpac-related super accounts. ASIC alleges both that the entities provided personal financial product advice not permitted under their Australian Financial Services Licences, and that they did not undertake a proper comparison of the super funds as required by law.

Source: ASIC (2016a).

ASIC has informed the Commission that should a robust, independent best in show list be developed and implemented by government to ensure better outcomes for consumers, it would seek to take this into account in its guidance to financial advisers, particularly around the application of the best interests duty. With regard to financial advisers providing advice to individual clients, ASIC would likely indicate proper research would include consideration of the best in show list, although choice of fund would ultimately depend on an individual client’s circumstances (ASIC, pers. comm., 10 April 2018).

ASIC has also indicated it would see merit in considering policy improvements to mandate advisers to consider a best in show list, although such a requirement would need to be legislated.

Further discussion of advice issues in general and in relation to self-managed super funds (SMSFs) is presented in chapters 5 and 10, respectively.

FINDING 9.2

Contract management processes, along with disclosure and reporting, need much improvement. While vertical integration is not a problem per se, conflicts of interest raised by the use of related parties need to be better managed by trustees and, where left poorly managed, redressed decisively by confident regulators.

A better definition of the term independent director is needed. Trustee directors are not independent if they are affiliated with parties related to a fund.

9.4 Disclosure by many funds needs to improve

Disclosure of (high quality) information is central to effective competition. Members (and their agents) need details about fees, returns, investment strategy, risks and insurance offerings to support switching to products that best fit their needs. Trustees need this information in order to benchmark their offerings and compete effectively with their peers. Regulators and policy makers need data to identify any practices contrary to members' best interests, and any impediments to the system maximising net returns, ensuring appropriate products are available to members and improving outcomes over time.

Disclosure has improved since new requirements took effect in mid-2014. More detail is now available, for example, on trust deeds, board appointment and removal processes, trustee qualifications, remuneration and conflicts of interest policies.

Fund practice in displaying this information, however, is mixed. A large proportion of funds — including most of the larger ones — place it prominently on their websites, or at least under a logical heading. But the same information is effectively 'buried' on a significant minority of websites, with no obvious pathway for members to find it.

Recent ASIC (2017e) work on member experiences identified other areas of poor disclosure, including:

- insurance details such as exclusions and changes to cover
- product dashboards on fund websites
- marketing materials that understated the risks associated with account consolidation while highlighting benefits
- information about claims and dispute resolution processes.

And the FSRC highlighted many examples of poor disclosure — not least to the regulators, but particularly to members — for example, in terms of fees charged, opportunities to move to lower-priced products and the situation relating to the transfers of members' accounts to MySuper products (FSRC 2018b).

In short, funds have a mixed record on disclosure. While they typically meet the letter of their legal obligations, too many have practices that signal a disregard for members. Fund disclosure needs to improve. Dashboards need action (chapter 5), transparency around outsourcing arrangements (chapter 7) has to improve, merger activity merits better reporting (below), and the disclosure gaps bedevilling the data (most chapters) provided to regulators (and, therefore, members and their agents) demand urgent attention. Regulators need to ensure this happens (chapters 10 and 13).

9.5 Investment governance is not sufficiently robust

‘Peer-risk’ appears alive and well

It is often argued that regardless of what trustees consider to be the fund’s best long-term investment strategy, many will mimic (at least to some degree) the strategy of rival funds (sometimes referred to as ‘herd behaviour’), fearing that they will otherwise perform relatively poorly in the short term and therefore lose members. These effects are likely to be particularly marked when asset prices are growing strongly and trustees ‘going against the trend’ could see short-term results well below those of rival funds.

Funds employing such strategies, however, are likely to record lower *long-term* returns than they might have (hence the term ‘peer risk’). Investment is distorted away from assets likely to produce the best long-term returns, and more frequent trading (higher transactions costs), occurs as funds try to stick with the herd.

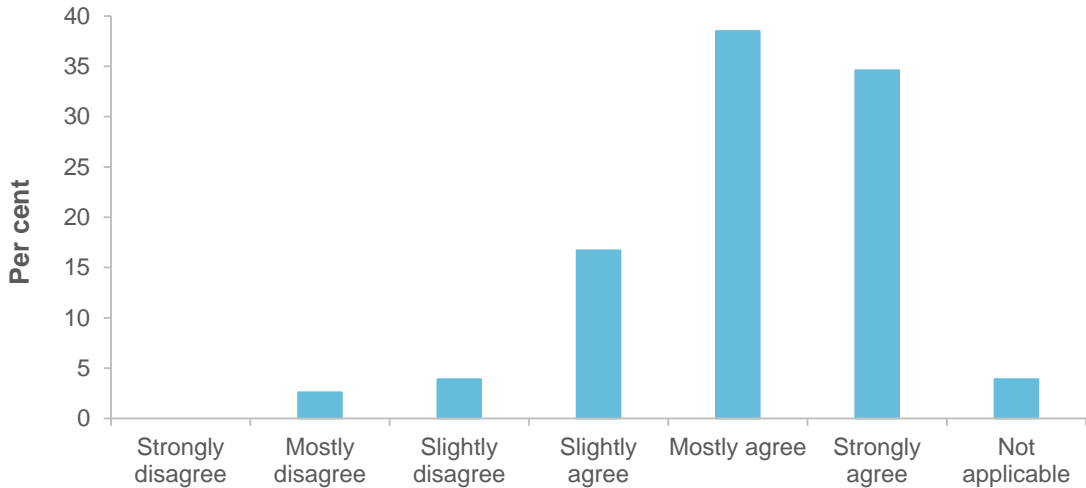
The evidence points to some degree of clustering in funds’ asset allocations. Much of this likely stems from funds ‘following the leader’ with regard to investment strategies (such as investing in unlisted infrastructure) that are perceived to have been successful. Adoption of similar investment strategies for many members in accumulation is unsurprising. And, as long as these strategies deliver strong long-term net returns, members are not necessarily worse off.

However, the wide range of responses to the question on peer risk in the Commission’s governance survey indicates that peer performance is a consideration in the investment strategy of a significant number of funds. Only 35 per cent of CEOs (representing around 30 per cent of assets and member accounts in the system) strongly agreed that ‘my board’s investment strategy is not materially influenced by the performance of peer funds’ (figure 9.2). Funds that only slightly agreed or disagreed with this statement tended to be relatively small. An element of clustering to avoid being a poorly performing outlier in the short term likely exists — with this outcome more typical among smaller funds. Coupled with evidence ‘that remuneration and performance measurement systems are creating a short-term focus’ (Sheedy and Jepsen, sub. DR108, p. 3), the evidence suggests that biases towards short-termism are likely crimping some members’ long-term returns.

Implementation of a best in show shortlist, with the associated scrutiny of funds’ long-term investment strategies (chapter 12), along with elevated outcomes tests (chapter 10) and more pressure on subscale funds to merge will help to mitigate any adverse effects of peer risk. Likewise, these changes would reduce the possibility of maverick (excessive) risk — funds moving from prudent to maverick levels of risk in the hope this lifts their realised investment performance — raised by Due Governance (sub. DR160).

Figure 9.2 Investment strategies in some boards are influenced by the performance of peers^a

Responses to survey question: My board’s investment strategy is not materially influenced by the performance of peer funds



^a Disagrees and slightly agrees represented around 15 per cent of assets and member accounts in the system.

Source: Governance survey.

FINDING 9.3

Many funds mimic (at least to some degree) the investment strategy of rival funds for fear they will otherwise exhibit poor short-term performance relative to their peers (‘peer risk’). This short-termism is likely to be at the expense of long-term returns to members.

Performance attribution — a must have for all trustees

Ongoing performance attribution is critical to funds understanding and improving their performance. In substance, it is the ultimate outcomes test for a trustee board to ask and answer robustly — are we, over time, ‘adding value’ above and beyond a market index return? A trustee board ought to satisfy itself (to retain the right to continue to take contributions and be the trusted guardian for their members) not simply by processes and

good intent, but in terms of delivered investment performance outcomes for members. Ideally, such attribution would be also assessed independently of the fund.

In its draft report, the Commission was critical of funds' inability to provide data on net returns by asset class, given a large majority of CEOs claimed their boards regularly assess and fully understand the attribution of investment performance outcomes (including by asset class). The FSC responded:

The FSC's members indicate they analyse investment performance outcomes of individual options, including by asset class, and this is how they responded to the governance survey. The survey did not explicitly ask about performance by asset class at a fund level, and FSC members (broadly) did not interpret the question this way. (sub. DR186, p. 22)

As the SIS Act (s. 52(6)(b)) requires funds to 'exercise due diligence in developing, offering and reviewing regularly each investment option', the Commission accepts that some funds would find it difficult to provide data on net returns by asset class at a fund level.

But this does not mean that all is well. Given the centrality of net returns to retirement incomes, it is not reassuring that only 53 per cent of CEO respondents to the Commission's governance survey *strongly* agreed that their board regularly assesses and fully understands the attribution of investment performance outcomes — particularly given the bias towards optimism in the survey results. Likewise, the long tail of options underperforming their performance benchmarks (chapter 2) suggests a lack of diligence in some review processes.

Moreover, the Commission's second funds survey revealed a concerning attitude on the part of retail funds towards choice members using platforms and wrap accounts. Funds did not provide performance data for these investments on the grounds that they reflected the choices of members, guided by financial advisers. Trustees appear to have 'outsourced' their best interests duty in this space to advisers. Apart from running contrary to funds' obligations under the SIS Act, evidence from the FSRC on funds' preferencing of advisers' interests over members' suggests this strategy has not played out well for choice members. Recommendations to improve outcomes in the choice segment are advanced in chapter 13.

FINDING 9.4

Robust and independently assessed performance attribution is needed for a trustee board to satisfy itself that it has acted in members' best interests. But trustees have considerable room for improvement in the use of performance attribution. Indeed, some even appear to have 'outsourced' their best interests duty for members using platforms and wrap accounts to financial advisers and product providers.

9.6 More is needed to encourage beneficial mergers

While mergers have been plentiful, more should have happened

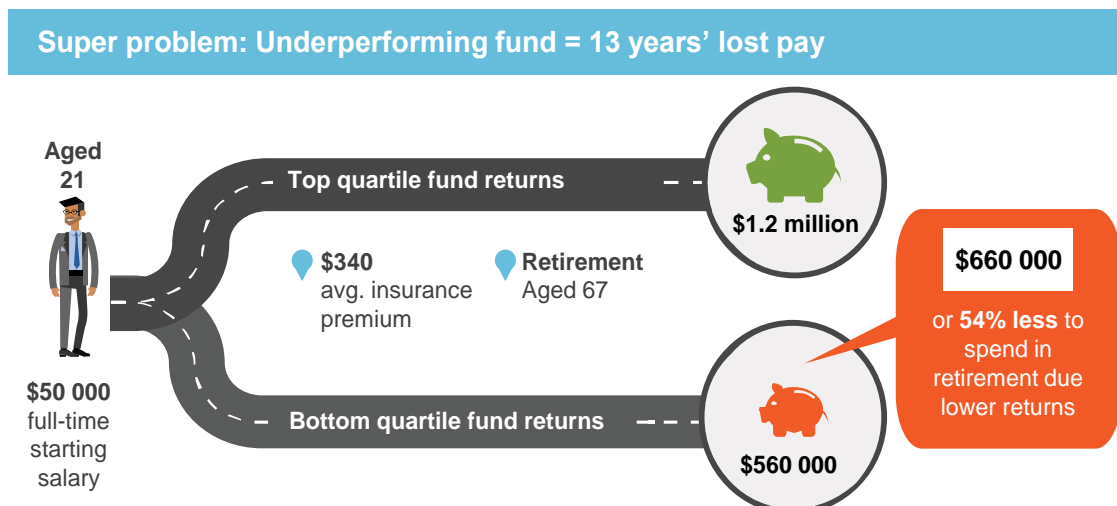
Consolidation saw the number of APRA-regulated funds fall markedly over the past decade (chapter 7). Most of this activity stemmed from the decline in the number of corporate funds (an inevitability with the move away from defined benefit arrangements). It is clear, however, given the economies of scale in super, that members would benefit from an increase in merger activity, particularly among the large pool (some 93) of funds with less than \$1 billion in assets (chapter 7).

Moreover, the industry contains funds that display consistently inferior performance (chapter 2). APRA has noted the problems confronting poorly performing funds:

APRA's ongoing supervision has identified some RSE licensees that appear not to be consistently delivering quality member outcomes, leading APRA to question whether these RSE licensee's business operations are appropriately positioned for future effectiveness and sustainability in an increasingly competitive industry environment. (Rowell 2017a, p. 1)

As the Commission's cameo modelling (chapter 1) illustrates, membership of an underperforming fund can impose large costs — a typical full-time worker who spends their working life contributing to the median bottom-quartile fund on investment performance, for example, is projected to retire with a balance 53 per cent (or \$635 000) lower than if they were in the median top-quartile fund (cameo 9.1).

Cameo 9.1 Underperforming funds drain retirement balances^a



^a The assumptions underpinning this cameo are set out in chapter 1.

The proposed outcomes test, especially if elevated and extended to choice products (chapter 10), in tandem with greater competition for the default market as recommended by

the Commission through best in show (chapter 12), should assist in bringing about rationalisation. New powers for APRA (chapter 10) would also help. As APRA noted, they have:

... limited regulatory capacity to influence the merger decision between RSE licensees. The proposed legislative directions powers would allow APRA to respond in a targeted way where one or more RSE licensees decides not to proceed with a merger which would clearly be in the interests of members. (APRA, sub. DR204, p. 14)

But the evidence gives rise to the question — why have there not been more mergers?

BT Financial Group's view suggests the answer lies, at least in part, in trustee self-interest. It noted:

... a number of instances in the past few years of trustee board directors (and their sponsoring bodies) having an incentive to avoid mergers that would force them to relinquish their position on the merged fund's board, which may have resulted in the merger not proceeding, regardless of whether or not the merger would be in the best interests of the members. (sub. 32, p. 7)

The Australian Council of Trade Unions (ACTU) took a different view, stating it was:

... unaware of any circumstance in which a trustee or a sponsoring organisation has opposed a merger because that merger would have led to a loss of a position or a level of representation. The ACTU would be pleased to respond to specific cases and would welcome the opportunity to provide the Commission with a factual account of events around failed mergers so that we can avoid further unsubstantiated, vague assertions. (stage 2, sub. DR71, p. 8)

Evidence to the FSRC (2018b) clearly reveals the role of board composition decisions in scuppered merger discussions. Energy Super and AUSCOAL talks ended because AUSCOAL wanted 60 per cent of positions on the new board, along with the inaugural Chair and CEO roles (FSRC 2018a). Energy Super and Equisuper talks foundered because Equip's employer directors opposed a dilution of their shareholding status, and Equip would not agree to Energy Super's demand for an ongoing role for union-nominated directors — despite KPMG advice about the advantages a merger would confer on members. And board composition was the sticking point in merger discussions between Catholic Super and Australian Catholic Super — despite Rice Warner advice that merging would create considerable strategic advantages and enable enriched service provision with lower cost.

However, there have been success stories, such as the 2011 merger between AustralianSuper and Westscheme (box 9.5). More recently, the merger between Equisuper and the Rio Tinto Staff Superannuation fund has reportedly resulted in larger savings than anticipated, and therefore larger fee reductions for members (Equisuper 2018), and significant cost savings and fee reductions have reportedly also stemmed from the merger between Sunsuper and Kinetic Super (Sunsuper 2018).

Box 9.5 **AustralianSuper and Westscheme merger — a best practice exemplar**

The 2011 merger between AustralianSuper and Westscheme, described in the media at the time as ‘a surprise to many within Australia’s super industry’ (Taylor 2011, p. 10), is viewed by many industry participants as an example of best practice in fund merger procedures.

The Chief Executive of Westscheme noted at the time of the merger — following shortly after the Cooper Review and a renewed government push to promote fund mergers — that it had become challenging for the fund to deliver services in a cost-effective manner and that this prospect was unlikely to change. Westscheme had \$3.4 billion in assets under management and 200 000 member accounts. Scale issues did not represent the predominant driver of the merger.

Significantly, 35 per cent of Westscheme’s member base was inactive (that is, not making contributions) and the government was looking to minimise the number of inactive accounts across the system. Westscheme faced the prospect of spreading its costs across 130 000 members instead of 200 000 (Taylor 2011). An independent report was sought from PwC (reflecting the Board’s recognition of an inevitable conflict in considering the merger had it not sought independent advice). Although the fund’s viability was not compromised, a merger with AustralianSuper was seen as strongly in the long-term best interests of members. Merger with a smaller fund, which might have raised the possibility of further subsequent mergers, and member transfers, was ruled out. Westscheme approached AustralianSuper with the merger proposal.

The timing of the merger (30 June 2011) was also cognisant of the deadline for tax relief on successor fund transfers — reportedly a major issue for Westscheme given parts of its investment portfolio had suffered significant write-downs following the global financial crisis.

The merger did not involve any insistence of Westscheme board members being transferred to the AustralianSuper board.

Sources: Investment Magazine (2011); Investor Daily (2011); Taylor (2011).

There is a lack of transparency about mergers that do not proceed

The stage 2 draft report noted that there is a general lack of transparency for both members and APRA in situations where a fund is approached regarding a merger, but the merger does not go ahead — in stark contrast to the extensive information provision requirements for listed companies (at all stages of the merger process) under Part 6.5 of the Corporations Act. The Commission proposed that trustees be required to disclose all merger approaches, and the reasons for any subsequent decisions, to both their members and APRA.

A number of participants supported introducing a framework incorporating greater transparency around merger proposals. But a number (for example, PwC, stage 2, sub. DR85; Sunsuper, sub. DR197) suggested that requiring funds to disclose all merger approaches could discourage early approaches and, by extension, prove counterproductive. BT Financial Group suggested the trigger for disclosure could be at the memorandum of understanding stage:

... the requirement to disclose merger negotiations to APRA could be established so that it only takes effect once a certain point is reached, such as when a Memorandum of Understanding (MOU) is agreed between the parties. (sub. 32, p. 8)

The Commission refined its proposal from the stage 2 draft report and in the stage 3 draft proposed a framework involving disclosure to APRA (at the time) of all merger attempts that reach a memorandum of understanding between two funds. Reporting should include disclosure of why any mergers failed to proceed, and an assessment of whether the merger would have been in the interests of members. This framework should provide APRA with increased information to promote mergers, and encourage the regulator to be more proactive in promoting mergers that would be in the best interests of members.

Because members' best interests have not always represented the predominant concern of trustees during merger discussions, ASIC should proactively investigate questionable cases where mergers between super funds have stalled or did not proceed. This investigation should include examination of trustee attitudes to mergers and the reasons mergers did not proceed. Where APRA has concerns about the motivations for a merger not proceeding, it should refer those concerns to ASIC for further inquiry.

Many participants supported this proposal (including FSC, sub. DR186; ISA, sub. DR162; and Sunsuper, sub. DR197). IOOF noted that:

... [a]rming APRA with more information about potential barriers for consolidating funds, particularly in relation to smaller funds, can help develop future prudential guidance and encourage efficiency within the superannuation system. (sub. DR138, p. 5)

But some expressed concerns that a requirement to report would stifle activity. The AICD, for example, responded that:

... [w]e are concerned that funds may hesitate to enter a memorandum of understanding, out of concern at having to explain a later withdrawal, even where all decisions have been taken with the interests of members as the primary driver. (sub. DR164, p. 4)

And suggested a review of the reporting requirement within two years to check it operates as intended. AustralianSuper, on the other hand, 'do not believe that elevating the level of disclosure will create a material risk of discouraging merger activity' (sub. 43, p. 21).

It would be an unprofessional trustee board that hesitated to sign an MoU on the grounds that later withdrawal might prompt an uncomfortable conversation with the regulator. And the related lack of board capability would likely be visible to regulators in other ways. As PwC (sub. DR129) noted, the Commission's draft report recommendations would prompt greater merger activity. They should also promote more professional governance, and more confident regulatory action against underperforming funds. And, as APRA noted, it is:

... likely that the onus of having to more formally disclose information pertaining to a failed merger attempt may also serve to dissuade RSE licensees from choosing not to proceed with a merger that would clearly benefit members. (sub. DR204, p. 15)

The Commission maintains its draft report position on the reporting of mergers to APRA.

PwC also argued that a regulator should be empowered to prevent mergers that were not in members' best interests:

... [f]or example, one unsustainable underperforming superannuation fund merging with another unsustainable underperforming superannuation fund to create a new unsustainable underperforming superannuation fund involves unacceptable and wasted costs to the members of both these funds. (sub. DR129, p. 4)

And for guidance to funds that the assessment of potential benefits from a merger should include the need for at least one expert assessment of likely impacts from a member perspective. Both suggestions have strong merit.

ASIC (sub. DR206) noted that it lacks powers under the SIS Act to pursue action against directors in the event of failed mergers because APRA has administration of s. 52A (the covenant relating to directors). This should be rectified. The Commission also supports the introduction of penalties for directors who contravene s. 52A, as proposed in the draft Treasury Laws Amendment (Improving Accountability and Member Outcomes No. 1) Bill 2017. This would help to dissuade director misconduct around mergers.

Impediments to mergers exist but are often overstated

Participants raised a number of impediments to mergers (for example, successor transfer rules and tax considerations). But APRA stated that it does not consider that legislative or regulatory settings create any material barriers to mergers:

In APRA's experience, there are a range of other factors, such as differing philosophies behind an RSE licensee's approach to board composition, views of shareholders and differences in strategy and business model, that are more likely to have contributed to some proposed mergers not proceeding. (sub. 89, p. 1)

Industry concerns about successor fund transfers (particularly requirements to ensure no fund members are disadvantaged) have been addressed by guidance from APRA (2017c).

This guidance provides clarity around the operation of the 'equivalence' test in a way that should facilitate future merger activity from the perspectives of both exiting and receiving funds. (AIST, sub. 39, p. 30)

But capital gains tax (CGT) issues will be an impediment in the absence of permanent relief:

With respect to CGT rollover relief, ASFA welcomes the government's decision (in the 2017-18 Budget) to extend CGT relief on fund mergers (until July 1, 2020). However, ASFA considers that relief should be made permanent. (ASFA, sub. 47, p. 24)

AustralianSuper (sub. 43) proposed a number of measures to facilitate mergers, including indefinite extension of CGT relief and annual APRA reporting to the Council of Financial Regulators about application of the scale/outcomes test for MySuper products.

Further, while the current equivalent rights test is manageable for voluntary mergers, it may inhibit prompt movement of members in the event of a product being closed. A relaxed equivalent rights test may be suitable in situations where a products fails an outcomes test and a fund cannot remediate — as discussed below.

Three measures would facilitate mergers and regulator accountability

Permanent Capital Gains Tax relief

Loss relief and asset roll-over provisions that provide relief from CGT were introduced to help the super industry cope with the severe economic and financial market conditions in late 2008, and initially applied for transfer events between 24 December 2008 and 1 October 2011 (Treasury 2012).

The provisions were extended (with some modifications) in 2012 to facilitate the mergers anticipated to flow from the introduction of the Stronger Super reforms. As Treasury noted:

Tax considerations are a major impediment to mergers as trustees of superannuation funds must consider the adverse tax impacts on members' accounts. Although a merger may be in the long-term interest of members, the effect on members' account balances may preclude this from happening. (Treasury 2012, p. 5)

And a further extension to 2020 was announced in the 2017-18 budget.

The arguments for extending CGT relief in 2012 were strong and apply equally today. CGT relief in the event of mergers should be made permanent.

Annual reporting by APRA to the Council of Financial Regulators

Effective application of the scale test (or the outcomes test if that becomes law) should give some funds cause to consider whether a merger would be in their members' best interests. The large number of sub-\$1 billion funds (with 1.7 million member accounts) remaining in the system suggests that the scale test has not been applied as rigorously as it might have been. APRA has a clear role in facilitating and encouraging mergers. As part of its role in promoting consolidations, APRA should report annually to the Council of Financial Regulators about how funds are progressing with implementation of the scale (and outcomes) test, the extent to which the tests are bringing about fund mergers and APRA's progress in supervising and enforcing mergers that are not proceeding when they should be. ASIC should report on enforcement action against directors who breach their duties by not pursuing a merger when it would be in their members' best interests.

A simpler equivalent rights test in limited circumstances

Funds considering a merger are expected to undertake a thorough assessment of members' rights in both the transferring and receiving funds (APRA 2017c) — a process involving significant time and effort. Elevated outcomes tests (chapter 10) could result in APRA revoking a funds' MySuper authorisation or directing that a choice option is withdrawn, and then having to find a recipient fund for affected members. To expedite movement of members in this situation, a simpler, short-form test focused only on product features should be adopted, provided APRA has determined that the transfer is, on balance, likely to be in the best long-term interests of both the affected members *and* members in the receiving fund. To avoid insurance being an impediment, the process could require that members receive broadly equivalent cover that reflects pre-existing conditions with current underwriting limitations, but that terms and conditions and premiums could be different. This short-form approach would have the benefit of reducing costs for members of both funds.

9.7 Some trustee expenditure is misdirected

Expenditure by funds of members' balances sheds light on how well they are acting in members' interests. The Commission has focused on advertising and employer inducements.

Advertising to build market share can benefit members

Participants raised concerns that fund advertising is not always consistent with a focus on members' best interests.

Advertising is one of the major tools (together with mergers) that funds can use to build scale, and members stand to benefit from the associated economies — provided they are realised, passed through and the fund is a good performer over time. Current levels of advertising aimed at attracting members, therefore, do not warrant a specific regulatory response. And an elevated outcomes test (chapter 10) would help to ensure that advertising was focused on potential scale benefits, and that these were passed on to members.

Advertising of a political nature can be more problematic, particularly if it is not directly focused on gaining new (or retaining existing) members. Many have questioned, for example, whether the 'fox in the hen house' advertisements run by Industry Super Australia were consistent with a 'members first' focus. Not least, the FSRC (2018b) examined AustralianSuper's contribution to this campaign and concluded that the fund's actions did not constitute misconduct or fall below community standards. Submissions to the FSRC reveal the diversity of opinion on political advertising. For example, the ANZ (2018, p. 1):

... considers that it is inappropriate and inconsistent with s. 62 of the SIS Act for member funds to be used by trustees to engage in political advertising. OPC and Oasis do not use member funds to engage in political advertising. It would be appropriate for the SIS Act to be amended to make clear that member funds cannot be used for political advertising.

Whereas AIST (2018a, p. 3) argued that:

Political advertising informs members and the community more broadly, about the benefits of belonging to a profit-to-member superannuation fund and the risks of proposals to change aspects of the existing system that protect members. This is a legitimate way for profit-to-member funds to participate in the public and political debate about proposed changes to the system, consistent with the sector's responsibility to protect and improve the system ... Such advertising is a valid form of advocacy and should continue to be permitted.

The Commission does not support a blanket prohibition on political advertising (this would be hard to define precisely, and only be justified if such advertising could never be in the interests of members), but ASIC, as the predominant conduct regulator (chapter 10), should monitor such campaigns to ensure that the interests of members are protected.

Participants also raised issues relating to sporting sponsorships, news websites, and provision of travel and commercial deals with sponsoring entities. But the available evidence does not suggest that these issues are of a material nature or that such expenditure is necessarily inconsistent with members' interests.

New requirements for funds to report management and operating expenditure on a 'look through' basis (APRA 2017g) would provide greater insight into advertising. Such expenditure should be an ongoing focus for ASIC to ensure trustees always prioritise the interests of members. At a minimum, when the new APRA standard SPS 515 (APRA 2018u) takes effect from 1 January 2020, ASIC should readily be able to request and sight evidence of both board decision making relating to such expenditures and monitoring against expected outcomes.

Inducements to employers must stop immediately

Over the course of 2017, ASIC surveyed 46 funds about whether they have provided benefits to employers involved in making default fund choices for employees. This work found that:

- 80 per cent of surveyed trustees had provided advice to employers
- 77 per cent had provided product disclosure to employers beyond just a product disclosure statement
- 33 per cent had provided free educational materials to employers, while 24 per cent had provided free tickets to sporting events or corporate hospitality (sub. 90).

Evidence presented to the FSRC about Hostplus's spending on corporate hospitality (box 9.1):

... suggests that, at least to some extent, employers choose a default fund based on relationships with executives and employees of superannuation funds and are influenced by inducements or experiences offered to them, including by way of corporate hospitality. ... [the] evidence suggests that performance of the fund, net benefits to members, and other product features are subsidiary considerations for employers in selecting a default fund, if they are considered at all. (FSRC 2018b, p. 91)

Section 68A of the SIS Act prevents funds offering benefits to an employer on the condition that their employees will join a fund. Hostplus argued its actions did not contravene s. 68A because the hospitality was not offered on a conditional basis. In light of this evidence, the FSRC (2018b) asked if s. 68A should be rewritten to prohibit inducements. ASIC (2018l) concluded that it should. Some other FSRC participants were of a similar mind. For example, AMP (2018, pp. 4–5):

... believes that it is necessary to make changes to s. 68A of the SIS Act as we strongly believe the prohibition on providing inducements to employers should be strengthened. ... The prohibition should include a ban on all entertainment and gifts, in addition to the incentives, discounts, allowances, rebates or credits that are currently banned under s. 68A of the SIS Act. Employers and tender consultants should only be invited by the Trustee or related party of the Trustee to events on the basis of education, business improvement and/or improved member outcomes for the employer and their employees in relation to their superannuation accounts.

On the other hand, Colonial First State Investments Limited and Avanteos (2018, p. 10) submitted that:

While there may be some issues with the application of section 68A, CFSIL generally considers that section 68A works well in the current context. Accordingly, it does not advocate for any amendment to the provision. Further, conduct covered by the prohibition, or more particularly the expense underlying the conduct, should already be regulated by application of the trustee's existing statutory and general law obligations.

The alternative approach of imposing an obligation on employers to act in the best interests of employees is infeasible — those interests will vary and employers cannot know what they are.

For as long as employers remain involved in default selection, therefore, fund trustees should be obliged to ensure that inducements are not offered in the first place. Funds should not feel a need to offer hospitality to prevent employers from making poor fund choices. The law already prohibits inducements and amendments suggested by ASIC (2018l), and supported by APRA (2018r), would strengthen its application. However, that should only be an interim solution. The only wholly effective way of dealing with employer inducements (and principal–agent issues involving employers more generally) is to remove employers from the process of selecting super products for employees. This is discussed further in chapter 12.

FINDING 9.5

Benefits provided to employers by some funds unduly influence some employers' choice of default fund.

9.8 Overall conclusions on fund governance

There have been material advances in fund governance in recent years, in large part due to improvements in the regulatory environment (chapter 10), but, as Richard Wilkins observed:

Fund governance has not kept pace with the strong growth of the sector, and is behind that regarded as normal in the listed company sector, and well short of best practice. (sub. DR169, p. 5)

Considerable room for improvement remains. Funds clearly do not always act in their members' best interests. In particular:

- not all funds employ satisfactory practices for appointing adequately skilled and qualified board members, and it appears that some sponsoring entities do not take this process seriously
- many 'independent' retail fund board members are on a number of related-party boards, which raises, at the least, perceptions of conflicts of interest
- there is inadequate independent assessment of board performance and capability at some funds
- not all funds have adequate practices in place to deal with related-party transactions
- conflicts of interest, particularly in vertically integrated entities, need better management
- some funds have poor disclosure practices, and while regulatory requirements regarding the information that must be displayed on websites are met, many funds make such information difficult to find
- many funds acknowledge that they are at least somewhat focused on the performance of their peers — biases towards short-termism are likely crimping members' long-term returns
- some funds have considerable room for improvement on performance attribution
- many funds have failed to merge when it appears likely mergers would have been in the best interests of members
- benefits provided to employers by funds unduly influence employers' choice of default fund.

This catalogue is surprising and disconcerting, given trustees' duty to act in members' best interests. Perhaps trustees are not clear about what is expected of them. Levy (2015, p. 1) argued that:

Superannuation fund trustees and their lawyers ... have been grappling for years with what the covenant in section 52(2)(c) of ... the SIS Act means.

And Moshinsky (2018) commented on the limited case law, despite the best interests duty having existed in one form or another for a considerable period. The current duty entered the SIS Act through the Superannuation Legislation Amendment (Trustee Obligations and

Prudential Standards) Bill 2012 (Cth), but the second reading speech provided no definition of the term.

Given the apparent confusion, and lack of case law, the Australian Government should pursue a clearer definition of members' best interests that reflects the twin principles that a trustee should act in a manner consistent with what an informed member might reasonably expect and that this must be manifest in member outcomes. The Government could do this by pursuing legislative change, issuing greater regulatory guidance, and/or having the regulator proactively test the law.

FINDING 9.6

Considerable evidence of trustees acting in ways that are inconsistent with members' best interests suggests that trustees and regulators adopt a broad and at times inappropriate interpretation of members' best interests.

The catalogue also points to a 'tick and flick' attitude towards governance, and a lack of pressure on funds to strive to deliver for members, both from competition and regulators.

Chapter 13 discusses the Commission's recommendations for improving fund governance.

10 System governance

Key points

- Governance of the superannuation system is still evolving. The ‘Stronger Super’ reforms have better equipped regulators to influence governance outcomes and have improved governance standards from a low base. But considerable room for improvement remains, and examples of poor outcomes for members abound.
- More recent policy improvements (both implemented and proposed) should further advance outcomes for members. The MySuper scale test has proven inadequate in protecting default members from poorly performing funds. The proposed MySuper outcomes test (a good first step) should better enable APRA to de-authorise poorly performing products and better promote fund consolidation. But the test needs to be strengthened, extended to choice and then fully and transparently enforced by APRA. Introducing (as proposed) civil and criminal penalties for trustee directors, and giving APRA more power to deal with ownership changes of funds, are policy ‘must haves’ to better protect members.
- Conduct regulation arrangements for the superannuation system are confusing and opaque, with significant overlap and no clear delineation between the roles of APRA and ASIC. This has reduced regulator accountability and, as highlighted by the hearings of the Financial Services Royal Commission, strategic conduct regulation (especially with deterrence intent) has been ‘missing in action’ or ‘too little too late’. Strategic conduct regulation has also been hampered by the absence of quality data and its meaningful analysis by the regulators.
- Superannuation is a distinct market — created by government compulsion and where investment risk resides with the member. Regulation therefore needs to be seen and conducted through the lens of member outcomes. Despite this APRA as the ‘lead’ superannuation regulator steadfastly regulates through a prudential lens — when superannuation is not a market characterised by prudential risk nor one of caveat emptor for most members.
- APRA and ASIC’s respective roles need to be more clearly delineated and better aligned with their distinct ‘regulatory DNA’.
 - APRA should be focused on matters relating to licensing and authorisation — ensuring high standards of system and fund performance — and held accountable by Government for outcomes in these areas
 - ASIC should be focused on the behaviour of players in the system — the conduct of trustees, advisers the appropriateness of products (including for particular target markets) and disclosure — and be held accountable by Government for outcomes in these areas.
- Regulators also need to be more confident and member-focused — becoming ‘member champions’. The absence of quality data and analysis by regulators requires immediate redress. The role of regulators is ultimately to protect member interests, but the absence of a ‘member voice’ in the many and major industry debates means the interests of funds more often than not dominate. A new (government-funded) organisation to understand, promote and give voice to member interests is urgently needed.
- Poor and incomparable data also constrain members — or their agents — from ascertaining the most suitable products for their needs. The relative wealth of information on MySuper products for default members is in stark contrast to the dearth of information on choice products.

Chapter 9 focused on governance within funds. This chapter focuses on system governance and, in particular, the role of regulators. The chapter also provides evidence on the following criteria.

- Are principal–agent problems being minimised? (E8)
- Are there material systemic risks in the superannuation system? (E10)

10.1 System governance is a work in progress

The maturation and growing importance of the superannuation system have prompted many re-evaluations of governance and regulatory arrangements, with a number of significant policy changes over the past 30 years (figure 10.1).

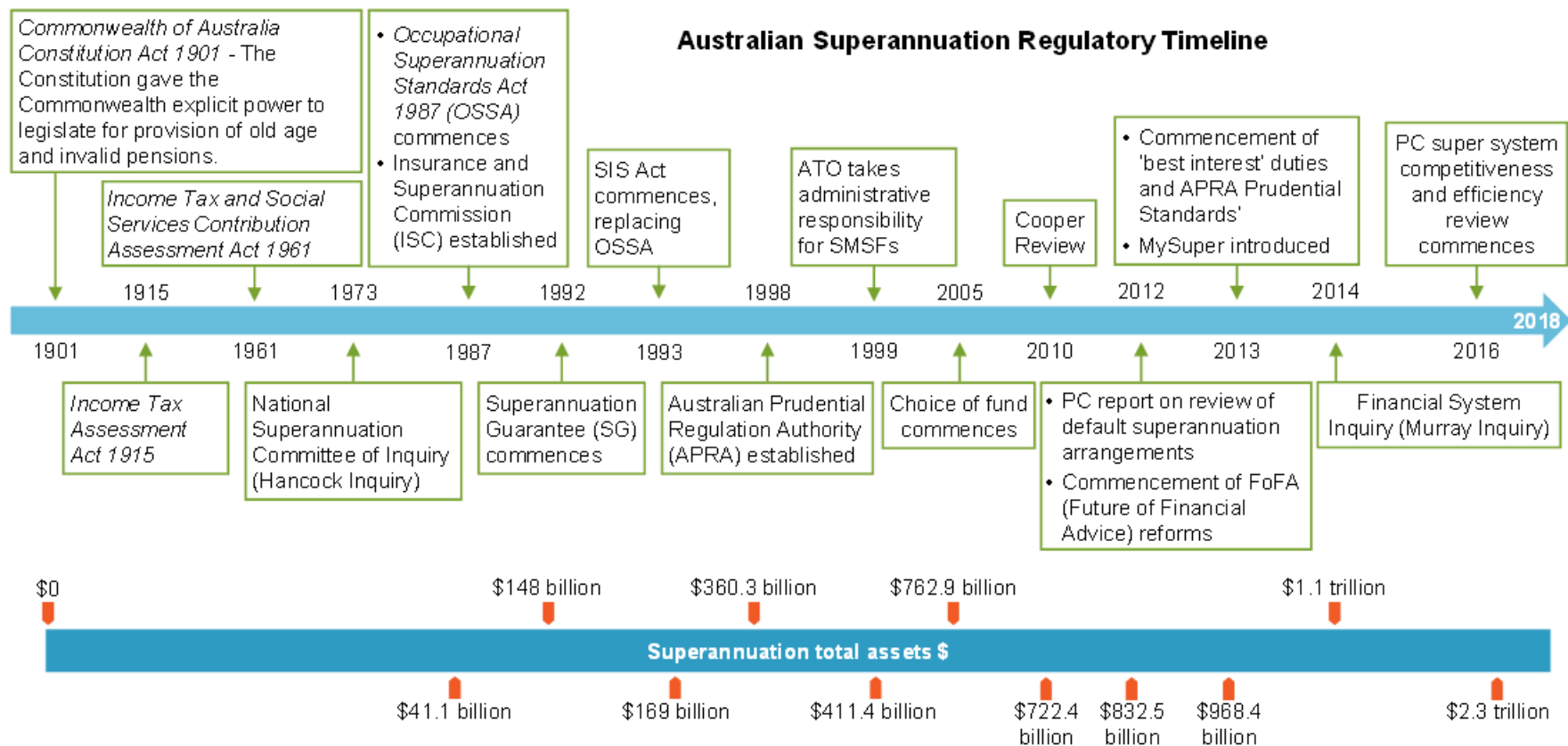
Prior to 1987, regulation was reliant on taxation law. By the 1980s, with superannuation more widespread in the workforce, it became apparent that the *Income Tax Assessment Act 1915* (Cth) provisions were inadequate. Members had no ownership of their balances, nor adequate protection against them being diverted to other purposes by employers.

The *Occupational Superannuation Standards Act 1987* (Cth) (OSS Act) represented the first major attempt at improving regulation. ‘Superannuation’ and ‘fund’ were defined, and the Act incorporated the sole purpose test — that a fund be maintained solely for the purpose of providing benefits to employees in their retirement. The OSS Act also introduced measures allowing members to take ownership of their benefits and change jobs without losing them, and established a new body, the Insurance and Superannuation Commission (ISC), to supervise the industry. However, the Act lacked penalty provisions for trustees.

The *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act) — still the major regulatory instrument for superannuation — commenced on 1 July 1994 and provided for the prudential management of funds. The SIS Act introduced penalty provisions, and empowered the regulator to disqualify and remove trustees. Eligibility requirements for trustees were introduced, and covenants were specified that trustees had to abide by. In July 1998, the Australian Prudential Regulation Authority (APRA) replaced the ISC, and in 2004, licensing of trustees (excluding SMSF trustees) commenced, and funds had to register with APRA (Cleary 2010).

However, the regulatory regime still had areas of weakness. While a wide-ranging review in 2010 (Cooper et al. 2010b) found no evidence of systematic governance failure, it identified a number of areas for improvement. Issues relating to conflicts of interest and duty were especially problematic. In particular, there was concern that trustees were often unclear about whether their main duty was to their employer or to fund members.

Figure 10.1 Superannuation regulation has evolved considerably, particularly in recent years



Sources: APRA Annual Reports (various); Commission analysis; Swoboda (2014).

Governance reforms implemented in response to the Cooper Review included:

- a duty for trustees and directors to give priority to the interests of fund members when that duty conflicts with other duties
- expansion of the covenants to which APRA-regulated fund trustees must have regard including expected costs and expected taxation consequences
- an increase in the standard of care, skill and diligence required of trustees and directors of trustees to that of a ‘prudent superannuation trustee’ (PC 2012).

In addition, APRA was given the power to develop ‘prudential standards’ for super funds, and responsibility for authorisation of MySuper products and enforcement of the scale test.

On balance, these ‘Stronger Super’ reforms represented improvements to governance, although they further blurred the lines of responsibility of APRA and the Australian Securities and Investments Commission (ASIC) in regulating conduct in the superannuation industry. (The immediate imperative to better clarify those roles is discussed later in the chapter.) And, to the extent that the reforms increased transparency, raised the standard of performance reporting and encouraged the development of products such as MySuper, they have also highlighted the need for further governance reform.

Further, the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Financial Services Royal Commission (FSRC)) identified a number of concerns relating to both APRA and ASIC’s regulatory responsibilities that are discussed throughout the chapter.

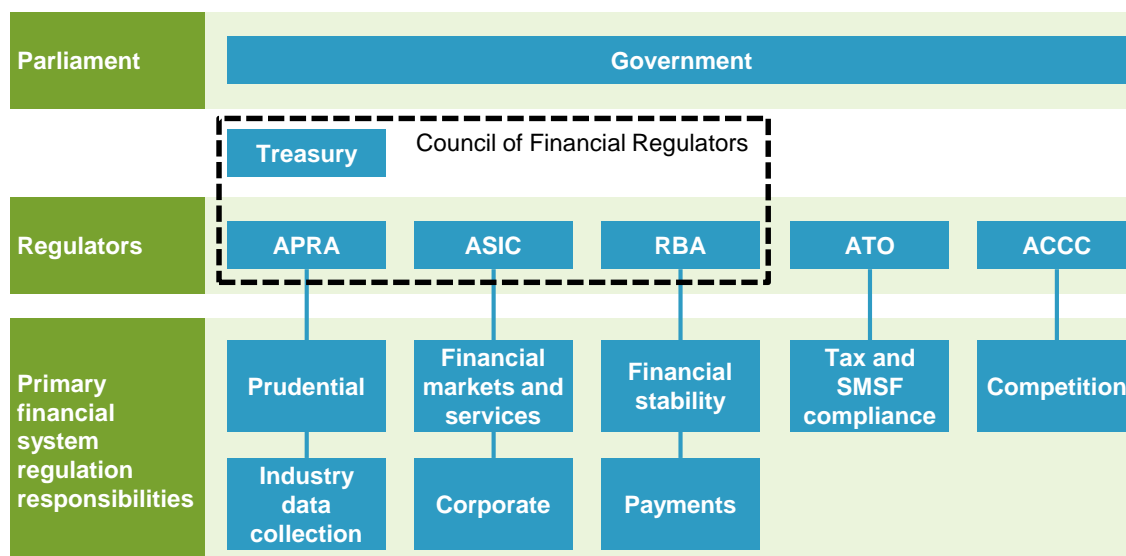
10.2 Multiple regulators have responsibility for system governance

Regulation of the superannuation system occurs within the broader financial system regulatory framework (figure 10.2). APRA, ASIC and the Australian Taxation Office (ATO) are the most prominent regulators, but a number of other agencies regulate specific aspects of the system (box 10.1).

The Australian Prudential Regulation Authority

Under the *Australian Prudential Regulation Authority Act 1998* (Cth), APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability. In the superannuation context, APRA’s role can be thought of as monitoring system performance and intervening where funds are performing poorly from a ‘prudential’ perspective (although, as discussed later, the appropriateness of regulating superannuation through a prudential — as distinct from a ‘member outcome’ — lens is questionable).

Figure 10.2 The Australian financial system regulatory framework



Source: Figure adapted from Murray et al. (2014).

Since the collapse of Trio Capital (box 10.2) there have been no major fund failures, although there are a number of persistently underperforming funds (chapter 2). APRA has identified 28 underperforming funds of particular concern:

APRA is also continuing ... attention on those RSEs that have been identified as poorer performers, with a view to determining the cause of shortcomings in the identified areas and requiring them to develop a robust and implementable strategy to address identified weaknesses within a reasonably short period ... to date 13 of those funds have agreed to restructure or exit the industry. Another 4 ... have revised their fees ... Two ... are no longer considered to be outliers ... and the remaining nine are in continuing discussions with APRA. (sub. DR204, p. 7)

The Commission welcomes the move by APRA to take action in relation to underperforming funds, although it has taken more than a year to get to this point and there are still nine funds in 'continuing discussions with APRA'. These funds should be dealt with promptly (that is, they should take immediate measures to improve or they should be forced by APRA to exit the industry). And, as discussed later in the chapter, this should be seen as a first step towards dealing with chronically underperforming funds.

The Trio Capital collapse highlighted flaws in the governance and regulatory framework, and was a key driver behind many currently proposed regulatory reforms (particularly those relating to ownership changes).

Box 10.1 Other regulators involved in the superannuation system

Reserve Bank of Australia (RBA) — uses monetary policy and administers the monetary and payments system to maintain a strong financial system. The RBA is not directly involved in the regulation of participants in the superannuation system.

Council of Financial Regulators (CFR) — the coordinating body for Australia's main financial regulatory agencies, operating as a high-level forum for co-operation and collaboration among members. Membership includes APRA, ASIC, the RBA and the Treasury.

Australian Competition and Consumer Commission (ACCC) — the competition regulator, promotes fair trading in markets to benefit the wider community. The ACCC regulates participants in the superannuation system as part of a broader mandate to ensure that individuals and businesses comply with competition, fair trading and consumer protection laws. The Commission's 2018 report *Competition in the Australian Financial System* foreshadowed a greater role for the ACCC as a 'competition champion', including through participation in the CFR, in which consideration of competition impacts could be promoted, analysed and made more transparent.

Australian Financial Complaints Authority (AFCA) — an independent dispute resolution body that deals with complaints within the superannuation system (and the broader financial services industry). This body commenced on 1 November 2018, replacing the Superannuation Complaints Tribunal.

Australian Transaction Reports and Analysis Centre (AUSTRAC) — Australia's anti-money laundering and counter-terrorism financing (AML/CTF) regulator and financial intelligence unit.

Office of the Australian Information Commissioner (OAIC) — administers the *Privacy Act 1988* (Cth) and seeks to ensure that trustees collect, store and use member information appropriately.

Sources: ACCC (2012); AFCA (2018); APRA (2016a); ASIC (2016e); ATO (2015b); CFR (2016); PC (2018a).

Box 10.2 The Collapse of Trio Capital

The collapse of Trio Capital, following a major fraud, saw the loss of approximately \$176 million of members' superannuation benefits, with over 6000 investors affected.

The Parliamentary Joint Committee Inquiry into the collapse of Trio Capital noted that the fraud was highly complex in nature, originating with the establishment of a managed investment scheme. Trustees, directors and investors were deceived throughout the operation of the scheme about its underlying assets and rates of return on investments.

The Committee raised a number of concerns about the manner in which APRA and ASIC dealt with problems at Trio Capital.

The regulators — APRA and ASIC — must take their share of the blame for the slow response to the Trio fraud. APRA conducted five prudential reviews between 2004 and 2009. It took no enforcement action as a consequence of any of these reviews. ASIC only began its investigation in October 2009 after [a tip-off from an industry participant about suspicious patterns of returns].

From late 2008 to mid-2009, APRA was unable to obtain from Trio a valuation of certain Trio funds' assets. The committee questions how a trustee can be subject to what APRA describes as 'active supervision' over a period of six years and yet, when essential information was not forthcoming at the end of this period, APRA did not act quickly. For a risk based supervisor, as APRA is, the inability of a trustee to provide basic valuation information should have raised strong concerns.

The committee also has concerns at the length of time it took for ASIC to detect the fraudulent activity. It is particularly concerned that communication between ASIC and APRA was lacking in the months from late 2008 to mid-2009. It seems that APRA had not communicated to ASIC its requests for Trio to provide information. As a result, when ASIC commenced its active surveillance of hedge funds in June 2009, it did not seem aware that Trio was not providing the prudential regulator with basic facts about the existence of assets and their value. This information should have been communicated. The committee also believes that the regulators missed key events that laid the platform for the Trio fraud. The first was the purchase of Tolhurst from its previous owners in late 2003 ... The second event related to investments in Trio products via a pooled superannuation trust called Professional Pensions PST (PPPST). In 2004, the trustee of PPPST, the Trust Company, was replaced after expressing concerns at the new investment approach of the interests associated with Trio. These concerns were either not relayed to APRA or did not lead APRA to take action. (PJCCFS 2012, p. xx)

APRA reported on its investigation into the failure of Trio Capital in April 2016. APRA identified concerns that Trio had failed to conduct adequate due diligence in relation to related party investments, made the investments on terms that were more favourable to the related parties than had the investments been at arm's length and failed to adequately monitor the performance of the investments. APRA also identified concerns that Trio's directors failed in their duties and functions under the *Superannuation Industry (Supervision) Act 1993* (Cth), and did not act in the best interests of members (resulting in APRA removing 13 former Trio directors from the superannuation industry for specified periods of time).

Sources: APRA (2016d); PJCCFS (2012).

Proposed legislation would provide APRA with new mechanisms to promote better member outcomes

The Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill 2017, which seeks to improve member outcomes, would provide APRA with increased powers and new mechanisms to deal with poor performance (ultimately encouraging poor performers to exit). At the time of writing, the Bill had not been passed. The proposed reforms include:

- the introduction of an outcomes test to replace the MySuper scale test
- enabling APRA to prevent ownership or control changes for MySuper products
- the introduction of civil and criminal penalties for trustee directors found to have breached their duties to members (whereas currently, contraventions of governing rules give rise to claims for losses or damages by affected members)
- enhanced powers for APRA to obtain information on management and operational expenses on a look through basis
- providing APRA with enhanced capacity to refuse authority to offer a MySuper product or to cancel an existing authority
- increased powers enabling APRA to intervene early where it has governance or conduct concerns regarding a fund
- the introduction of compulsory annual member meetings.

Although the package of measures would not remediate all the problems in system governance (including those identified by the Commission and the FSRC), the package is welcome and warrants support. Four of the measures are likely to be particularly important: the outcomes test; the ability to refuse ownership changes; the introduction of civil and criminal penalties for trustee directors; and enhanced expense reporting.

An outcomes test to replace the scale test

Designed to raise the overall quality of MySuper products, the outcomes test (box 10.3) is the most significant of the proposed reforms — and the Commission supports its passage through Parliament (although this proposed test ultimately does not go far enough to deal with chronic underperformance and should be further elevated to ensure good outcomes for members of both MySuper and choice products) (section 10.4).

Box 10.3 The MySuper outcomes test focuses squarely on members' interests

Trustees would be required to make, and publish, an annual written determination of whether the financial interests of the members in a MySuper product are being promoted based on:

- the appropriateness of the options, benefits and facilities offered
- the appropriateness of the investment strategy
- the appropriateness of the insurance offering
- whether insurance fees inappropriately erode the retirement income of the beneficiaries
- whether there are scale problems in relation to the MySuper product (potentially in relation to an insufficient number of beneficiaries or assets)
- any other matters, including those prescribed in regulations.

Trustees would also be required to compare their MySuper product and others' based on: fees, costs and taxes; return targets; returns; the level of investment risk; and any other matter prescribed in regulations (Australian Government 2017).

Strong arguments exist for replacing the scale test. While it:

... was designed to ensure that members were not disadvantaged by being in a small fund with high costs per member, there are limitations to the value of the current test. For example, trustees with a large number of members and assets in the MySuper product can easily pass the scale test, even if they are underperforming ... member outcomes are influenced by more than just the scale of the superannuation fund. (Australian Government 2017, pp. 7–8)

And the test (or its enforcement) has proven inadequate in protecting default members from poorly performing products (chapter 2).

Some participants saw the proposed test as likely to promote industry and product consolidation. For example, the Australian Institute of Superannuation Trustees said:

... the creation of an “outcomes” test applying to trustees in respect of both MySuper and choice products should provide further impetus towards mergers or takeovers – as well as requiring trustees to provide greater justification of excess levels of choice of investment strategy within funds. (sub. 39, pp. 30–31)

APRA is also progressing stronger supervision of outcomes for both MySuper and choice products

Ahead of the outcomes test being legislated, APRA has developed prudential standard SPS 515 *Strategic Planning and Member Outcomes* (APRA 2018g), to apply from January 2020, which will require RSE licensees to undertake an annual assessment of outcomes being provided to members (for both choice and MySuper products) and identify opportunities for improving them (box 10.4).

Box 10.4 **APRA's outcomes assessment would cover all products**

Metrics that APRA expects funds will take into account include:

- net investment returns, on an absolute basis and relative to risk/return targets
- fee levels, including costs per member
- level and cost of insurance cover, including measures of account erosion such as the premium as a percentage of salary or superannuation guarantee contribution
- administration and operating expenses as a percentage of average net assets
- net cash flows as a percentage of average net assets (net cash flow ratio)
- net member benefit outflow ratio
- net rollovers as a percentage of average net assets (net rollover ratio)
- trends in membership base
- active member ratio (APRA 2018f).

Funds will be required to compare their results to: their own benchmarks and targets; objective benchmarks and targets; and the outcomes of other RSEs. Where a fund consistently underperforms, it will be expected to actively consider whether their operations are consistent with the best interests of members.

Under the standard, APRA could request the assessments from funds at any time, but funds would not be required to publish them. This differs from the proposed *legislated* outcomes test, which does require publication of the results.

APRA's proposals are deliberately principles based, which allows RSE licensees the flexibility to undertake the assessment in a manner that suits the size, nature and complexity of their business operations. ... APRA expects that many RSE licensees will focus on financial returns in assessing the delivery of outcomes, particularly for default membership cohorts. However, APRA's long-held view, which is reflected in its proposals, is that a focus on financial returns to the exclusion of other considerations is not sufficient ... an outcomes assessment that incentivises a focus on net investment performance to the detriment of key areas of the sound operation of an RSE licensee, such as the adequacy of its governance and risk management frameworks, may compromise outcomes for members in the longer term. (APRA, sub. DR204, p. 6)

These tests are an important step forward, but will **not be sufficient** in the Commission's view to ensure members are protected from underperforming funds — particularly given the poor governance processes discussed in chapter 9 regarding funds' self-assessments. The tests require an objective benchmark and requirements for review to audit-level standard (section 10.4).

Stronger oversight of ownership changes

The Trio Capital collapse followed an ownership change that did not require approval (Australian Government 2017), pointing to a regulatory gap.

Under the proposed laws APRA would be able to: refuse authority for a change in ownership where it has concerns about the new owner; give directions to relinquish control of a licensee whether that control is through share ownership or exists in practice; or suspend or remove a licensee where it has reason to believe the licensee is unable to satisfy trustee obligations. As such, the laws would bring APRA's powers with regard to ownership changes for superannuation funds more into line with those for other APRA-regulated industries.

Civil and criminal penalties for directors

APRA has noted that the trust deeds for superannuation funds have worked against enforcement, given members were often likely to bear the cost of enforcement actions:

Almost all superannuation trust deeds provide that the assets of the trust are to be used to indemnify the trustees from liability in most instances. The trustees of superannuation funds, whether corporate trustees or individual trustees, do not maintain any material capital resources compared to other entities regulated by APRA. Judgements or penalties assessed against a trustee may, absent legislative intervention to provide otherwise, be paid for by the superannuation members of the trust ... it is reasonable and appropriate for it to take this matter into consideration when considering potential enforcement action. (2018r, p. 21)

Introducing civil penalties for directors would ameliorate this. The proposed laws would allow civil and criminal penalties to be imposed on trustee directors where they fail to properly act in the best interests of members, or use their position to further their own interests to the detriment of members.

The Bill introduces obligations not to contravene the SIS Act general covenants applying to directors of corporate trustees of superannuation entities, and the further obligations in relation to MySuper products. Thus it is not the initial breach that gives rise to penalties, but rather the breach of the obligations not to contravene the covenants and obligations. The penalties would be similar to those imposed on directors of managed investment schemes, who have a fiduciary duty to members under the *Corporations Act 2001* (Cth) (Corporations Act).

In the event of a civil penalty provision being contravened, APRA could apply to the court for a civil penalty order. Serious breaches of director's duties (such as those involving intentional or fraudulent contravention) may constitute criminal offences punishable by imprisonment. Where duties are breached, members would still be able to make claims for losses or damages stemming from the breach (Australian Government 2017).

Both the Commission's findings and evidence provided to the FSRC suggest many trustee directors have failed to take their duties to give precedence to members' best interests seriously (chapter 9). The hitherto absence of civil and criminal penalties for trustee directors is likely to have played a role here. The introduction of such penalties would make trustee directors more directly accountable for their failures to protect member interests. However, it is less clear that the responsibility for instigating these penalties should belong to APRA,

given that ASIC is appropriately the predominant conduct regulator for the superannuation system (section 10.3).

Enhanced reporting of expenses

APRA currently has imperfect insight into how funds are using member contributions and whether expenses are in line with trustee obligations under the SIS Act (chapter 9), and into related party transactions (chapter 7).

The new laws would enable APRA to require trustees to report management and operational expenses on a look-through basis. Notably such powers already exist for investment expenses, although the quality of data provided are often poor, as discussed later in the chapter. Where a fund gives money (or other consideration) to another entity, new reporting standards would require the licensee to provide information such as the detail of the other entity, the purpose of the transaction, how the money was used by the other entity and any entity with which the other entity deals (Australian Government 2017).

The Commission's view on proposed reforms

The proposed outcomes test, in tandem with an enhanced capacity to cancel a MySuper authority, represents a good first step towards dealing with chronic underperformance by better enabling APRA to eliminate poorly performing MySuper products and promote fund consolidation. The test is also consistent with the Commission's view that member outcomes should be regulators' key focus, and that there is a need to raise the standards of superannuation products. While APRA's outcomes assessment will improve fund performance, and has the advantage of covering choice products, the greater transparency and, therefore, scrutiny that would come with publication of the proposed outcomes test would be a stronger inducement.

Proposals to give APRA more power to deal with ownership changes would address the unsatisfactory situation that a person or entity can purchase an existing RSE licence and continue to operate without regulatory checks of their suitability or background.

The proposal to introduce civil and criminal penalties for trustee directors is particularly important in view of revelations at the FSRC (chapter 9), although implementation of this regime would more appropriately sit with ASIC as the conduct regulator for superannuation, particularly in view of APRA's reluctance to pursue public enforcement action (section 10.3).

As highlighted at many points in this report (and discussed below), there are too many gaps and inconsistencies in the data provided to regulators. The Commission does not understand why the regulators, to date, have not made inroads. Improving reporting requirements for management and operational expenses would improve the quality and usefulness of reported data. And better

data on related party transactions would shed light on their impacts on member outcomes and reduce the breach of trustee duties, including the potential avenues for fraud.

Subject to the maintenance of an appeal process (as contained in the exposure draft of the Bill), reforms enabling APRA to respond more decisively and promptly to perceived threats to members' interests would ensure members are better protected.

But the benefits of annual member meetings are less convincing. The meetings would have the benefit of providing members with increased transparency. However, it is unlikely that they would be widely attended and would come at a cost to members (although allowing the meetings to be conducted electronically should significantly reduce that cost).

FINDING 10.1

The package of reforms contained in the Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill 2017 would improve member outcomes if legislated.

In particular, the proposed MySuper outcomes test (a good first step) should better enable APRA to de-authorise poorly performing products and better promote fund consolidation. But the test needs to be strengthened, extended to choice investment options and then fully and transparently enforced by APRA.

Introducing civil and criminal penalties for trustee directors, and giving APRA more power to deal with ownership changes of superannuation funds, are policy 'must haves' to better protect members.

Is a prudential approach to superannuation optimal?

As discussed in chapter 9, APRA, as the lead superannuation regulator, steadfastly applies a prudential approach to regulating superannuation, with a focus on processes and inputs and the financial strength of superannuation funds rather than explicitly on member outcomes. As APRA recently described it:

Our primary objective in undertaking ... actions is to continually build strength in the financial system for the benefit of depositors, policy holders and super fund members. (Byers 2018a, p. 20)

Participants have expressed differing views about the appropriateness of this approach, and whether prudential concerns should be a major consideration in a defined contribution system where investment risk lies overwhelmingly with members. APRA noted that:

The Wallis Inquiry found that, because the risk in defined contribution superannuation is largely retained by the investor, prudential regulation of superannuation should sit at the lower end of the intensity scale and should focus on ... 'ensuring that superannuation funds have risk management strategies and conduct, and administrative systems, which are appropriate to their purpose and accord with both government requirements and with the governing investment policies contained in the trust deed.' (2018r, p. 7)

APRA also argued that, in practice, prudential regulation in superannuation is about the ability of funds to produce good member outcomes:

Because the defined contribution nature of most superannuation funds means that it is the superannuation fund members who bear the risk of the amount of their superannuation benefit increasing or decreasing, the focus of the Prudential Standards, and prudential supervision for the superannuation industry generally, is on ensuring that the RSE Licensee has the necessary governance, risk management and operational capability and capacity to deliver quality outcomes for members. (2018r, p. 13)

Scott Donald from the Centre for Law, Markets and Regulation at UNSW Law argued for a shift away from a ‘prudential’ to a member outcomes focus:

It is obviously desirable that superannuation funds and their trustees have processes and resources in place to limit operational and payment risks. It is also desirable that regulators look to the robustness of DB [defined benefit] promises. Beyond that, it is hard to see how prudential regulation, specifically, can get traction in a DC [defined contribution] environment. The current focus on member outcomes is not prudential regulation unless one dilutes the notion of ‘prudential regulation’ to the point where it ceases to have any real meaning. If requiring trustees to strive for better returns, lower costs and greater accountability is desirable (and I think it is hard to argue against that), it would be better to have a regulatory approach tailored specifically to that set of objectives, rather than an approach originally designed to limit the impact on customers of insolvencies in the insurance and banking sectors. (sub. DR141, p. 2)

In response to evidence before the FSRC, the Finance Sector Union stated:

Under the current law APRA has significant obligations to act as a conduct regulator in connection with superannuation. ... APRA appears reluctant to embrace these obligations, but instead sees itself as a prudential, not conduct regulator, with a focus on the overall stability of funds and the sector. (2018, p. 29)

The FSC stated:

While the general notion of what a financial promise is measures true for banking, insurance and defined benefit superannuation, it is important to note that unlike many other pension systems in developed economies, over 95% of the Australian superannuation environment is defined contribution. The major difference here is that there is no financial promise to the member, as the member bears the investment risk. Traditional prudential regulation does not adequately regulate for members in such an environment and is also the reason that managed investment schemes in general do not come under prudential regulation. (2018, p. 8)

In a defined contribution world where the risk of poor outcomes lies largely with members, the risks are more about liquidity impacting member outcomes, rather than simply accounting for the money (the latter role being more relevant to a defined benefit world, or in other sections of the financial services industry). However, the prevailing mindset of APRA with regard to superannuation was demonstrated recently by its Chairman, Wayne Byers, testifying before a parliamentary committee:

... the fundamental purpose of APRA is the safety and soundness of the financial system, and there is no question that the financial system is sound and robust. That is what we’re here to do:

to make sure that depositors' money is safe and it can be repaid when people need it; the insurance companies have the financial wherewithal to repay claims as and when they're there; and superannuation money is accounted for. That is our primary task. I don't think there is any question that those tasks are not being performed well. (Byers 2018a, p. 24)

Superannuation is by and large not a market categorised by prudential risk or caveat emptor for most members, meaning the approach that has guided much regulation to date is both inappropriate and inadequate. This difference compared with other financial services has been highlighted by APRA:

The nature of prudential regulation is also different for products where a commercial promise of a capital guarantee of funds has been made (for example, as in the case of bank deposits, or defined benefits superannuation) compared to products where no such promise has been made and funds are deployed and applied on a 'best-endeavours' basis, by a trustee structure (as in the cases of superannuation fund contributions). (2018r, p. 10)

Regulation therefore needs to be seen and conducted through the lens of member outcomes — APRA would be a more effective superannuation regulator if provided with an explicit 'member outcomes' mandate rather than a traditional prudential mandate. The main threats to members are likely to be issues of poor performance, excessive fees or poor handling of conflicts of interest by trustees, rather than failure of a fund.

Evidence to the FSRC also highlighted that APRA often defined regulatory outcomes in terms of adherence to process, as opposed to focusing on the actual financial outcomes for members. The term 'outcomes' needs to be synonymous with actual member outcomes and not just compliance with mandated processes (which might provide limited protection to members).

The Australian Securities and Investments Commission

ASIC is the conduct and integrity regulator of the superannuation system. Legislation in train has the potential to better enable ASIC to be a more strategic and proactive conduct regulator which, as discussed later in the chapter, the Commission sees as critical to improving member outcomes.

Proposed legislation will expand ASIC's toolkit

Recognising that ASIC was often restricted from intervening until after legal breaches (and therefore potential consumer harm and detriment) became apparent, the Financial System Inquiry (Murray et al. 2014) recommended that the regulator be given a product intervention power (enabling intervention without a demonstrated or suspected breach of the law). Specifically, the Inquiry recommended that ASIC be given power to require or impose:

- amendments to marketing and disclosure materials
- warnings to consumers, and labelling or terminology changes

-
- distribution restrictions
 - product banning.

The government released exposure draft legislation for the intervention power in December 2017. The draft proposed that interventions can last for up to 18 months to enable determination of whether they should become permanent. It is also proposed that:

... in order to use the power, ASIC must identify a risk of significant consumer detriment, undertake appropriate consultation and consider the use of alternative powers. ASIC must determine whether there is a significant consumer detriment by having regard to the potential scale of the detriment in the market, the potential impact on individual consumers and the class of consumers likely to be impacted. (Treasury 2016a, p. 5)

The government also accepted a recommendation for the introduction of a product design and distribution obligation. Under the proposed law, anyone offering a financial product must make a target market determination. Products cannot be offered or distributed (nor the subject of financial advice) if a current determination is not in place, and those offering or distributing (or advising on) a product must take reasonable steps to adhere to the determination.

ASIC is to be given powers to enforce the new arrangements, including the ability to issue stop orders. And people suffering loss due to contraventions of the obligation would be able to take civil action.

But ASIC's capability has been judged as not quite fit for the future

A 2015 Capability Review of ASIC found that 'ASIC has a tendency to be reactive in the way it uses the regulatory tools at its disposal and is often excessively issue driven (that is, responding to high profile events) rather than more consistently strategic in its focus' (Chester, Gray and Galbally 2015, p. 11). ASIC was particularly seen as too heavily focused on *reactive* as distinct from *strategic* enforcement, including in respect of the selection and priority afforded deterrent enforcement action.

The Review also highlighted key risks for priority action by ASIC: financial system corporate culture, with a focus on business integrity and treating customers fairly, through targeted supervision of high risk entities to review their conduct policies, and to assess the alignment of incentive structures and risk management as a proactive approach to identifying possible misconduct; more innovative approach to regulation in an environment of digital disruption and financial disintermediation; dealing with policy and member needs around superannuation (and asset decumulation during retirement). Along with other challenges, this was seen as requiring ASIC's regulatory decision making 'to be better informed, more evidence and analytically based, more strategic and ultimately more transparent' (Chester, Gray and Galbally 2015, p. 38).

In discussing reforms prompted by the review, ASIC acknowledged that:

ASIC's regulatory framework ... places too much emphasis on investigation and punishment after the event, with few tools to address problems as they emerge or before major losses are suffered. Further, the only available remedy has often been criminal prosecution, again limiting options for ASIC for a range of misconduct. (Kell 2017, p. 3)

Concerns have also been raised about the performance of ASIC as a superannuation regulator more recently at the FSRC, as discussed below.

And tougher penalties have been recommended

Following the recommendations of the ASIC Enforcement Review Taskforce, the Australian Government has introduced into parliament the Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Bill 2018. The Bill seeks to address general concerns that penalties for 'white collar' crimes are inadequate, and increases potential penalties for superannuation trustees in the event of breaches of the Corporations Act.

The Bill would increase maximum civil penalties for individuals from \$200 000 to \$1.05 million or three times the benefit obtained or detriment avoided and, for corporations, from \$1 million to either the greater of \$10.5 million, or three times the benefit obtained or detriment avoided, or 10 per cent of annual turnover (up to a cap of \$210 million). The Bill would also enable courts to make a 'relinquishment order' requiring a payment to the Commonwealth of an amount equal to the benefit derived or detriment avoided because of the contravention (Frydenberg 2018b).

The Bill would also widen the number of Corporations Act provisions that are subject to civil penalties for contraventions, including section 912A of the Corporations Act which contains obligations to:

- do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly
- have in place adequate arrangements for the management of conflicts of interests
- ensure that its representatives comply with the financial services laws.

While the SIS Act is not covered by the Bill, most superannuation trustees have an Australian Financial Services Licence (AFSL) (see below) and are therefore required to meet these obligations. The Bill would therefore increase both the options for enforcement action against superannuation trustees, and the potential penalties.

The Commission's view on the proposed measures

ASIC has traditionally been reactive, rather than proactive, in its regulation of superannuation (and more generally). To some degree this has been because of limitations in its regulatory toolkit. The product intervention powers, and the design and distribution

obligations, are welcome in providing ASIC with increased ability to deal with regulatory breaches in a more proactive manner. The foreshadowed increased penalties for breaches of the Corporations Act will also provide greater incentive for trustees to meet their obligations, and provide ASIC with a ‘bigger stick’ to pursue enforcement.

The Commission’s proposed ‘right to remain’ test, while enforced by APRA (section 10.4), would also assist ASIC by flagging underperformance in a more timely manner, providing ASIC with guidance about where members interests were at risk of material harm and ‘flag’ pre-emptive conduct surveillance.

The Australian Taxation Office

The ATO is the superannuation system’s ‘SMSF regulator’. Its core focus is to ensure SMSF trustees comply with their duties, responsibilities and legal obligations and to take action where they do not.

The ATO’s regulatory activities include:

- verifying that a fund’s primary purpose is to pay retirement benefits to its members
- providing information and forms to help members set up and manage funds
- checking funds are managed in accordance with the superannuation laws
- implementing and maintaining systems to check compliance with the laws
- taking enforcement action when there is a breach of the law
- checking that SMSF auditors perform their duties to the required standard (ATO 2015b).

The ATO is also a major holder of data relating to SMSFs. These data are critical to assessing SMSF performance and, as discussed later (and in chapter 13), could be better integrated with other superannuation data to better inform members and to assist in gauging the performance of the superannuation system overall.

The ATO also provides administrative oversight of all compulsory employer contributions (and has enforcement responsibilities where contributions are underpaid or not paid at all), manages some reporting by APRA-regulated funds and has responsibility for administering the early release of superannuation on compassionate grounds.

10.3 The respective roles of APRA and ASIC merit attention

Overlapping regulatory responsibilities are a problem

The provision of greater powers to APRA to set prudential standards, and its role in MySuper authorisation, mean it has become more involved in regulating the conduct of trustees and

other agents involved in the superannuation industry — traditionally ASIC’s territory. As APRA Chairman Wayne Byers has stated:

While most matters of conduct are primarily the responsibility of our colleagues at ASIC, these issues are nevertheless of great interest to a prudential regulator for what they say about an organisation’s attitudes towards risk. So as with the balance sheet strengthening of the financial system over the past few years, we have also taken a greater interest in efforts to strengthen behaviours and cultures. We can’t regulate these into existence, but we have been working to ensure Australian financial institutions have been giving greater attention to these matters than may have traditionally been the case. (Byers 2018b, p. 3)

Current arrangements stem from recommendations of the Cooper Review. The Cooper panel recognised the potential for overlap and recommended that ‘the Government should explore with APRA and ASIC ways in which the two regulators can work more closely together in discharging their superannuation mandates’ (Cooper et al. 2010b, p. 316). However, while the (then) Government legislated to provide APRA with standards-making powers, the potential for (increased) overlap was not adequately addressed.

Participants disagreed on the levels of overlap (box 10.5). But the Commission considers that the arrangements have become confusing and opaque with significant overlap, no clear delineation between the roles of APRA and ASIC in many areas, and heavy reliance on cooperation between the regulators. The arrangement poses the very real and ongoing risk that regulatory breaches ‘fall through the cracks’ as a result of divided responsibilities (with each regulator believing the other was, or should be, dealing with a matter), leading to poor outcomes for members. The blurring of responsibilities also inevitably detracts from the accountability of the respective regulators.

The Commission identified a number of areas of potential overlap.

- APRA is responsible for the vast majority of the SIS Act, including the Section 52 covenants covering trustee directors’ responsibilities and duties. These include general covenants, investment covenants, insurance covenants and covenants relating to risk. ASIC is responsible for provisions of Parts 3 and 6 of the SIS Act (including the Section 52 covenants) *to the extent to which they relate to keeping of reports or disclosure of information*.
 - A failure, for example, on the part of trustees to exercise care, or to enable beneficiaries to receive information (an APRA responsibility) — both contained in the general covenants — could in part relate to disclosure or record keeping (thus potentially also falling into ASIC’s area of responsibility).

Box 10.5 Participants expressed varying views about the clarity of ASIC and APRA's respective roles

Mercer saw the current delineation of responsibilities as clear:

... the division of responsibilities between APRA and ASIC for superannuation is currently clear ... if trustee boards are behaving badly (e.g. by preferring their own interests to those of the fund members in the event of a fund merger proposal), APRA is the regulator that should be taking action. In fact, ASIC's role as the corporate regulator is displaced in this regard, because section 52(4) of the SIS Act makes it clear that the SIS Act obligations to give priority to member interests in relation to any conflict of interest in a superannuation context overrides any conflicting obligation under Part 2D.1 of the Corporations Act. (sub. DR175, pp. 46–7)

AustralianSuper expressed a similar view:

The division of responsibilities between APRA and ASIC is clear to AustralianSuper. We note that APRA and ASIC respond differently to conduct engaged in by superannuation funds, as they should, given their differing regulatory responsibilities. (sub. DR150, p. 17)

However, AIST saw it as timely to review the respective roles of the regulators:

... we agree with the Productivity Commission's view that it is timely to revisit the respective roles of APRA and ASIC. Additionally, given the increasing role of the ATO within superannuation through single touch payroll and the development of myGov, AIST strongly recommends that this role also be reviewed concurrently. ... AIST believes that a ... functions ... review of both APRA, ASIC and the ATO would be most beneficial, especially given the ever-increasing size and complexity of the superannuation system. (sub. DR130, p. 61)

Scott Donald agreed there was a blurring of roles:

I concur with the draft conclusion ... that the Commission has drawn that to some extent the jurisdictions of those two organisations, in respect of superannuation, has become blurred; it's unclear who is necessarily responsible for what; there are places where there appear to be gaps and there are places where there appear to be overlaps. ... I would agree with that. (trans. p. 97)

Colonial First State Investments Limited and Avanteos Investments Limited said:

CFSIL supports the twin peaks model but has observed growing overlap and inconsistency between regulators in the superannuation context, in particular when considering the functions of ASIC and APRA. ... CFSIL recommends a review of both ASIC's and APRA's roles in relation to superannuation. The review should assess whether their functions remain consistent with the intentions of the twin peaks model. (2018, p. 36)

AMP stated:

At the time [APRA and ASIC commenced] there were well defined roles for each of the regulatory bodies, but over time their roles and responsibilities have blurred. This needs to be rectified. (2018, p. 22)

And Pamela Hanrahan observed that the steady expansion of APRA's powers has added to regulatory overlap:

In significant part the regulatory overlap can be explained by the steady expansion of APRA's responsibilities into areas of non-financial risks, which often crosses into the realm of conduct regulation. This element ... expanded with the introduction of RSE licensing in 2004 and the Stronger Super governance and integrity reforms and introduction of prudential standards from 2013 onwards. The effect of this expansion is that maladministration of a superannuation fund ... may potentially trigger protective, remedial or enforcement action by APRA – for breach of the RSE licensing laws, breach of prudential standards, or breach by the trustee or its directors of the SIS Act duties and statutory covenants – and by ASIC – for breach of AFS licensing laws, breach of the SIS Act statutory covenants relating to reporting and disclosure, or breach by the directors of their Corporations Act duties as directors of the RSE licensee. (2018b, pp. 21–22)

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- ASIC is responsible for the AFSL regime under the Corporations Act. This requires public offer superannuation funds to hold an AFSL and also requires an AFSL where fund trustees give financial product advice or provide another financial service. There is potential overlap, for example between conditions placed on licences, between AFSL and APRA superannuation entity licensing (a SIS Act responsibility). Further, the Corporations Act requires AFSL holders to comply with all Commonwealth, State and Territory laws relating to the provision of financial services, creating intentional regulatory overlap between the SIS Act and AFSL regimes.
 - The SIS Act was amended in 2012 to give APRA power to develop prudential standards. APRA can do so in areas relating to the conduct of superannuation entity licensees and connected entities, including to protect the interests of beneficiaries, to ensure funds maintain a strong financial position and to ensure the activities of funds are undertaken with integrity, prudence and professional skill.
 - Prudential standards cannot be in conflict with the SIS Act or the SIS Regulations, but are not legally constrained by traditional areas of regulator responsibility. Standards dealing with management of conflicts could, for example, overlap with Corporations Act provisions (an ASIC responsibility) in this area. APRA consults with ASIC when developing prudential standards. The Commission understands the prudential standards developed by APRA do not represent disallowable instruments and therefore cannot be overturned by parliament. This is not consistent with good regulatory practice and should be rectified — particularly given the significance of the prudential standards and the potential for their importance to grow over time.
 - Where a trustee Board had failed to undertake a merger that was clearly in the best interests of members, it is unclear whether APRA or ASIC would deal with this matter (as both deal with the requirement to act in the best interests of members, APRA through the SIS Act, and ASIC through the Corporations Act). The Commission’s conclusions on future roles for each regulator in relation to mergers are discussed in chapter 9. APRA has a clear role in facilitating and encouraging mergers, and should report annually to the Council of Financial Regulators about progress. ASIC should proactively investigate recent questionable cases where mergers between superannuation funds stalled or did not proceed.

APRA has stated that it sees the current regulatory roles as broadly appropriate:

... the general philosophy behind the allocation of prudential and conduct regulatory roles between APRA and ASIC remains broadly appropriate. Subject to improving its powers ... ASIC is best placed to have responsibility for consumer protection, as this is a central aspect of ASIC’s role in relation to each of the superannuation, banking and insurance sectors. APRA is best placed to have responsibility for protecting the collective best interests of fund members. This is central to APRA’s role as prudential regulator of (most of) the superannuation industry, and is consistent with APRA’s role in protecting depositors and policyholders through its regulation of the banking and insurance sectors respectively. (2018r, p. 2)

Further, APRA considered that concerns about overlap are overstated given the level of cooperation between regulators:

APRA and ASIC effectively work together to ensure there is a strategic approach to regulating the superannuation industry to the benefit of members. While areas of common interest in the jurisdictions of APRA and ASIC can create the perception of regulatory overlap and duplication, in practice both agencies seek to effectively manage this risk through well-established communication and coordination practices. (sub. DR204, p. 17)

... while also noting some overlap is inevitable.

There will inevitably be occasions when RSE licensee conduct may attract the attention of both APRA and ASIC, albeit from different regulatory perspectives. For example, while matters of poor conduct in the dealings of RSE licensees with individual consumers is the responsibility of ASIC, that conduct may also raise prudential concerns in relation to the operations or practices of RSE licensee that may ultimately impact the interests of members and raise prudential concerns and hence also fall within APRA's responsibility. (sub. DR204, p. 18)

ASIC observed that many of APRA's roles in superannuation would be undertaken by ASIC in other parts of the financial system.

... APRA has a different role in superannuation compared to its role in other parts of the financial system. APRA is tasked under the SIS Act with a greater conduct regulation role in relation to superannuation, which is different to its traditional prudential role. While APRA monitors risk in the superannuation system to mitigate the chance of a fund failure, APRA's focus is additionally directed at monitoring the performance of funds, licensing superannuation entities, product authorisation and ensuring that trustees act in the interests of members – much of which would be performed by ASIC in other parts of the financial system. (sub. DR206, p. 21)

Regulatory failures are clearly observable

The Commission's findings on both governance failings within funds and persistent underperformance highlight areas of regulatory failure. Moreover, concerns were raised at the FSRC about the effectiveness of regulatory arrangements for superannuation:

It is submitted that one of the critical functions of a conduct regulator is to take strategic action that will specifically deter the targeted entity from engaging in misconduct and generally deter other entities from engaging in misconduct. ... It is submitted that the case studies suggest that the approach of neither APRA nor ASIC to regulation of superannuation entities is sufficient to achieve specific or general deterrence. (FSRC 2018b, p. 216)

In part, these regulatory failures stem from an absence of high quality data and its meaningful analysis by regulators (section 10.8). However, they are also likely to stem from confusion of responsibilities and a lack of prioritisation of strategic conduct regulation by APRA and ASIC.

On the issue of fees for no service, APRA provided evidence to the FSRC that it had not pursued some matters because it was aware ASIC was also already doing so. Notably, in taking what could best be seen as a 'wait and see' stance, APRA was unable to provide written evidence of such an internal decision being made; was cognisant that ASIC had no mandate under the SIS Act to deal with these issues (FSRC transcript pp. 7473–74), and was

unaware of the statute of limitations that applied should it have needed to take action (FSRC transcript p. 5181).

Where regulatory overlap is apparent, the most appropriate approach in areas where both APRA and ASIC suspect regulatory breaches would be for both regulators to discuss the relevant matter thoroughly at an early stage, consider the respective evidence each has, and which regulator had the better powers and tool kit to deal with the breach (effectively who was the better ‘model litigant’). And only then the regulators can best determine whether one or both should pursue enforcement action, including litigation, by assessing the relative potential enforcement outcomes and consequential deterrent value.

The need for deterrence and public enforcement

It is clear that *strategic* conduct regulation with deterrence intent — where public enforcement action in response to material member harm (and with a reasonable probability of success) is undertaken to deter similar behaviour by others — has generally appeared either largely ‘missing in action’ or been ‘too little too late’.

Examples of public enforcement action by APRA relating to superannuation have been extremely rare and seemingly restricted to particularly egregious cases such as the Trio collapse — with APRA stating that public enforcement action is not part of the regulator’s ‘normal modus operandi’ (FSRC transcript, p. 7477). APRA has also recently (December 2018) commenced actions against IOOF entities, directors and executives relating to concerns about whether they were acting in the best interests of members. These include seeking to impose additional licence conditions and issue directions to IOOF entities, and commencing disqualification proceedings against five individuals (APRA 2018c).

The ‘behind closed doors’ nature of APRA’s supervisory activities means that there is little potential for demonstration effects. Even if poor behaviour is curtailed at one fund, there is limited capacity for it to be discouraged at others.

In commenting on a lack court action by regulators, Counsel Assisting the FSRC noted that:

A significant problem with not commencing court proceedings is that no pecuniary penalty or other relief is obtained which would achieve specific and general deterrence. (2018b, p. 217)

The Australian Institute of Company directors said:

More proactive enforcement action would be a powerful deterrent to misconduct, and regulators need to be appropriately resourced, focused and qualified to take it. The AICD acknowledges that it is at least arguable that, to date, regulatory action has been insufficient to address concerns in the superannuation sector. (2018, p. 9)

And Scott Donald noted the importance of observable enforcement:

Working behind closed doors to find a solution can give you the space to find something that works for members, there’s no doubt about that. But if you do everything behind closed doors,

then you lose the opportunity to signal to others what's expected. You also have a bit of a rule of law problem that you actually want people to know that the law will be enforced, that's actually part of it. (trans. p. 107)

As Sparrow (2012) succinctly put it, regulators should:

Pick important problems, Fix them, Then Tell Everybody!

Following recent concerns raised in response to evidence at the FSRC, both APRA and ASIC are currently undertaking internal reviews of their enforcement policies, processes and decision-making procedures. APRA stated:

In light of the issues raised in the course of the [FSRC], APRA is commencing a review of its enforcement strategy and related procedures and internal governance structures regarding issue escalation and the use of formal enforcement powers in all the industries it regulates, including superannuation. (2018r, pp. 2–3)

In addition to cases that provide remediation for members, there is a clear role for the increased use of test cases to establish the law. While test cases need to be chosen carefully, regulators should not be so conservative that they never risk losing a case. Indeed, the outcome of an unexpected loss might be a legislative change where this was considered desirable by government.

The ATO, for example, regularly utilises test cases to clarify taxation laws where such cases are likely to provide legal precedents providing certainty and clarity on future cases, and has a Test Case Litigation Program which provides financial assistance to taxpayers helping them meet reasonable litigation costs in cases that have broader implications beyond their individual disputes. Cases chosen for funding must have significance to a substantial section of the public or have significant commercial implications for an industry. Examples provided by the ATO of cases that might be funded include cases determining whether goods and services tax is payable on properties that were leased before being sold, the meaning of 'direct aid' for fringe benefits tax and the application of civil penalties in relation to promotion of tax schemes (ATO 2018i).

The ACCC is also a strong user of test cases, noting it is more likely to pursue litigation where 'ACCC action will assist to clarify aspects of the law, especially newer provisions of the [Competition and Consumer] Act' (ACCC 2017a, p. 3). ASIC and APRA also factor the need to clarify the law into their enforcement decisions, but appear overly reluctant to pursue such test cases despite their potential to lead to better outcomes for members.

It's time to clarify the respective roles of APRA and ASIC

Recent airing of concerns about regulatory arrangements in the FSRC, elevate the imperative to revisit the roles of APRA and ASIC, and to better align them with the distinct 'regulatory DNA' each possesses.

APRA should focus on matters relating to superannuation fund **licensing and authorisation** — ensuring high level system and fund performance. And it should be responsible and accountable for outcomes in these areas. Its core focus should be on *safeguarding member outcomes* — a much broader regulatory remit than conventional prudential regulation. APRA should monitor both system and fund performance and intervene when a fund’s performance is inconsistent with the best interests of members. Firmer rules for outcomes tests and remediation will help with this, as would the passage through parliament of the Treasury Legislation Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill 2017. APRA should encourage underperforming funds to ‘lift their game’ or, alternatively, firmly ‘nudge’ and then manage a merger or exit and ensure the interests of members are protected during the process.

APRA can continue to use its risk assessment tool (the Probability and Impact Rating System, or PAIRS) and supervisory response system (the Supervisory Oversight and Response System, or SOARS) to supervise the risk management of trustees, and to maintain the stability of the overall system. But these activities are focused on avoiding events (such as Trio style collapses), and should not be the predominant focus of regulation when common issues such as unchecked persistent underperformance cause significant member harm.

It should be clearly articulated that ASIC be the **strategic conduct regulator** for the superannuation system. Its focus should be on the *conduct of trustees and financial advisers*, the *appropriateness of product offerings* (including to particular target markets) and *disclosure* — and it should be responsible and accountable for outcomes in these areas.

While not fully aligned on the mechanism, both APRA and ASIC have flagged legislative change to enable ASIC to take an expanded role to deal with conduct matters:

ASIC considers that it could assume an expanded role in the regulation of conduct in the superannuation sector. The broader regulatory environment has evolved significantly ... since ... the Wallis report. ... If ASIC were to assume an expanded conduct role this could involve some allocation to ASIC of the primary regulatory responsibility for particular provisions directly impacting consumers. (2018o, p. 44)

... while APRA stated:

In sharpening the distinction between prudential and conduct responsibilities ... consideration should be given to granting ASIC wider responsibilities and powers, in addition to APRA’s current powers, to take enforcement action in relation to misconduct and potential misconduct. ... however, a considered review process would be appropriate to ensure that the specific changes made to APRA’s and ASIC’s respective regulatory responsibilities achieved the intended purpose and did not have unintended adverse consequences. (2018r, p. 10)

Consistent with the concept of strategic conduct regulation, it would not be expected that ASIC would seek to prosecute every breach of trustee duty (although it might be expected to raise issues with trustees and seek to have breaches remedied), but rather that its enforcement activities would be designed to be strategic — proportionate to the misconduct and its consequential member harm and provide public deterrence where needed.

But, importantly, ASIC's enforcement activities would generally be *public*, and focused on matters that would provide a strong demonstration effect to all trustees. This is not to imply that APRA should not engage in public enforcement activities. To the contrary, the same logic regarding demonstration effects applies to APRA, and the Commission considers this to be an important role for APRA in its areas of regulatory responsibility.

APRA has stated that it is considering giving greater weighting to potential strategic benefits of public enforcement:

... APRA acknowledges that it could give greater weighting to the strategic benefits of formal enforcement action, including litigation, for the purposes of specific and general deterrence. ... APRA is commencing a review of its enforcement strategy to ensure that it has appropriate regard to specific and general deterrence. APRA envisages, as part of this review, identifying where additional guidance would be beneficial for supervisors on appropriate circumstances in which to escalate an issue for consideration of formal enforcement action and the type of action that may be appropriate. (2018r, p. 18)

Legislative change would likely be required to clarify roles

For ASIC to be well placed to take the lead as superannuation's strategic conduct regulator, legislative change (potentially additional powers for ASIC within the SIS Act) is likely to be needed:

... ASIC agrees that there is a significant role for strategic conduct regulation in superannuation, in particular that goes beyond disclosure and addresses misconduct relevant to outcomes. ASIC is currently implementing an enhanced approach to its regulation of superannuation, but ... a greater conduct regulation role would desirably require law reform ... (ASIC, sub. DR206, p. 23)

Furthermore, there will always be matters with both an authorisation and conduct aspect. As noted by ASIC:

It would be important to clarify as part of any such reformulation who is the primary regulator expected to act in relation to specific instances of misconduct where shared responsibilities exist. (2018o, p. 44)

However, clarifying APRA and ASICs' respective roles within legislation would require a thorough and methodical consideration of superannuation legislation and the Commission is not best placed to undertake this. The Commission is also mindful that these matters are subject to consideration by the FSRC. Ultimately, and with the benefit of the principles laid down in this report and the more detailed legal findings and recommendations of the FSRC, the Government should clarify the precise allocation of roles between APRA and ASIC without delay — involving a clearer delineation of their respective roles, including through legislative change where this is considered necessary.

The memorandum of understanding between APRA and ASIC would also need to be updated to reflect the new delineation of roles, and would continue to be critical to ensuring the regulators performed effectively in tandem. It would be important for APRA and ASIC to work closely together to overcome information asymmetry. Arrangements should seek to

ensure that where either regulator had information that was likely to be of significance to the activities of the other regulator, this information should be provided in a timely manner.

APRA and ASIC need to become ‘member champions’ in a world of compulsion and member disengagement

Although the key focus of regulators in a compulsory superannuation system should be to protect member interests, the absence of member voice in the many and major industry debates — and the absence of quality data to inform regulator analysis — means the views of funds more often than not dominate. Clarifying the respective roles of APRA and ASIC should also assist them in becoming more confident, member-focused regulators — ‘member champions’ — and increase their accountability for outcomes. There is some evidence of this member focus emerging with, for example, moves towards the adoption of the outcomes test for APRA and recent enforcement actions by ASIC (chapter 9), but there is still a way to go before either regulator could really be seen as truly member-focused. The National Foundation for Australian Women noted that:

Emerging evidence from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry shows that major reforms are required to bring regulatory agencies together to protect the interests of consumers. (sub. DR127, p. 6)

A peak body for members would add to better regulation

Chapter 5 highlighted the need for an organisation that could effectively represent consumers of superannuation products. The potential regulatory significance of such a body was noted by ASIC in a submission to the FSRC:

The establishment and funding of a properly resourced and independent consumer advice and advocacy centre focused on superannuation would also assist regulatory action in a number of ways, including through:

- (a) identifying and demanding action on misconduct and conduct below community standards;
- (b) assisting in the assessment of what issues are most significant and worthy of regulatory attention from a consumer perspective;
- (c) urging regulators to take action and raising public alarm where they do not act or act too slowly; and
- (d) providing a balancing consumer voice in policy and other debates. (ASIC 2018o, p. 43)

As discussed in chapter 5, a new government-funded organisation to understand, promote and express member interests is urgently needed to ensure the ‘member voice’ is heard in debates surrounding superannuation.

FINDING 10.2

Conduct regulation arrangements for the superannuation system are confusing and opaque, with significant overlap between the roles of APRA and ASIC. These arrangements inevitably lead to poor accountability and contribute to the lack of strategic conduct regulation, especially public deterrence through enforcement action, with poor outcomes for members.

A capability review of APRA is overdue

The Financial System Inquiry recommended a running series capability reviews for ASIC, APRA and the Reserve Bank of Australia (with respect to the payments system). To date the Government has only initiated the ASIC capability review. In the case of APRA, no such review has taken place, and should be a high priority. It should consider, in particular, the adequacy of APRA's superannuation-related resourcing: whether there are an adequate number of staff dedicated to regulating superannuation, and whether they have the necessary capabilities (noting a funding increase was recently announced of \$58.7 million over four years) (Frydenberg 2018a). In addition, the review should consider future resourcing needs given the need to deal with poorly performing funds and implement the elevated outcomes tests and the recommendations of this inquiry.

It would also be well placed to consider matters such as internal governance structures, data analytical capacities and the appropriateness and use of APRA's powers. While the internal review of APRA's enforcement procedures (discussed above) is welcome, the Commission does not see this — or the recent Financial Sector Assessment Program undertaken by the International Monetary Fund — as representing in substance an alternative to a comprehensive independent review of APRA's capabilities and internal governance structures as recommended by the 2015 (Murray) Financial System Inquiry Report and agreed to by the Government in its response (chapter 13).

Consideration of outside expert opinions is important for driving regulatory improvement, and therefore the capability review should consult widely with experts and stakeholders (whereas recent evidence to the FSRC highlighted the APRA enforcement review would be largely an internal exercise, with the external independent advisory panel to the enforcement review playing a limited sounding board role).

Under questioning from FSRC Counsel Assisting Michael Hodge, APRA Chairman Wayne Byers noted APRA had no objection to a capability review, especially given the International Monetary Fund review has now concluded.

[MR HODGE:] Do you have any inherent objection to opening APRA up to external scrutiny, to have an external capability and enforcement review done? [MR BYERS:] No. We've said many — we've been asked this many times, do we have a fundamental objection to a capability review. The answer is no. The government, after the FSI inquiry, the government decided it would do a capability review of ASIC first. It did that. The only thing we have said is that because in the last

18 months we've been subject to a number of reviews, including, in particular, a recently completed review that was very extensive by the [International Monetary Fund], that there was simply an organisational capacity that we didn't want multiple reviews all happening at the same time. That's the only thing we asked for, not to have multiple reviews happening on top of one another. (FSRC transcript pp. 7460–61).

Is a single regulator the answer?

Some participants, and the FSRC, have raised the possibility of a single superannuation regulator. However, as ASIC noted:

The creation of a third regulator would exacerbate boundary issues and overlap issues between the responsibilities of regulators and open up greater possibility of inconsistent or conflicting approaches. ... regulatory agencies should be allocated functions in a way which minimises overlaps, duplication and conflicts. ... superannuation is part of a broader continuum that can not easily be 'hived off' into a discrete and separate space. For example, financial advisors advise clients on their overall financial plans including superannuation and non-superannuation aspects. Life insurance is inextricably linked to superannuation. Superannuation funds may invest in other financial services investment products. (2018o, pp. 49–50)

APRA noted that forming a single superannuation regulator with responsibility for prudential and conduct regulation would not remove the tensions between these objectives:

A separate superannuation regulator could, *prima facie*, avoid the boundary issues between prudential and conduct matters, and bring clearer accountability for carriage of particular regulatory compliance matters. It would also allow significant specialisation in one agency. However, to the extent there are tensions between prudential and conduct related objectives, a revised structure would not remove these: they would simply be internalised into one body. (2018r, p. 9)

The Commission does not consider that a single regulator would solve regulatory problems in superannuation — most of which stem from a lack of effective regulator accountability on the part of the Government (discussed below). New boundary issues would be created and tensions would remain, albeit located within one body. A regulator focusing exclusively on superannuation would also potentially lack the broader perspectives gained from being exposed to issues elsewhere in the financial services sector. It would be preferable for APRA and ASIC to each stick to what they do best, while government seeks to minimise overlap and provide greater clarification of their respective roles.

There has also been commentary about whether ASIC's mandate, which the ASIC Capability Review noted is 'not fully replicated by any other conduct regulator globally' (Chester, Gray and Galbally 2015, p. 34), is too broad. ASIC's responsibilities can be broadly categorised into three areas:

- financial markets, financial services and corporate regulation
- business and company registration
- credit and insolvency practitioners (Chester, Gray and Galbally 2015, p. 34).

Consistent with the findings of the ASIC Capability Review, the Commission does not consider that ASIC's mandate is too broad for it to be an effective conduct regulator for superannuation. Rather, it is essential that ASIC's internal and external governance arrangements, and particularly its recruitment and deployment of staff, are optimal to ensure ASIC can fulfil all aspects of its mandate. It is also important for the Government's Statement of Expectations for ASIC (discussed below) to provide guidance on government regulatory priorities, and for ASIC to detail in its Statement of Intent any intended trade-offs between objectives given inevitably limited resources.

Guidance to APRA and ASIC must reflect current priorities

Statements of Expectations are an important accountability mechanism for clarifying the Government's expectations of regulators and a vehicle for ministers to provide guidance on regulatory priorities and, importantly, assess regulator performance. In the absence of such guidance, regulators are left to determine what to prioritise and, given the flexibility afforded to them, cannot be held fully accountable for their decisions. Moreover, they are left to make decisions in isolation regarding the 'public interest' that are properly the preserve of elected ministers. Statements also need to be updated regularly to ensure they reflect current government priorities which has not always been the case in recent years.

In its response to the Financial System Inquiry, the Australian Government pledged to update the Statement of Expectations for APRA and ASIC by mid-2016 'to provide additional guidance about the Government's expectations for their strategic direction and performance and improve regulator accountability' (2015, p. 8). However, updated Statement of Expectations for ASIC (dated April 2018) and APRA (completed June 2018) were not publicly released until September 2018 and October 2018 respectively. And then for ASIC the Statement did not fully implement the accountability mechanisms proposed by the ASIC Capability review.

Scott Donald noted the previous (2014) Statements of Expectations for APRA and ASIC placed little emphasis on enforcement:

When you look at the statement of expectations that the current Government has articulated for both of these organisations, it gives very little emphasis on enforcement, a lot of emphasis on light touch and efficiency and so on, which is fine, but it seems to me that it's very unfair to stand back and criticise them for not enforcing the rules if you haven't actually really emphasised that as being a priority. (trans. p. 98)

APRA highlighted the importance of the Statement of Expectations reflecting a contemporary shared understanding of APRA's role.

APRA agrees that it is important that the Government and APRA have a contemporary shared understanding of how APRA's supervisory approach can optimise consumer and community outcomes whilst not jeopardising prudential safety. (sub. DR204, p. 17)

The APRA and ASIC Statements of Expectations released in September 2018, while more reflective of current government priorities than the previous versions, do not appear to fully reflect recent developments in which flaws in the regulation of superannuation have been identified by the Commission and the FSRC. Although updating of the documents (which was recommended in the Commission’s *Competition in the Australian Financial System* inquiry report) is welcome, in view of recent revelations of governance and regulatory failings, it is likely another updating of the Statements will be required in the near future — including to reflect any policy changes stemming from the Commission’s report (such as highlighting the need for greater strategic conduct regulation), and the recommendations of the FSRC.

The ASIC Capability Review suggested the ASIC Statement of Expectations include a clear articulation of the market risks confronting ASIC and of the Government’s risk appetite with regard to ASIC’s regulation of the financial system. It also suggested the responsible Minister should provide an Annual Ministerial Statement to the Parliament on ASIC’s overall performance, including on the assessment as to how well ASIC has met the Statement of Expectations, and how ASIC is performing in the achievement of its mandate (Chester, Gray and Galbally 2015). The Commission considers these accountability elements should be incorporated in the Statement of Expectations for APRA and ASIC.

Regulators issued with Statements of Expectations should, consistent with current practice, respond by publishing Statements of Intent, outlining how they intend to meet the Australian Government’s expectations (Chester, Gray and Galbally 2015). Further, they should include information on the actions taken that are in line with their Statements of Intent in their annual reports (including performance reporting required under the Public Governance, Performance and Accountability Act) to ensure they remain accountable to the Government and the community. The public nature of this process should assist in ensuring both the accountability and independence of regulators by providing transparency regarding the expectations placed on regulators by Government, and communication between the Government and the regulators.

More generally, the accountability mechanisms for regulators that exist within the Australian (Westminster) system of government detailed and discussed in the ASIC Capability Review — such as ministerial and parliamentary oversight and inquiries, performance reporting, the Statement of Expectations and Statement of Intent — have been left largely dormant or at best underutilised by Government in the case of ASIC and APRA. As a result, ASIC and APRA have not been held fully to account by the Government. These mechanisms are available to be utilised and supplant the need for another ‘regulator to regulate the regulators’ as is sometimes proposed.

Importantly, the Commission is also proposing additional accountability measures for ASIC and APRA — reporting by APRA to the Council of Financial Regulators on how members are being shepherded to better funds (section 10.4), how mergers are progressing within the superannuation sector (chapter 9) and a joint biennial report by APRA and ASIC on the state of the superannuation sector (section 10.8).

10.4 An elevated outcomes testing regime is required to deal with underperformance

A material tail of entrenched underperforming MySuper and choice products clearly demonstrates that the system has failed to deliver good outcomes for many members (chapter 2). Evidence provided at the FSRC strongly reinforces this conclusion. As discussed above, the prudential and caveat emptor approach that has guided much regulation to date is both inappropriate and inadequate, especially (but not only) for default products. Members would have a realistic expectation that government and regulators would ensure their fund is looking after them, but this expectation would have been sadly misguided — with no regulatory disposition nor effective mechanism in place for weeding out underperforming funds and products.

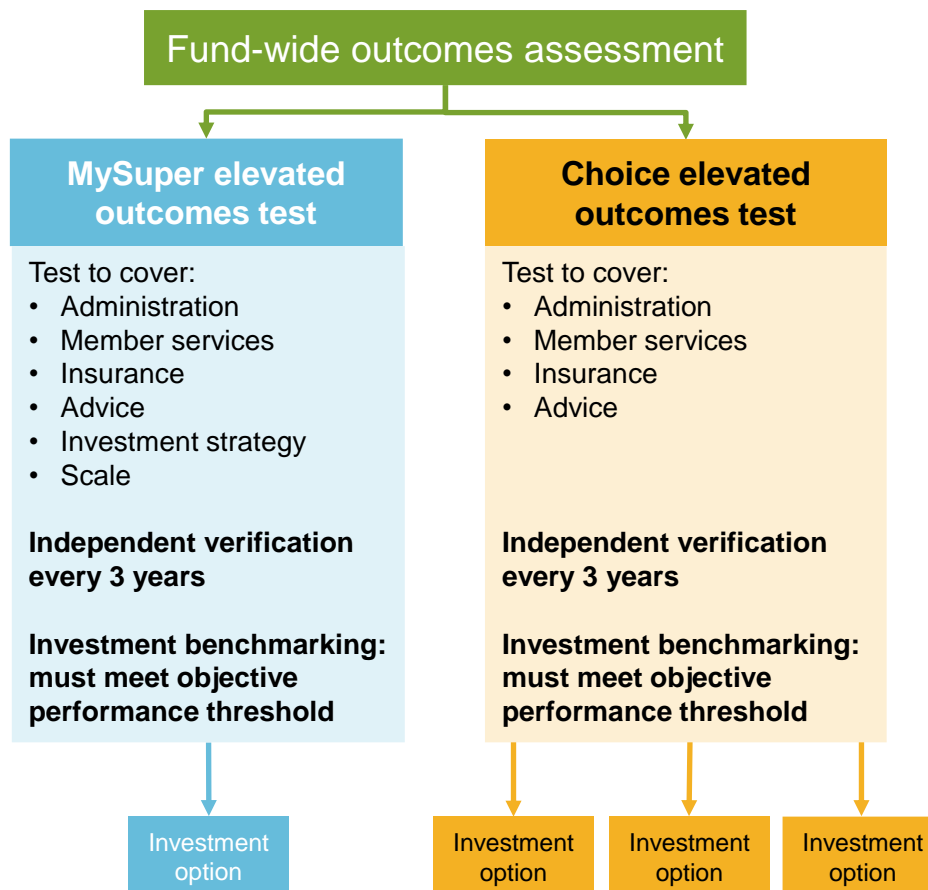
The Commission considers the initiatives already underway to make all super fund trustees more accountable for the outcomes they deliver to their members need to be considerably strengthened (figure 10.3). The Commission's recommendations for an elevated outcomes testing regime will likely see a number of products being withdrawn from the system, as well as much needed consolidation (tech. supp. 8). However, the products to be withdrawn will largely be those without merit — the chronic underperformers. Such consolidation involving the exit of chronic underperformers is long overdue and should be welcomed. Indeed, that is the *raison d'être* of the changes: to significantly reduce the incidence of member harm by lifting fund performance and, where funds cannot achieve this, to encourage and, if necessary, compel mergers or exits ('cleaning up the tail' of underperformers). However, while many of the underperforming products produce significant member harm, they can be very lucrative for funds and therefore strong regulator commitment will be required to ensure the test is fully enforced.

Elevating the MySuper outcomes test: a policy 'must have'

At the time the authorisation process for MySuper products was introduced, it was intended to set strong safeguards to protect disengaged default members, while also helping more engaged members to compare products and thus exert competitive pressure on funds (Cooper et al. 2010a).

But MySuper authorisation has not lived up to expectations, with many of the funds that were granted MySuper authorisation persistently underperforming (chapter 2). Regulators have shown little appetite or ability to revoke the MySuper status of these underperformers, in part because of the ineffectiveness of the legislated annual scale test (section 10.2).

Figure 10.3 **Earning the ‘right to remain’: an elevated outcomes testing regime^a**



^a Elements in bold font are in addition to draft legislation (MySuper outcomes test) and APRA standards (fund-wide outcomes assessment).

A clear objective performance threshold is needed for MySuper

The MySuper outcomes test before parliament is overdue and passage of the legislation containing it should be expedited. However, to be truly effective, the standards required for the test need to be elevated and clear standards set for benchmarking investment performance. This should include a clear, objective performance threshold that funds must meet each year (described below) to retain their MySuper authorisation. The threshold should effectively serve as a ‘right to remain’ test designed to ensure funds (which are ultimately a ‘vessel’ designed to service the needs of members) have to earn their right to be part of the compulsory superannuation system and that members’ interests are paramount rather than the interests of funds.

The adoption of a dispassionately objective performance benchmark provides clear guidance to both trustees and regulators, and helps ensure both are accountable (whereas accountability is diminished when the standards required are vague or subjective, and open

to gaming or selectivity). Funds should also be required to obtain independent verification — to an audit-level standard — of their MySuper outcomes test determination and assessment at least every three years. APRA will need to closely review the outcomes tests undertaken by funds and take action where deficiencies are revealed, including drawing on guidance from ASIC on the appropriateness of investment strategies.

Performance thresholds are needed to send a clear signal to fund trustees that persistent investment underperformance is not to be tolerated and will be much harder to dispute than the more qualitative parts of the outcomes assessment. They will also assist in cleaning up the large stock of high-cost legacy products hitherto remaining in the system. While there may be an element of ‘rough justice’ for funds, this is unambiguously preferable to the ‘rough justice’ the system has frequently meted out to millions of members — whose interests’ trustees are required by law to prioritise. By putting the onus on funds to justify why they should remain in the system, the thresholds will help to hold them more accountable for member outcomes — an accountability which has been lacking to this point.

Clear thresholds will also put a stronger onus on APRA to take timely and decisive action against underperformance. This approach of basing the right to remain in the system on *objective* performance is also superior to alternative less targeted approaches to dealing with underperformance sometimes proposed — such as prohibiting retail funds from offering MySuper products, or banning particular board structures — particularly given underperformance occurs across *all* fund segments (chapter 2).

A further benefit of applying an objective ‘right to remain’ test is that by dealing with poor performance, it also deals with poor trustee conduct. Whether poor performance is due to poor competence, conduct or a combination of both (‘the three c’s’) is irrelevant — poor performers would be weeded out. By flagging poor performance, however, the right to remain test also provides a red flag to ASIC that there could be conduct issues to investigate at those funds.

Further, the inevitability of some chronically underperforming funds failing the test provides a strong incentive for those funds to exit ahead of the test’s introduction — meaning the test could deliver better outcomes even before its implementation.

Extending the outcomes tests to choice: another policy ‘must have’

There is little (enforced) regulation of member outcomes in the choice segment or of the products and investment options that are offered to choice members — and yet this is where many of the worst member outcomes occur. While some trustees have voluntarily stopped new members from entering poorly performing products, regulators have often allowed them to keep existing members in those products, as has been highlighted at the FSRC. The Commission’s analysis shows legacy products accounted for just under half of assets in the high fee tail in 2017 (chapter 3) and represented over 3 million member accounts (chapter 2). The prevalence of persistently underperforming choice products in the super system shows

that existing safeguards — in relation to financial advice and product disclosure — have been inadequate (chapters 2, 3 and 5).

Some inquiry participants called for greater regulatory oversight of outcomes in the choice segment (AIST, sub. DR130; ISA, sub. DR162). For example, the Australian Institute of Superannuation Trustees (sub. DR130, pp. 5, 60) argued that the fees and returns of choice products should be benchmarked, and supported extending the MySuper outcomes test to choice (with the results being made publicly available).

As discussed above, APRA has developed a new prudential standard applying from January 2020 requiring trustees to undertake a fund-wide ‘outcomes assessment’. Trustees of all large APRA-regulated funds will need to assess the member outcomes being delivered across all their products and investment options — including by setting clear metrics and objective benchmarks — and identify how these outcomes can be improved. APRA could request the assessments from funds at any time, but funds would not be required to publish them (APRA 2018f).

This fund-wide outcomes assessment will effectively sit above the MySuper outcomes test (if and when it is enacted). It will cover all products and investment options within each fund, including the MySuper product where one exists. In undertaking the fund-wide assessment, funds will effectively undertake their MySuper outcomes test in conjunction with a comparable exercise for their choice products (APRA 2018f).

A clear objective performance threshold is needed in choice too

The assessment of outcomes in the choice segment needs to be strengthened — and given real teeth — by extending the elevated outcomes test to choice. Funds should be subject to a clear, objective investment performance threshold for each choice investment option — the same elevated ‘right to remain’ test as should apply to MySuper. Those options that fail will need to be remediated or withdrawn (described below). Applying the test at the investment option level negates the common refrain that trustees cannot be held responsible for outcomes given members are making their own decisions. It is the quality of investment options being *offered* to members (or in the case of legacy products, those that have previously been offered) that should be the focus of regulatory attention.

In applying this elevated outcomes test to choice products, funds would need to consider administration fees, member services, insurance and financial advice provided by the fund. There would presumably be a lesser focus on the appropriateness of investment strategies for choice members, given the potential for members themselves (or their advisers) to set their own investment strategy.

All funds should also be required to obtain independent verification — to an audit-level standard — of their fund-level outcomes test at least every three years. The entire outcomes test would not need to be published, but funds should be required to publish the performance

benchmarking of each of their investment options, as well as a certificate of the independent verification of their assessment.

As part of the fund-wide outcomes assessment, an elevated objective outcomes test for choice would increase trustee and regulator accountability for the outcomes delivered, and give APRA greater oversight of fund performance. Compliance with the outcomes test regime should also be a condition of funds retaining their RSE licence. Individual choice products and investment options would not be subject to a direct authorisation process before they can be offered (as distinct from MySuper), although they would be subject to the forthcoming ‘design and distribution’ obligations to be enforced by ASIC (which will require funds to ascertain that the options are being offered to a suitable target market) (section 10.2).

Operationalising option-level performance benchmarking

In benchmarking investment performance in both MySuper and choice investment options, funds should be required to benchmark each option to a portfolio of listed market indexes that reflects the asset allocation of the product — a listed benchmark portfolio (BP1), as applied by the Commission in chapter 2. This benchmark represents a ‘counterfactual’ set of assets that members could have been passively invested in, and which funds should at least be matching in performance over reasonable timeframes. It should include an allowance for reasonable costs incurred in the provision of investment options through superannuation.

Benchmarking to a portfolio of indexes side-steps the need to benchmark choice options to comparable options in the market. And because a benchmark portfolio is tailored to (and thus agnostic of) the asset allocation of each option, it can be flexibly applied to a range of product types, including life-cycle products. Funds should therefore be required to benchmark all MySuper products and virtually all choice investment options. This should include pre-mixed options, single-class options and options delivered through a member-directed investment ‘platform’, as well as term deposits and managed funds issued by outsourced providers. Retirement products should also be included, except where the investment return is fully guaranteed (for example, some annuities).

While benchmarking some investment options is impractical, exemptions from the requirement should only be made on an ‘if not, why not’ basis where a compelling case can be made to APRA that benchmarking is not feasible — for example, where there are investment options that comprise a single asset (such as shares in an individual company).

Most importantly, a clear performance threshold should be set that all MySuper and choice investment options are expected to meet or exceed. This threshold should be based on average annual performance against the listed benchmark portfolio for the preceding 8 years, less a margin of up to 0.5 percentage points (50 basis points). Assessing performance over an 8-year period would abstract from much of the year-to-year volatility of investment markets, and thus not discourage funds from long-term investment strategies or from making investments that differ from those that constitute the market indexes. APRA should issue

clear and specific guidance on the construction of the benchmark portfolios (informed by the Commission’s work in this inquiry), and revise the parameters over time as necessary.

In light of substantial evidence of underperformance over many years and ongoing harm to members if this is not promptly rectified, the performance threshold should be applied retrospectively. Initially, it can be expected to capture most of the long-term underperforming options in the super system (chapter 2). To avoid capturing products with reasonably good long-term performance as a result of historical data anomalies (chapter 2), APRA should have discretion in the initial year of application in how to interpret the results — although this discretion should be removed once data are of sufficient quality for an 8-year period. The Commission envisages that the ‘right to remain’ test can be applied fully by 2022, when enough high-quality data on investment options have been collected, by both funds and the regulator.

Where an option fails to meet the benchmark, the fund should be given no more than 12 months to remediate performance, and demonstrate to APRA that this will likely result in a timely improvement to member outcomes. The Commission envisages that effective remediation within that timeframe (given the 50 basis point margin in the benchmark test) could typically only be achieved by fee reduction. It would be unlikely to be achieved through changes in investment strategy or outsourced providers (unless the latter involves material fee changes).

Careful oversight of the remediation process will be essential. As the results of the elevated MySuper and choice outcomes tests will be published, there will be public scrutiny of funds that have options that fail one of the tests.

APRA should have the power to deal with attempts to ‘game’ the process or implement short term strategies not in members’ interests. APRA should have the power to direct a trustee to take a specific course of remedial action, to make remediation plans a condition of a fund’s RSE Licence, or to prohibit funds from accepting new members into the affected option or launching new investment options until remediation is complete (or the affected option is withdrawn). In parallel, the proposed product intervention powers for ASIC (section 10.2) would allow it to ward off ‘phoenix’ behaviour, whereby trustees that cannot rectify poor performance (or do not wish to) simply introduce a new option that is substantively the same but superficially different.

While for some funds, remediation may be relatively straightforward — for example, by cutting fees as outlined above — other funds may not be able to turn around their performance within 12 months (through, for example, better investment decisions), and instead could voluntarily seek to withdraw the investment option and transfer members to a better performing option (either in their own fund or a different fund), or enter into a merger arrangement with another fund.

Where a trustee takes the initiative to transfer its members to another investment option or fund (including through a merger), the transfer would be subject to the equivalent rights tests (chapters 4 and 9). The fund should also allow the affected members — regardless of

whether they are MySuper or choice members — at least 90 days to voluntarily switch to another option or fund (although these transfers could be prevented where there are concerns about ‘runs’ on funds). Any remaining members should then be transferred in a timely manner. Fund mergers should be completed within two years.

Decisive regulator action is required to clean up the tail

While implementation of an elevated outcomes testing regime will put long overdue pressure on trustees of underperforming funds and products to improve their performance or exit the superannuation system, it needs to be backed by decisive regulator action to enforce the regime and clean up the tail of underperformers — which would give trustees an added incentive to take voluntary action before this occurs. The ‘right to remain’ performance threshold would make the enforcement task easier by providing greater clarity and certainty about when regulator action could be expected.

In the event a fund has failed to sufficiently remediate its underperformance or voluntarily arrange a merger or transfer, APRA should then be compelled to revoke the fund’s MySuper authorisation or direct the fund to withdraw the affected choice investment option. If the underperformance is a result of broader governance failures, APRA may need to go further and revoke the RSE Licence — and APRA should not be reluctant about doing so given that members’ interests should be paramount. In addition, ASIC could — at any time — direct a choice option to be withdrawn if it deemed it inappropriate for its target market, or if the fund had not correctly identified and targeted that market.

Should these situations arise, APRA may need to temporarily limit flows of money out of the affected fund to avoid a ‘run’ of members seeking to roll out balances all at once (which could disadvantage remaining members if assets were required to be sold quickly for liquidity reasons). The specific course of action would be decided by APRA on a case-by-base basis, but could involve, for example, allowing employer contributions to continue but restricting withdrawals to pre-existing income stream payments and special conditions of release (such as severe financial hardship or terminal medical conditions).

APRA will also need to ensure a suitable recipient fund is found for the affected members — which could be either the members of a specific investment option, or members in the fund as a whole (if it needs to be wound up). In the first instance, the trustee of that fund should identify a suitable successor fund to take the members, and APRA should have discretion to approve or reject this transfer. If no suitable fund has been identified, then APRA should transfer the members to a fund on the ‘best in show’ shortlist (box 10.6).

Box 10.6 **How to protect members transitioning out of underperforming funds**

Where a fund has an underperforming investment option (either MySuper or choice) that cannot be remediated and a voluntary merger or transfer has not been arranged, APRA should take decisive action to oversee or direct a transfer of members to a better fund.

In the first instance, the trustee of the affected fund should identify a suitable successor fund to take the members, on the basis of being able to provide a similar 'bundle of rights' to members but better investment performance. APRA should have the power to approve or direct this choice of fund, and to exempt the process from the formal and detailed equivalent rights test. Instead, APRA must determine that the transfer is, on balance, likely to be in the best *long-term* interests of the members of *both* funds. Trustees of both funds would still be required to act in their members' best interests at all times.

Such a process could involve the creation of a temporary sub-fund within the successor fund. The successor fund trustee would become the acting trustee for the affected members, and would be given time to gradually sell underperforming assets and move the members to either its own MySuper product or the most similar choice investment option. Appointing the successor fund as acting trustee (rather than an independent 'gun for hire' trustee) should provide a clear alignment of incentives to transfer the members in an efficient and timely manner.

Should no successor fund have been identified, or the original choice vetoed by APRA, then APRA should approach funds on the 'best in show' shortlist to take the affected members. This could also be on a temporary sub-fund basis to reduce the risk of affecting the best in show fund's existing members. Accepting members on this basis should be an attractive proposition for best in show funds, and provide even greater incentive to compete in the best in show process. It would also reduce any adverse effect of lower short-term performance on the fund's ability to compete in subsequent rounds of the best in show process (though the expert panel should also recognise and account for any short-term adverse impact on performance associated with absorbing members from an underperforming fund).

If best in show funds are unwilling to take the members on this basis, APRA should approach funds outside the shortlist. Only in the scenario where no willing fund can be found would APRA need to appoint an independent acting trustee with a remit to wind-up the fund.

Enabling such an APRA-directed transfer process may require legislative change. It will also require careful implementation to ensure the process is manageable for APRA and the receiving funds (chapter 13). To promote accountability, APRA should be required to report on its progress in applying the elevated outcomes testing regime and in shepherding members to better performing funds — reporting to the Council of Financial Regulators annually, and to the public every two years in the biennial *State of Superannuation* Report (section 10.8).

10.5 New arrangements are in place for dealing with complaints

A 2017 review (the ‘Ramsay Review’) investigated dispute resolution procedures (that is, procedures where an impartial person such as an Ombudsman assists in obtaining resolution of an issue) shared between the Financial Ombudsman Service, the Credit and Investments Ombudsman and the Superannuation Complaints Tribunal (SCT).

At a general level, the Ramsay Review found that the existence of a number of schemes has led to confusion, difficulty in pursuing complaints where financial services businesses were involved in multiple schemes, and unnecessary duplication (Ramsay, Abramson and Kirkland 2017). Specific concerns with regard to superannuation included:

- significant delays in resolving disputes
- chronic underfunding and resourcing, with a lack of flexibility in these areas
- a lack of focus on achieving system-wide improvements as well as identifying recurring or systemic issues
- outdated, passive and indirect oversight and accountability arrangements
- restrictive and inflexible dispute resolution processes
- lack of stakeholder engagement.

On average, SCT resolution of a dispute from lodgement to determination was 796 days in 2015-16 (although 87 per cent of cases were resolved before the determination stage). Funding for the entity was not linked to the number of cases dealt with, and staff numbers had fallen from 44 to 32 between 2010 and 2015-16 (Ramsay, Abramson and Kirkland 2017).

The Review concluded that ‘dispute resolution arrangements for superannuation are broken’, with the SCT ‘unable to resolve disputes quickly’ (p. 9) and that:

The pressures on SCT will increase in the absence of significant reform, as the superannuation system matures and an increasing proportion of the population moves from the accumulation to the drawdown (retirement) phase. Fundamental reform will be required to manage ongoing changes in demand and to provide more effective dispute resolution for consumers. (Ramsay, Abramson and Kirkland 2017, p. 9)

The Australian Government, in response to the Ramsay Review, put in place the Australian Financial Complaints Authority which operates across the entire financial services sector including the SCT. The new body commenced operations on 1 November 2018. This is a positive reform. Given past funding issues with the SCT, ensuring the new complaints body is adequately resourced to deal with what the Ramsay Review correctly identifies as a workload likely to grow in future years, needs to be a high priority (Ramsay, Abramson and Kirkland 2017, p. 87).

FINDING 10.3

The formation of the new Australian Financial Complaints Authority should be a positive reform for members, provided it is adequately resourced to deal with the level of complaints received.

The Commission's stage 1 study foreshadowed that the proportion of successful complaints to the SCT would be reported in stage 3 as one indicator of whether principal-agent problems are being minimised. In view of the workings of the SCT, it is difficult to draw any strong conclusions from SCT complaints data. Many complaints are withdrawn by complainants, or are considered withdrawn by the SCT if, for example, they are considered to be misconceived, lacking in substance, trivial or vexatious. Complaints can also be withdrawn if the subject matter has been, or could be, more effectively dealt with by another statutory authority, or has already been dealt with by the SCT.

Where complaints are not withdrawn, the SCT may require parties to attend a conciliation conference to attempt to settle the complaint. Only if this is unsuccessful, and the complaint is not withdrawn, will the complaint proceed to review. If complaints proceed to the review stage, the SCT may:

- affirm a decision
- remit a complaint to the trustee, insurer, ... or other decision maker for reconsideration of its decision in accordance with the directions of the Tribunal
- vary a decision
- set aside a decision and substitute its own decision (SCT 2017, p. 7).

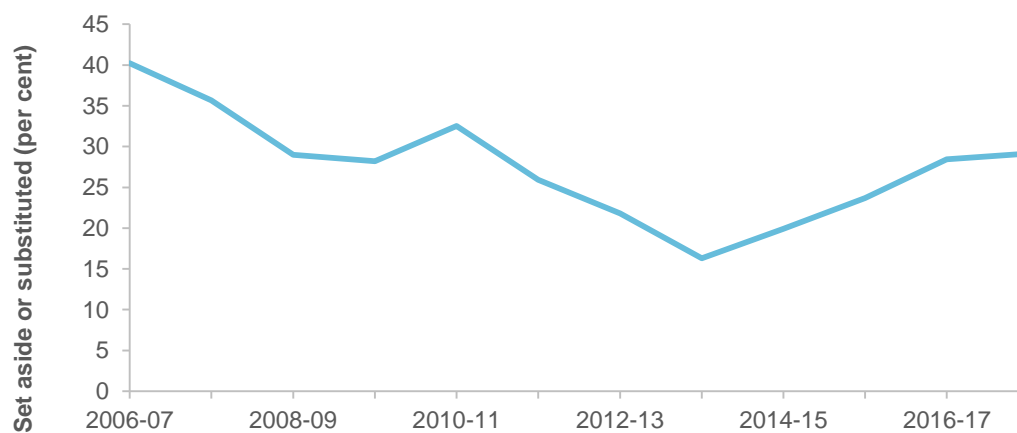
Since 2006-07, the number of complaints to the SCT that made it to the review stage has ranged from around 100 to close to 300 in any given year, and show a rising trend (table 10.1; figure 10.4). Of these, a relatively small proportion of trustee decisions have been set aside or substituted. However, the Commission does not see this as necessarily reflecting that principal-agent issues are not a material concern.

Table 10.1 Complaints to the Superannuation Complaints Tribunal (that reached review stage), 2006-07 to 2016-17

<i>Year</i>	<i>Number of complaints</i>	<i>Affirmed</i>	<i>Remitted</i>	<i>Varied</i>	<i>Set aside or substituted</i>
2006-07	169	94	6	1	68
2007-08	143	87	4	0	51
2008-09	100	71	0	0	29
2009-10	78	54	1	1	22
2010-11	123	79	3	1	40
2011-12	108	76	0	0	28
2012-13	133	101	2	1	29
2013-14	270	220	4	2	44
2014-15	286	224	1	2	57
2015-16	173	121	10	1	41
2016-17	211	144	6	1	60
2017-18	254	166	4	10	74

Source: SCT Annual Reports (various years).

Figure 10.4 Only a minority of reviewed SCT complaints involve trustee decisions being set aside or substituted



Source: SCT Annual Reports (various years).

10.6 SMSF regulation is appropriate but SMSF-related advice is of concern

Members of SMSFs are directly responsible for their own strategic superannuation decisions and thus face fewer principal–agent problems (with the notable exception of financial advisers) than members in the default and choice segments. Regulation of SMSFs — largely the responsibility of the ATO — therefore focuses on compliance with legislative and regulatory requirements. ATO regulatory activities include:

- providing information to help members set up their fund
- ensuring funds comply with taxation obligations
- checking funds are managed in accordance with the superannuation laws
- taking enforcement action to correct matters when there is a breach of the law
- checking that SMSF auditors perform their duties to the required standard.

The Financial System Inquiry considered whether APRA or ASIC should have a role in regulating SMSFs, concluding that:

The Inquiry does not support [prudential regulation of SMSFs by APRA]. The defining characteristic of the SMSF sector is that trustee members are directly responsible for each fund and must take responsibility for their own decisions. (Murray et al. 2014, p. 234)

The Cooper Review reached similar conclusions and the Commission is of a similar view. One of the major attractions of SMSFs for members is that they have greater control of their investments, and they overwhelmingly do not want regulatory ‘red tape’ constraining them.

Given that SMSFs are exempt from prudential regulation, they are also exempt from the statutory compensation that APRA-regulated funds can access in the event of theft or fraud (Treasury 2014) although, as highlighted by Victims of Financial Fraud, it is likely many SMSF members are not aware of this.

After the Trio fraud, Part 23 of the Superannuation Industry (Supervision) Act 1993 was displayed as if everybody understood the legislation. But this was not the case, the legislation only surfaced after the fraud event. With all the rules and regulations around superannuation, why Part 23 of the SIS Act legislation was not made available in guidance or information material remains an unanswered concern. (sub. DR170, p. 2)

The Parliamentary Joint Committee Inquiry into the collapse of Trio Capital concluded:

The committee is concerned that some SMSF investors in Trio Capital seemed not only unaware that their investment was unprotected from theft and fraud, but unaware they had even established a self-managed fund. (PJCCFS 2012, p. xxv)

Consequently, financial advice laws and regulations on financial products (administered by ASIC) are the main forms of protection available to SMSF members.

While the day to day operations of SMSFs are not subject to the principal–agent problems present in other superannuation funds, there are concerns with regard to the advice provided to SMSF members, including about whether to set up an SMSF (chapter 5).

ASIC, in its research on the quality of advice and member experiences in SMSFs, also noted the Commission’s draft findings with regard to SMSF performance and stated:

The draft findings of the Productivity Commission about fund size for SMSFs highlight the risks for consumers with lower balances. Advice providers should carefully consider the Productivity Commission’s draft findings and discuss these draft findings with clients. (ASIC 2018n, p. 10)

The ASIC study raises clear concerns about the quality of advice being provided to SMSF members, and the processes undertaken by financial advisers to ascertain the client’s best interest. The forthcoming higher educational and training standards (commencing 2019) that will be required for financial advisers (O’Dwyer 2017b) should go some way towards improving the quality of advice provided. The Commission’s proposed best in show list would also represent an if not, why not reference point for advisers and their clients (chapter 12).

The Government should strengthen ASIC’s toolkit by extending the proposed product ‘design and distribution obligations’ to SMSF establishment — given this area is where many of the most egregious cases of poor advice have occurred. A mandatory minimum balance for SMSF establishment is not justified and represents too blunt an instrument. However, given the Commission’s findings on scale and SMSF performance (chapter 2), advisers should be prepared to justify to ASIC why they are recommending any SMSF be established with the balance not expected to surpass \$500 000 within a few years of establishment (chapter 13).

To provide greater assurance about the suitability of clients for SMSFs, ASIC should produce a document containing a list of ‘red flag’ events, similar to that currently produced to guide advisers, about circumstances in which SMSFs could be inappropriate for clients (for example, where the client wants to delegate the running of the fund, or has limited time to manage their financial affairs). Advisers should be required to provide prospective SMSF trustees with this document, and obtain the client’s signature to confirm they have seen the document and considered it.

ASIC should undertake a thematic review in 2021 to assess whether the quality of advice provided to SMSF members has improved relative to the 2018 study.

The ATO’s role in the system has been expanding

In addition to their role as SMSF regulator, the ATO has played an increasing role in managing the infrastructure of the superannuation system. This is appropriate; the ATO is uniquely placed to facilitate and monitor transactions between funds, employers and employees, and recent initiatives such as SuperStream, Single Touch Payroll and SuperTICK have improved the efficiency of the superannuation system.

As discussed elsewhere in this report, the Commission envisages this role will increase and importantly so over time with the comprehensive remediation of unintended multiple accounts (chapter 6; chapter 13). In particular, the ATO would have a role in creating a universal centralised online service for members to virtually eliminate unintended account proliferation. The ATO would also have a greater role in reuniting members with ‘lost’ accounts and ensuring employer compliance with superannuation guarantee payments.

The ATO is also effectively the ‘keeper’ of much of the available data for SMSFs — data widely utilised in the Commission’s SMSF analysis, and which are critical to understanding the sector, measuring how it is performing and gauging whether members are appropriately in SMSFs. It is important for the ATO to continue to improve the quality of SMSF data, and for the ATO to work closely with ASIC and for the two agencies to share information. This should be reflected in the Statement of Expectations for both entities. The ATO’s Statement of Expectations should explicitly refer to the ATO’s role as the SMSF regulator, confirming the appropriateness of a generally light handed regulatory approach but also highlighting that the collection of better quality data would likely lead to better outcomes for members.

The Australian Government needs to ensure the ATO is adequately funded to undertake these additional tasks.

10.7 Material systemic risks are not evident

Systemic risk in the superannuation system is disparate to other parts of the financial system. With superannuation investment risk residing with the members, systemic risk is primarily manifest in systemic member harm, and is appropriately managed by government and regulators seeking to ensure members are guided to high performing funds suitable for their needs, the elimination of poorly performing funds, and the elimination (or at least effective management) of conflicts of interest.

Concerns have also been expressed by some participants across the Commission’s three stages of work on superannuation about the potential for an event at an individual firm or fund-level to have such a catastrophic impact it could threaten stability of the overall system (due to the potential for flow on impacts elsewhere). However, relatively few viewed this as a material issue or a major inhibitor to system efficiency.

The Commission’s stage 1 framework proposed two indicators to examine whether there are such risks in the superannuation system:

- risk exposures in the SMSF sector due to limited recourse borrowing
- market concentration and interconnectedness at the upstream service provider level.

SMSF use of limited resource borrowing should be monitored

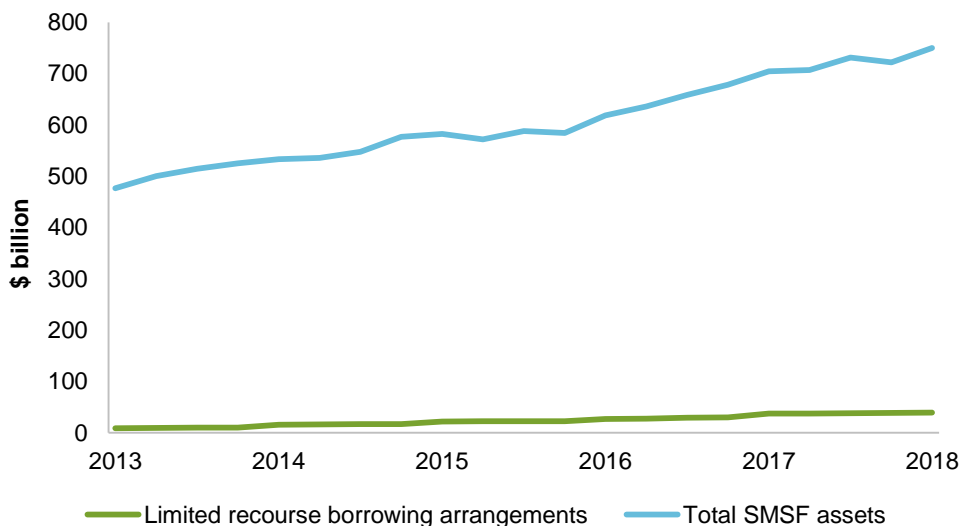
Since 2007, superannuation funds, including SMSFs, have been permitted to borrow under ‘limited recourse borrowing arrangements’ (LRBAs). LRBAs differ from a typical loan because in the event of borrower default, lender recourse is limited to the assets purchased with the loan. This feature is typically priced into the terms of the loan.

LRBA investments within the SMSF sector more than doubled in the five years to June 2018 (figure 10.5), but off a very low base, and in June 2018 they represented only 5.2 per cent of total SMSF assets.

Concerns that the increased use of LRBAs could impact SMSF stability — and general concern about the potential for borrowing to drive speculative investments in property — motivated the Reserve Bank of Australia, APRA and the Financial System Inquiry to propose the removal of the limited recourse borrowing exception to the general prohibition on borrowing by superannuation funds (APRA 2014a; Murray et al. 2014; RBA 2016).

Rather than accepting the Financial System Inquiry’s recommendation, the Australian Government commissioned the Council of Financial Regulators and the ATO to monitor leverage and risk in the superannuation system and report back after three years.

Figure 10.5 **Limited recourse borrowing in the SMSF sector has been growing but is still small in the context of SMSF asset growth**
June 2013 to June 2018



Source: ATO (2018f).

As of 30 June 2016 (the most recent period for which data are available), 6.9 per cent of SMSFs had some form of LRBA. This relatively small proportion — combined with the

relatively small proportion of SMSF assets accounted for by these arrangements — provides some confidence that LRBAs are unlikely to pose a material systemic risk. However, given recent growth, coupled with taxpayers ultimately underwriting (in large part) any gross underperformance of SMSFs through the Age Pension, ongoing monitoring (along with public reporting and discussion by the Council of Financial Regulators) is clearly warranted to ensure that SMSF borrowing to fund investments does not have the potential to generate systemic risks in the future.

In response to the draft report, ASFA and the Chartered Accountants of Australia and New Zealand broadly supported the Commission’s conclusion. ASFA noted that:

It would be appropriate for regulators to monitor and assess leverage in SMSFs to ensure that SMSF borrowing does not have the potential to generate systemic risks. This could include stress — testing to determine whether there are systemic risks associated with leverage and asset concentration in the SMSF sector, and assessment of the linkages between SMSFs and the rest of the superannuation system (and the broader financial system), and how a disruption could be transmitted through those linkages. (sub. DR148, p. 64)

Since the draft report a number of major financial institutions have indicated a reluctance to lend to SMSFs to purchase property (Hughes 2018; Roddan 2018). This should further assuage concerns about risks attached to LRBAs. However, in the Commission’s view monitoring long-term trends in LRBAs is still justified and subject to reporting to and assessment by CFR.

Many of the concerns expressed about LRBAs relate not to their potential impact on the superannuation or financial system, but on SMSF members for whom such arrangements might not be appropriate. In particular, there are concerns about ‘one-stop shop’ property agents encouraging SMSF members to invest in heavily leveraged property when the members might lack the financial literacy to understand the risks involved (particularly where the SMSF invests solely in property). These concerns are legitimate, and are best dealt with through measures to ensure SMSF members receive better advice (as discussed above).

FINDING 10.4

The relatively small number of SMSFs with some form of limited-recourse borrowing arrangement (about 7 per cent of SMSFs representing 5 per cent of SMSF assets) means such borrowing does not currently pose a material systemic risk. However, active monitoring (along with public reporting and discussion by the Council of Financial Regulators) is warranted to ensure that SMSF borrowing does not have the potential to generate systemic risks in the future.

Concerns about SMSF borrowing arrangements being utilised by members that lack the requisite financial literacy to properly understand the risks associated with them (or for whom such arrangements are unsuitable for other reasons) are best dealt with through measures to improve the quality of SMSF-related advice.

Failure of an upstream service provider would cause disruption not systemic risk

Some participants raised concern that high levels of concentration in wholesale service provider markets — and linkages between entities at this level of the system — could impact system stability in the event of an upstream service provider unexpectedly failing.

Markets for administration and actuarial services are highly concentrated (chapter 7). More generally, it is notable that the wholesale level of the system is more concentrated than the retail level.

While the impact of a wholesale service provider unexpectedly closing would vary from case to case, any such closure would cause disruption and short-term losses or inconvenience to members. This could reduce confidence in the system and have flow on effects for other participants. However, based on the information available it is not clear such closures would present a material systemic risk. Moreover, while APRA’s licensee-focused prudential regulation means wholesale service providers are not within their direct purview, funds are required under the relevant prudential standard to demonstrate to APRA that they have developed contingency plans in the event of disruptions to outsourced services.

10.8 Significant issues lie in data reporting

In assessing the efficiency and competitiveness of the superannuation system, the Commission has frequently been (beyond) frustrated by the limitations of official data collections, and the quality of data provided to, and maintained by, APRA, ASIC and the ATO. Issues include:

- widespread reporting of ‘zero’ investment costs by funds
- poor data on costs attributed to related parties
- inconsistent reporting of costs due to the discretion given to funds
- an absence of product-level data outside of MySuper
- funds reporting zero or an implausibly low level of assets
- non-alignment of data collection and reporting between institutional funds and SMSFs
- the absence of panel data for SMSFs
- inadequate member-level data
- information about the types of insurance cover in individual accounts is inaccessible.

Although these limitations have been frustrating for the Commission, of greater significance is that they limit the ability of members — or their agents — to ascertain the best performing funds (and products), as well as the products most suitable for their needs (table 10.2).

Table 10.2 **Data and disclosure: members need to mind the gap**

Is my fund the best performer?

Q: Can members readily compare fund performance?

A: No. Dashboards are not readily comparable and do not exist for many products.

Q: Can others make these comparisons (on behalf of members)?

A: Not easily as there is no long-term, consistent and exhaustive data source.

- APRA MySuper data are the best available, but:
 - are only available from 2014 (cannot measure long-term returns)
 - do not capture the whole market (no non-MySuper products)
 - are missing net investment returns and fees by asset class (sources of performance are hidden).
- APRA fund-level data are available from 2004 but:
 - are not representative of a member's experiences
 - only have asset allocation data (needed to measure relative performance) for default investment options.
- Research firm data include product and investment options with a long time series but cover a smaller, biased selection of products.

Am I getting value for money with my insurance?

Q: Can members readily assess the value for money of their insurance?

A: No:

- Funds are not required to report — to members or the regulator — on how insurance erodes member balances
- The ATO knows who has multiple insurance accounts, but funds cannot access these data, and the ATO does not notify members directly.

Q: Do funds appropriately use member data to develop value-for-money default insurance?

A: Many funds do not. Funds use limited data and do not use it well

- At least 10 per cent of funds use no data.

Is my trustee looking after my interests?

Q. Can members determine whether trustees are looking after their best interests?

A: Not easily:

- Data on payments made to related parties provided to APRA are questionable and not reported to members
- The gap between the actual and desired skills of trustee Boards is not disclosed to members or regulators
- Trustees do not always report, to members or regulators, on why some mergers do not go ahead (even though they may be in members' best interests)
- There is no disclosure, to members or regulators, on financial flows between RSEs and RSE licencees.

And reporting to regulators seems to focus on the interests of funds

They also limit the ability of regulators to monitor potentially undesirable or illegal practices (although, as discussed below, regulators could have better utilised the data available to them). The Cooper Review concluded that transparent and accurate data represent ‘one of the most powerful regulatory tools available’ (Cooper et al. 2010b, p. 315).

Product-level data are particularly important to members

Although there is a relative wealth of information available regarding MySuper products for default members, there is a dearth of information available on member outcomes in the choice sector. This largely stems from the absence of product-level data. Assessments of performance in the choice sector generally have to rely on fund-level data. This has limitations from a member decision-making perspective, given that the factors affecting the actual returns to members are not always determined at the fund level.

Although the Commission is cognisant of the difficulties associated with provision of product-level data, these must be weighed against the requirements of members to be able to determine how their products are performing relative to other products and the system overall. It is likely a number of members in the choice sector would switch to more suitable products if better information were available to measure relative performance.

APRA should enhance both its data capabilities and fund reporting framework to provide greater visibility of outcomes at the product level (and therefore over actual member outcomes). Provision of performance data at the product level would achieve:

- increased ability to proactively monitor products across the system
- inform strategic surveillance and conduct regulation by both APRA and ASIC
- the provision of higher quality financial advice to members
- improved engagement and decision making by members
- a better informed and, therefore more efficient, superannuation system.

ASIC should also develop and elevate its data and data analytic capabilities in superannuation. This is a ‘must have’ for strategic conduct regulation and pre-emptive surveillance of particular funds flagged by such data analytics as being poor performers (be it poor investment performance or inappropriate products or fees). In response to the draft report ASIC stated:

We also strongly support increased product-level reporting into APRA’s reporting framework. In addition to enhancing ASIC’s ability to better analyse and understand practices, and identify misconduct, there may also be scope to explore publication of some of this data to promote better consumer decision making (like the joint ASIC-APRA project to publish life insurance claims data). (sub. DR206, p. 25)

AIST has said:

To be effective, the regulators also need data on the performance and fees and costs of every MySuper and choice superannuation product and investment option. This would enable the regulators to understand which members are vulnerable to being switched into poor-performing, high-fee products that are not in their best interests, and prioritise their regulatory activity to preventing and addressing this. (2018c, p. 22)

Ongoing reporting of ‘zero’ investment expenses — a ‘red flag’

The APRA framework for the reporting of investment expenses is clearly not delivering the data it is intended to identify, with many funds reporting zero investment expenses, and is under review. Issues arise because the current framework relies heavily on the goodwill of funds to report investment expenses that they do not incur directly (for example, where those expenses are netted out of returns that the fund receives from managers that undertake investments on the funds behalf).

Reliance on funds to report expenses that reflect the spirit of the reporting framework is inadequate. The framework must, as a matter of priority, be strengthened to ensure that all investment expenses are reported, whether incurred directly or not.

It is ultimately the responsibility of regulators — and specifically APRA in most cases — to ensure useful data are collected and thus provided by trustees. If the current review fails to resolve data anomalies, APRA should seek to ensure correct data are provided — the *Financial Sector (Collection of Data) Act 2001* (Cth) provides significant penalties (of up to \$10 500 a day) for entities failing to adequately supply data to APRA. Moreover, in many cases, the continued provision of imperfect data would represent a ‘red flag’ that should prompt further regulatory action.

Data quality should be a key focus

Data issues in the system are not new — for example, the 2015 ASIC Capability Review (Chester, Gray and Galbally 2015) highlighted the need for ASIC to develop its data capabilities — and warrant a comprehensive response. In its draft report, the Commission recommended that the respective regulators (APRA, ASIC and the ATO) should work with the Commonwealth Treasury and the ABS to establish a superannuation data quality working group to improve data quality, and that this group should report annually to the Council of Financial Regulators on its progress and on regulators’ data analytics capabilities (chapter 13). It is disappointing that such suggestions, which require no decision of the Government, remain un-actioned.

ASIC supported the establishment of a working group and noted that its:

... ability to achieve its regulatory objectives could be improved through increased data availability. ... The increased sharing of data across government agencies is also of benefit to ASIC. (sub. DR206, p. 25)

ASFA considered that creation of the data working group is an urgent reform and noted that:

It would not only help to minimise duplication and other inefficiencies, but also strengthen information security protections – currently weakened by the patchwork approach to data collection. (sub. DR148, p. 50)

Other participants were supportive but argued for industry representation on the group:

... the FSC believes any such working group should involve industry representatives to ensure solutions are developed in a way that is workable for funds. (FSC, sub. DR186, p. 13)

The challenge, without industry representation is that some proposals may be impractical and that this is only going to be understood with the benefit of industry contributions. (Association of Financial Advisers, sub. DR173, p. 14)

There is a role for regulators to liaise with industry, but industry has often been a source of resistance to improved reporting — in the absence of a countervailing strong member voice. The working group should, therefore, consist only of the regulators.

APRA should continue to collect data relating to APRA-regulated funds, sharing it with ASIC and typically making it public in the absence of a need for commercial confidentiality. The ATO should continue to collect data relating to SMSFs; provide high quality data to ASIC; and ensure that the data are of high quality to provide reassurance that the regulator is well informed on SMSF issues. These respective roles should be contained in the Statement of Expectations for each entity.

Existing data should have been better utilised, and must be in the future

While data quality has been a major source of frustration for the Commission, this has not prevented the completion of a large body of work demonstrating high levels of underperformance among superannuation funds and the subsequent degree of associated member harm. This work has guided the Commission's conclusions and recommendations, and will ultimately provide guidance to regulators (and the FSRC) regarding future regulatory priorities.

However, there has never been any impediment to regulators doing this work themselves. Had this been a priority, regulators would have been much better informed about member outcomes and much better placed to improve them. The Commission considers that such work should in future be considered de minimus 'core business' for superannuation regulators (particularly APRA).

Regular industry-wide reporting is required

In view of the member harm identified by the Commission from the superannuation system's failings, the importance of improving system governance to ensure high standards are maintained, and system transparency afforded by the better utilisation of pertinent data, APRA and ASIC should jointly produce a biennial *State of Superannuation* report to detail the performance of the system (akin to the Commission's analysis in this report) (chapter 13). Such a report would include how the system is progressing in relation to the assessment framework identified in this report — and to provide reassurance that both funds and the regulators are delivering better outcomes for members (box 10.7).

Box 10.7 **A biennial *State of Superannuation* report**

In view of the significant level of underperformance the Commission has found, together with the fund and system governance failings discovered by the Commission and the Financial Services Royal Commission, every two years APRA and ASIC should jointly author a *State of Superannuation* report to detail the performance of the system and report on progress by the industry and regulators to address issues identified in this inquiry.

The report should incorporate:

- analysis of the system's performance akin to the Commission's assessment framework and analysis in this inquiry
- progress on addressing member harm (for example, multiple accounts, underperformance, low balance inactive accounts)
- progress on implementing government policy changes
- discussion of progress on fund mergers, and the capacity for further mergers to benefit members
- progress on issues of poor governance
- progress on further advances in data collection, use and analysis (beyond the Commission's analysis)
- the regulators activities and how they are benefitting members.

10.9 The overall burden of regulation is proportionate from a member perspective

Comprehensive regulation of the system is inevitable

A number of industry participants raised concerns about regulatory burden. For example, the Association of Superannuation Funds of Australia (ASFA) expressed concern that:

There are considerable opportunity costs associated with regulation. Regulation potentially inhibits innovation as participants' investments are concentrated on implementing changes to comply with regulatory requirements ... In the case of superannuation, fund members ultimately bear the costs – via a combination of higher fees, lower net returns and a reduction in the quality

of products and services provided (particularly where regulation stifles innovation). As such, ASFA is cautious about any new reforms which add to the regulatory or reporting burden for its members without a clear purpose or benefit first being established. (sub. 47, p. 21)

On the other hand, the Australian Council of Trade Unions (ACTU) was more relaxed about the regulatory environment:

Clearly much of the regulation which has existed for 30 years has been developed with the policy intent of a structured system but one which maximises outcomes to the system participants. Hence the development of a system to regulate superannuation fund selection and default arrangements within the framework of industrial regulation is a cornerstone of policy settings in this area. Much of the regulation around superannuation emanates from this setting. The ACTU does not view this as an impediment to a successful superannuation system: we see it as the foundation of one. (sub. 50, p. 6)

Participants also suggested the burden associated with the ongoing regulatory data collection was unnecessarily high.

As noted throughout this report, there are undoubtedly areas of regulation requiring reform. However, many of the specific examples of unnecessary or outdated regulation provided in submissions, surveys and consultation sessions represented relatively minor regulatory burdens or were only peripherally related to superannuation. Many referred to concerns about RG97 (chapter 3), which has recently been reviewed. In other areas flagged by participants, such as unnecessary impediments to mergers (chapter 9), there have been significant improvements in recent years.

Further, it is inevitable that the superannuation system is comprehensively regulated in view of the:

- dollars at stake
- compulsory nature of superannuation
- prevalence of principal–agent issues
- level of disengagement of many members
- high level of information asymmetry regarding superannuation products.

Arguably, the superannuation industry (collectively) has also shown a tendency to be resistant to change and has struggled to get agreement on self-initiated reforms. This has likely led to a higher level of regulatory intervention than might otherwise have been the case. There is also an (understandable) commercial reluctance within the industry to share information, which has similarly led risk averse regulators to determine the data that are to be collected (albeit typically with varying degrees of industry consultation).

Therefore, although the Commission has recommended a number of areas of reform, including some where a tougher regulatory stance is considered necessary, the regulatory burden is broadly appropriate given the nature of superannuation and the necessary focus on protecting the interests of members.

But potential reform impacts are not always adequately assessed

A number of participants raised concern about regulatory uncertainty and a seemingly ‘never ending’ reform process (box 10.8). Further, 34 of 71 CEOs responding to the Commission’s governance survey identified dealing with regulatory changes as the top challenge confronting their Board, and 65 of 71 listed it among their top four challenges.

Box 10.8 Participants’ views on regulatory change

A number of participants suggested constant regulatory changes affecting the superannuation system were a major problem.

Vision Super stated:

The biggest threat to Australians’ confidence in the system is continued unnecessary regulatory change. What the superannuation system needs is a long period of stability with any changes made only to address urgent issues that are putting Australians’ retirement at risk, not further changes that may or may not prove to actually increase competition or engagement with superannuation. (sub. 30, p. 3)

ASFA said:

ASFA firmly believes in the need for a prudent regulatory framework for superannuation. However, excessive regulation – and unduly frequent changes in the regulatory framework and requirements – adversely affects efficiency, productivity and innovation. Changes to superannuation and tax settings necessitate capital expenditure, and the complex and prescriptive nature of the regulatory framework imposes material ongoing compliance costs. (sub. 47, p. 2)

Many highlighted benefits of recent regulatory reforms, while seeing others as ill-conceived. PwC stated:

Many [regulatory changes over the past 25 years] were positive changes for the industry such as the introduction of APRA prudential standards to improve fund governance and the Super Stream reforms to improve the back office functions, efficiency and quality of data. However, many changes were the result of constant tinkering with taxation, SG levels and contribution caps and rules in order to meet budget or other political objectives, all of which were possible as there was no overarching framework and objectives for superannuation. (sub. 62, p. 2)

As highlighted in this chapter, policy and the regulation of superannuation have traditionally struggled to keep up with the sector’s significance and diversity. It is therefore unsurprising that there have been regular changes. While the pace of reform is often seen as a problem (and undoubtedly creates real pressures for superannuation system participants), most of the recent major reforms (for example, Stronger Super, SuperStream, MySuper) have been overwhelmingly beneficial from a public interest perspective.

FINDING 10.5

The frequency and pace of policy change undoubtedly create real pressures for participants in the superannuation system. However, most of the recent major reforms (such as MySuper and SuperStream) have been overwhelmingly beneficial from a public interest perspective.

11 Overall assessment

Key points

- A competitive superannuation system compels funds to become more efficient and work to better serve members' needs. It also 'weeds out' underperformers. An efficient superannuation system, over time, maximises net returns for members, ensures members are in the most appropriate products given their needs, and finds ways to improve member outcomes.
- Competition and efficiency are not delivering on their potential for members.
- Competition is muted, constraining efficiency and member outcomes. The system lacks the critical mass of engaged and well-informed members needed to place competitive pressure on funds to deliver better products and services. Rivalry between funds in the default segment is superficial and there are many signs of unhealthy competition in the choice segment.
- Overall most institutional funds have delivered solid net returns (and the system exhibits no material systemic risks). But a comparison of returns with benchmarks, and the wide spread of performance, shows that many members could be doing much better. Too few are in the very best products. And too many remain in persistently underperforming funds and products.
- Fees, the biggest drain on net returns, have been slowly falling at a system level, but primarily because retail segment fees have come down from excessive levels. And substantial realised economies of scale have not been systematically passed through in lower fees.
- Structural (policy) flaws, exacerbated by fund, regulator and Government inaction, have contributed to a third of all member accounts being unintended multiples. Members holding these accounts (and attached insurance policies) suffer unnecessary erosion of their account balances. Recent reforms will improve, but not eradicate, this endemic problem.
- Much of the system is failing to deliver the right products and services. Many accumulation products fail to effectively manage the risks faced by members. The suite of retirement products appears to be sufficient, but many members do not have access to high quality, affordable and impartial advice to choose the option that best fits their needs.
- Insurance held through super provides value for money for many, but not all, members. It contributes to excessive balance erosion and system complexity. Some members have policies that ill-suit them (including 'zombie' policies they cannot claim on). The Government-prompted industry code of practice, while a step in the right direction, falls short of what is needed.
- Governance within funds falls well short of best practice. Board appointment processes and performance assessment, management of conflicts of interest (particularly related-party transactions), disclosure practices and investment governance remain areas of concern. And many funds have failed to merge when that path would have been in members' best interests.
- Conduct regulation arrangements are confusing and opaque, and strategic conduct regulation (especially with deterrence intent) is missing in action. APRA and ASIC's respective roles are not clear. More generally, enforcement has been weak and regulation ineffective.
- Poor quality data inhibit member engagement and good decision making, constrain funds in benchmarking their performance and impede regulator effectiveness.

Australians are compelled to save a material portion of their wages through super. As the system matures — today representing \$2.7 trillion in members’ assets — super is becoming more important to living standards and equity in retirement. Reflecting this, the Government asked the Commission to assess the efficiency and competitiveness of Australia’s superannuation system.

Over time, an efficient super system will maximise net returns, ensure members are in the most appropriate products given their needs and find ways to improve members’ outcomes. Competition promotes efficiency, prompting funds to become more efficient and to better serve members’ needs, and in the process, helps to ‘weed out’ inefficient (poorly-performing) funds.

The Commission’s assessment has been guided by a framework — five system-level objectives, 22 assessment criteria and 89 corresponding indicators (chapter 1) — which was publicly released after consultation during the stage 1 study that preceded this inquiry. This chapter presents summary assessments against the criteria (in tables 11.1 through 11.5). More detailed findings from the Commission’s assessment are presented in the preceding chapters.

11.1 The assessment was not straightforward

Multiple sources of evidence informed the assessment:

- submissions from participants, conversations with experts and roundtable discussions
- data collections from the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC), the Australian Taxation Office and research firms (local and international)
- fund publications, policy documents and official reports, and research papers
- hearings of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Financial Services Royal Commission (FSRC))
- Commission-initiated separate surveys of **members** of super schemes, of APRA-regulated super **funds** (covering their operations and market conditions), and of funds’ CEOs (covering **governance** practices).

And the Commission undertook several novel analyses (box 11.1). But data gaps and inconsistencies dogged the work (chapter 10). And, while the Commission’s surveys were designed to fill some of the gaps, the quality of responses to the initial **funds** survey was (at best) disappointing, prompting a supplementary survey of funds on a subset of topics (assets, returns and investment management fees by asset class, and fund expenses by category and type of service provider). The latter proved revealing — some funds do not undertake comprehensive performance attribution analysis nor due diligence on underlying products.

Box 11.1 What the Commission has done that is new and novel

To gather evidence for this inquiry, the Commission collected data and undertook several novel analyses. As part of this, the Commission:

- constructed **investment benchmark portfolios** to compare performance across the system (by segments, funds and products) adjusting for investment strategy (asset allocation)
- benchmarked **investment performance by asset class** against financial market indexes and the performance of international pension funds
- undertook **attribution analysis of investment performance** to identify the contributions from tax, expenses and asset selection
- compared **investment management costs** by asset class across segments and countries
- used survey data to investigate the impact on funds' expenses from their use of **related parties**
- tested alternative approaches to estimating **self-managed super funds' net returns** and the relationship between **self-managed super fund size** and expenses and net returns using unpublished Australian Taxation Office data
- developed a range of **cameos** to illustrate how retirement balances can be eroded by multiple accounts, unpaid super, insurance premiums, high fees and low net returns
- undertook **econometric analysis of products** to look at impacts of product proliferation on costs and fees, combined with **stochastic analysis** of how these fees affect members' retirement balances
- **simulated sequencing risks** that members might face to evaluate how effective life-cycle products are at managing these risks
- **surveyed members** to:
 - support analysis of how members might behave when choosing a super product when they are assisted by a shortlist of good products
 - gather new evidence on members' behaviour, including how they engage with their super fund and their levels of satisfaction, use of information and experiences with switching funds and investments
- **surveyed super funds** to fill gaps in the evidence base for key metrics such as net returns and fees by asset class, market contestability, related-party costs, insurance and regulation
- **surveyed fund CEOs** in relation to governance, and especially in areas where limited evidence is in the public domain, such as Board member selection, Board capability, and conflict and risk management
- undertook Bayesian **econometric analysis of economies of scale** to estimate realised cost savings attributable to greater fund scale, savings that might be realised from further gains in scale, and the extent to which benefits of scale have been passed through to members as lower fees
- **modelled the fiscal effects** of insurance held through super for a set of member cameos, including the impact of insurance payouts on social security payments and the impact of balance erosion caused by insurance premiums on Age Pension liabilities.

The framework proved to be a useful guide for the assessment, although data gaps rendered a few indicators unworkable and complicated the analysis of others. Where possible, other information and data sources were drawn on to circumvent these gaps.

The following summary assessments rest on a collective interpretation of the relevant indicators and criteria, and draw on other evidence and judgment, as necessary.

11.2 Competition is not being fully harnessed

Competition in any market depends on the actions of both consumers and producers. In super, it requires a critical mass of engaged members making informed decisions, and rivalry between funds to attract and retain members. Neither member engagement nor fund conduct is fully consistent with healthy (or effective) competition in the Australian system.

Members are not always able to drive competition (chapter 5). Some are highly engaged and create a competitive discipline on funds, but engagement is generally low — many members simply default into a fund and a product. For many, this is rational. Engaging takes time and effort, and trustees are legally required to act on members' behalf and in their best interests. But the system contributes to making it difficult for those who want to engage to do so effectively. While many Australians know the basics of super, product complexity, lack of quality information and advice, and behavioural biases combine to constrain informed engagement.

On a cursory glance, the market is conducive to rivalry and contestability (chapter 7). There is no shortage of funds, nor high barriers to entry or exit. While there are relatively few firms in some wholesale markets (such as custodian services and asset consulting), those few firms are likely capturing the benefits of economies of scale. And the potential of insourcing by larger funds adds to competitive pressure.

But a closer look reveals, at best, muted competition. Disengagement among members in the default segment means competition is reliant on fund rivalry. But there is no competition *for* the market (that is, between funds for the right to provide default products), and little *in* the market (that is, from rivalry between funds to attract members) (chapter 7). Processes for listing default funds in modern awards constitute an effective barrier to entry. And use of employer inducements suggests that, at least to some extent, the competition for employers that does exist is unhealthy.

Nor is competition delivering for most members in the choice segment. While the structure of the choice segment is superficially consistent with competitive pressure between funds (there are many options), and self-managed super funds (SMSFs) add competitive tension, poor comparability of options (due to poor data and product proliferation), the charging of fees for no service and the long and persistent tail of high-fee products point to a lack of healthy competition.

At the wholesale level, while concentration is low in the investment management market, evidence suggests that managers have some market power (chapter 7). As a consequence, smaller funds, in particular, pay more than would be the case if competition was more robust. Some larger funds have responded by bringing some of their investment management in-house. Evidence that Australian funds pay more for investment management than pension funds in other countries across most of the main asset classes (chapter 3), indicates scope to reduce fees and improve members' net returns.

Table 11.1 Competition is not being fully harnessed to members' benefit

System-level objective #5: Competition in the superannuation system should drive efficient outcomes for members	
<i>Assessment criteria</i>	<i>Assessment</i>
<i>Market structure</i>	
C1 Is there informed member engagement?	Member engagement is generally low but increases with age and account balance.
C2 Are active members and member intermediaries able to exert material competitive pressure?	Demand side pressure on competition is muted.
C3 Is the market structure conducive to rivalry?	The large number of funds at the retail level, and multiple options at the wholesale level, create market structures conducive to rivalry.
C4 Is the market contestable at the retail level?	Contestability is largely present in the choice segment, but it is precluded by high barriers to entry in the default segment.
C5 Are there material anticompetitive effects of vertical and horizontal integration?	Vertical and horizontal integration do not create material anticompetitive effects, but give rise to conflicts of interest that harm members.
<i>Conduct and outcomes</i>	
C6 Do funds compete on costs/price?	Funds compete on costs/price to a degree, but this delivers limited benefits to members.
C7 Are economies of scale realised and the benefits passed through to members?	Significant economies of scale have been realised, but there is little evidence that gains have been systematically passed through to members in the form of lower fees.
C8 Do funds compete on member-relevant non-price dimensions?	Funds compete on things other than fees (prices), but fees are more important for most members.
C9 Is there innovation and quality improvement in the system?	Innovation and quality improvement are evident, but not widespread, and progress is slow.
C10 Are outcomes improving at the system level?	Outcomes are improving at a system level, but many members are being left behind and harmed.

More generally, symptoms of muted competitive pressure and unhealthy competition are apparent across the system. The system exhibits: persistent underperformance by some funds; unrealised economies of scale (93 small APRA-regulated funds, holding 1.7 million member accounts, remain in play); low levels of genuine new entry; a profusion of regulation aimed at trying to ensure members' best interests are met; and limited evidence of innovation in data analytics and more broadly. Vertical and horizontal integration are also problematic,

with a lack of transparency on related-party arrangements, poor management of conflicts of interest by some trustees and cross-selling that facilitates outcomes contrary to members' best interests.

11.3 Long-term net returns are not being maximised

An efficient super system would, over time, maximise long-term net returns for members through strong investment performance, competitive fees and prevention of unnecessary balance erosion. On each count, the system could do better.

The system has delivered mixed investment performance for members (chapter 2). Over the 11 years to 2017, APRA-regulated funds and SMSFs respectively delivered net returns of 5.3 and 5.8 per cent a year on average (although smaller SMSFs delivered significantly less). And the default segment generated average returns of over 7.3 per cent a year over the 13 years to 2017. Top default performers are typically (but not always) larger, not-for-profit funds. But returns at many funds stack up poorly against reasonable benchmarks calibrated to their asset allocation, and persistent material gaps between the top and bottom performers in both the default and choice segments show that many members could be doing a lot better.

Marked and persistent outperformance by not-for-profit funds relative to retail funds is most likely explained by investment choices within asset classes (asset selection). Not-for-profit funds outperformed retail funds within most asset classes. At a fund level, measures of this within asset-class investment success appear to be associated with measures of good governance, though precisely which features of governance account for this association is not clear.

Fees — the biggest drain on net returns — have been falling slowly, primarily because of falls in the retail segment (chapter 3). Fees remain relatively high in this segment (averaging 1.6 per cent of balances, compared with 0.9 per cent in the not-for-profit segment). A material share (15 per cent) of member accounts are paying fees that are well above average, particularly in choice products, mostly offered by retail funds, and about half are closed to new members. High fees are generally not associated with higher returns, and can markedly impact retirement balances. And high-fee funds tend to persistently have this status over time. Some members in SMSFs are also faring poorly. Many (but not all) in SMSFs with balances under \$500 000 pay materially higher costs relative to their assets (and earn lower returns) than members in APRA-regulated funds. Many SMSFs that start small appear to stay small (chapter 3).

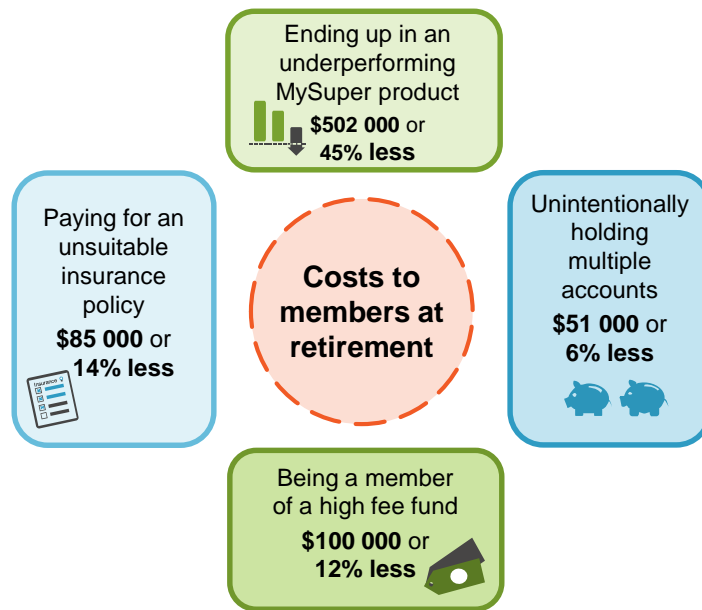
Unnecessary erosion of members' balances has not been prevented (chapter 6). One in every three member accounts is an unintended multiple, compromising retirement incomes via multiple sets of fees and insurance premiums, and foregone returns. While these accounts are typically a product of a system that sees people default into a new fund on changing jobs, funds could have done more to reduce the stock of multiple accounts. Regulators should have acted earlier to identify and assess the cost of this systemic problem and Government

should have acted before now to redress it through more aggressive policy action. Recent policy initiatives have made inroads, but the stock of unintended multiple accounts remains large, and current policy settings are making slow progress on reducing it by treating the symptoms and not the structural cause.

Potential retirement incomes are also being compromised by employers who fail to pay contributions to funds, and affected members are often young and low paid.

Subpar system performance (including via inappropriate insurance, discussed below) can do considerable harm to members' balances at retirement (figure 11.1). For example, holding an underperforming MySuper product can reduce a typical member's balance by 45 per cent (\$502 000) by retirement.

Figure 11.1 **The character of member harm^{a,b}**
Subpar system performance leads to much lower member balances



^a Figures reflect the projected impact at retirement for an average wage member of: being in a top performing MySuper product (the median of the top 10) versus the median underperforming MySuper product (MySuper cameo); having one account versus two across their working life (multiple accounts cameo); or paying an extra 0.5 percentage points a year in fees (high fee cameo). The fourth cameo reflects the projected impact for a low income member of holding insurance including a light blue collar loading and income protection. ^b The assumptions underpinning these cameos are set out in chapter 1.

The payoffs from fixing some of the worst problems would be significant. Collectively, members would have been in the order of \$2.6 billion better off each year if there were no unintended multiple accounts in the system. And they would have collectively gained at least a further \$1.2 billion each year had all bottom quartile MySuper products delivered returns in line with the median top quartile performer. While these figures may appear immaterial across a \$2.7 trillion system, being defaulted into a single top quartile MySuper product would lift the retirement balance of even today's median 55 year old by up to \$79 000 when they

retire, compared with being defaulted into two bottom quartile products. For a new workforce entrant today, the gain would amount to \$533 000 by the time they retire in 2064.

FINDING 11.1

Fixing some of the worst problems in the current superannuation system would bring substantial benefits. If there were no unintended multiple accounts (and the duplicate insurance that goes with them), members would have been collectively better off by about \$2.6 billion a year. If members in bottom quartile MySuper products had instead been in the median of the top quartile performing MySuper products they would collectively have gained an additional \$1.2 billion a year.

Table 11.2 Long-term net returns are not being maximised for members

System-level objective #1: The superannuation system contributes to retirement incomes by maximising long-term net returns on member contributions and balances over the member’s lifetime, taking risk into account

<i>Assessment criteria</i>	<i>Assessment</i>
E1 Are long-term net investment returns being maximised over members’ lifetimes, taking account of risk?	Persistent wide variation in investment performance (especially underperformance) across the system indicates that long-term net returns are not being maximised.
E2 Are costs incurred by funds and fees charged to members being minimised, taking account of service features provided to members?	Investment management costs are higher for major asset classes in Australia than in other developed countries. Fees have fallen gradually at a system level, primarily because of falls in the retail segment, but many high-fee products persist.
E3 Do all types of funds have opportunities to invest efficiently in upstream capital markets?	There are no material barriers to funds investing in upstream capital markets.
E4 Is the system effectively managing tax for members, including in transition?	It is unclear whether funds effectively manage tax for members.
E5 Are other leakages from members’ accounts being minimised?	Unintended multiple accounts and unpaid contributions contribute to egregious erosion of member balances and member harm.

11.4 Members’ needs are not being fully met

An efficient system would ensure that members can access a range of products and services suited to their needs (including products that appropriately manage key risks), and that they can readily access good quality information to inform any choices they seek to make. The system would also ensure that members who do not make a choice are allocated to the best-performing products. While the system is accommodating some members’ needs, others remain unmet. This gap will widen and cause more harm to members without action.

Members' needs are a product of the economic and social environment. That environment today is very different from the one that gave rise to Australia's super system, and will become more so (chapter 1). Contributions are much higher, people are working longer, women are more likely to work and life expectancies are higher. And super's role in intergenerational wealth transfer means it will play a growing role in wealth inequality. Much more is at stake today in financial terms than at the system's inception. Furthermore, if rates of home ownership fall then people's retirement asset portfolios and their approaches to lifetime saving will change. Members' needs for retirement income planning and engagement with funds are likely to grow. Labour market change also shapes people's retirement savings. People changing jobs are more likely to switch occupation or industry than they were 30 years ago, and multiple job holding is higher. Looking forwards, some expansion of the gig economy will occur and digital disruption could prompt a higher rate of job change between businesses, industries and occupations — inflating the risk of balance erosion that comes with unintended multiple accounts being created when members are allocated a default scheme on changing to a new job.

Members' needs during the accumulation phase are relatively clear cut — high average net returns, appropriate asset allocation to manage risk, low fees, good disclosure and transparent product features. A low-fee product that exposes a member to a mix of defensive and risky assets over their working life is likely to meet the needs of most people. Yet many products do not effectively manage the risks faced by members (chapter 4). Some life-cycle products dial down risk too early, elevating the possibility that people will outlive their savings in retirement. Single-strategy products fail to adequately protect members from the risk that asset prices will fall as they near retirement, crunching their retirement balance. Life-cycle products can address these risks, but many do so at the cost of excessively degrading overall returns. Further, the proliferation of little used and complex options (numbering in the tens of thousands in 2016) in the choice segment complicates members' decision making and increases fees, without boosting long-term net returns (chapter 4). And members who default face the risk of landing in an underperforming product. In sum, members' needs in accumulation are not being met.

The decumulation phase is more complex (chapter 4). The large diversity of household preferences, and interactions with the Age Pension, health and aged care, and assets held outside of super, make for wide variety in members' situations in relation to their super. The range of retirement products on offer — including account-based pensions, annuities and new hybrid annuity products — does not appear to be deficient. A bigger issue is whether people are making the 'right' choices. The extent to which a person can make good decisions in retirement will depend on their financial literacy and cognitive capacity. For many members, high quality, affordable and impartial financial advice will be needed to ensure that they select retirement offerings that meet their needs.

Data will be key to improving the fit between products and members' needs. Businesses in many sectors are mining data to identify customers' needs, offer products and services that better meet them, and communicate more meaningfully. But this activity appears nascent in Australian funds (chapters 4). Most collect little information about their members, and few use the data they do collect to design and price products or insurance offerings.

Unfortunately, a key policy challenge, across all phases, is the availability of quality, comparable information and quality (impartial) financial advice. While there is no shortage of information (indeed arguably the excessive quantum of information available amounts to disinformation), many members find it complex, overwhelming and inconsistent with their needs. And many do not know where to turn for good, impartial financial advice. When they do receive advice, many struggle to judge its quality (chapter 5).

Further, while a number of bodies advocate on behalf of funds, there is no dedicated, independent voice arguing for members, analysing outcomes and assisting them to navigate the system.

11.5 Not all members receive value for money insurance

Around 12 million members hold insurance through super. Many benefit, but entrenched problems mean it is of little or no value (and not worth the premiums) for others.

On the positive side, group insurance offers substantial cost savings over individually written cover, resulting in more favourable pay-out ratios (chapter 8). And the opt-out nature of most group policies means that the pool of insured members includes a larger share of lower risk members than would otherwise be the case. The inherent cross subsidisation reduces costs for many. Provision of group insurance without an individual risk assessment means that members who might otherwise struggle to find affordable insurance are covered.

Against these benefits, balance erosion heads the list of problems. Higher than average premiums; unintended multiple policies; premiums that do not vary with income (particularly costly for the balances of lower income workers); contributions on inactive accounts (particularly deleterious for people with interrupted work history); and relatively expensive income protection insurance contribute to excessive balance erosion for some members. Many of these factors are correlated, making erosion highly regressive. Members with low income, intermittent labour force attachment and multiple accounts are hit especially hard. A worker with these characteristics, who attracts a light blue collar loading and is paying for income protection insurance could be 28 per cent (or \$125 000) worse off at retirement than if they had no insurance.

Other problems range from complex and incomparable policies, through difficulties for members in opting out, inappropriate application of risk premiums (for example, for occupation or smoking status) and inadequate tailoring of policies to members' needs. More fundamentally, wide variation in the types and levels of default cover (as well as premiums) across funds does not seem fully justified based on inherent differences in each fund's membership cohort. A general lack of member awareness about the insurance in their super (around a quarter do not know if it is attached to their account) exacerbates the problems.

Recent initiatives could enhance the value for money of insurance. The Government-prompted industry code of practice is a step in the right direction, but falls short of what is needed. Its

ultimate success will depend on it being universally adopted by funds, its provisions substantially bolstered and it being effectively enforced. The Government is seeking to legislate changes to make insurance opt in for some members — those under 25 years, with balances under \$6000 or where their account has been inactive for 13 months — which should remove insurance in many instances where it is of less value.

Table 11.3 Not all members receive value-for-money insurance

System-level objective #4: The superannuation system provides value-for-money insurance cover without unduly eroding member balances

<i>Assessment criteria</i>	<i>Assessment</i>
E11 Do funds offer value-for-money insurance products to members?	Insurance within super provides value for money for many members, but the cover is inappropriate for some.
E12 Are the costs of insurance being minimised for the level and quality of cover?	Group insurance reduces premiums for some members; others pay too much. Undue balance erosion is an egregious problem.

11.6 Governance has improved, but still falls short

High-quality governance is integral to the protection of members’ interests. Super fund members are heavily reliant on the conduct and actions of others — funds, financial advisers, government and regulators. Consequently, governance within funds needs to be robust, and regulators need to diligently and confidently supervise fund performance, trustee and financial adviser conduct and the quality of products, services and information provided to members.

While fund governance has improved in recent years (albeit off a low base), and some funds have strong and effective governance regimes, governance practices of other funds fall well short, working against members’ best interests (chapter 9). Considerable evidence of trustees acting in ways that are inconsistent with what might reasonably be expected if they were acting in members’ best interests, particularly from the FSRC, suggests this trustee duty needs to be better defined and enforced.

Inadequate governance practices are evident in Board appointment processes and performance assessment, management of conflicts of interest (particularly related-party transactions), disclosure practices, investment governance and provision of inducements to employers. Further, many funds have failed to merge when that path would have been in members’ best interests. Failed mergers are very costly for members, especially for subscale and underperforming funds — a typical full-time worker who spends their working life earning bottom-quartile investment returns, for example, is projected to retire with a balance 54 per cent (or \$665 000) lower than if they earned top-quartile returns.

Unfortunately, little is known about mergers that have been broached but not completed. Some barriers to mergers are still evident, despite recent guidance to funds (on successor fund transfers). Trustee self-interest is clearly one of the barriers. The temporary nature of provisions to provide funds with relief from capital gains tax is another. Measures in train to improve members’ outcomes should prompt fund consolidation, but the proposed outcomes test and outcomes assessment clearly need strengthening.

Turning to system governance, APRA steadfastly regulates through a prudential lens — when super is by and large not a market characterised by prudential risk nor one of caveat emptor. Regulation needs to be seen and conducted through the lens of member outcomes (chapter 10). APRA and ASIC need to be more confident and member-focused — and become ‘member champions’.

Conduct regulation arrangements for the system are confusing and opaque, with significant overlap between the roles of APRA and ASIC. This has reduced regulator accountability and, as highlighted by the hearings of the FSRC, strategic conduct regulation (especially with deterrence intent) has been ‘missing in action’ or often disproportionate — a case of too little too late. APRA and ASIC’s respective roles need to be more clearly delineated and better aligned with their distinct ‘regulatory DNA’. APRA should be focused on authorisation, ensuring high standards of system and fund performance; ASIC on the conduct of trustees and advisers and the appropriateness of products.

Regulation is (at best) hampered by the absence of quality data and meaningful analysis by the regulators. The continued absence of regulators confidently collecting and analysing the right data (on member outcomes) will preclude their effective supervision, enforcement and ultimate protection against member harm. The Commission’s analysis highlights the value of quantitative analysis in identifying member harm. Members (and their agents) are also directly impacted by the data gaps and quality issues — constrained in their product choice and capacity to evaluate regulator effectiveness. And any fund seeking to assiduously benchmark against its peers would struggle.

Table 11.4 Members’ needs, including for best practice governance, are not being fully met

System-level objective #2: The superannuation system meets member needs, in relation to information, products and risk management, over the member’s lifetime

<i>Assessment criteria</i>	<i>Assessment</i>
E6 Is the system providing high-quality information and intrafund financial advice to help members make decisions?	Members face a plethora of information, but many find it hard to access and interpret. There is little information available that is genuinely comparable; intrafund advice provides limited guidance. Data gaps hamper regulatory activity.
E7 Is the system providing products to help members manage risks over their life cycles and optimally consume their retirement incomes?	A wide range of products is available (especially in accumulation), but not all members land in products that suit their needs.
E8 Are principal-agent problems being minimised?	Conflicts of interest are often not well managed.

11.7 System performance and member outcomes have improved, but have a way to go

The preceding discussion acknowledges many positive aspects of the system, but the many problems identified indicate that the system is not effectively dealing with some substantive impediments to better long-term outcomes for members. Many of the impediments to improving long-term outcomes are well within the system's control, whilst some will require policy change.

Table 11.5 System efficiency and member outcomes have improved, but have a way to go

System-level objective #3: The efficiency of the superannuation system improves over time	
<i>Assessment criteria</i>	<i>Assessment</i>
E9 Does the system overcome impediments to improving long-term outcomes for members?	The superannuation system could do better in improving long-term outcomes for members.
E10 Are there material systemic risks in the superannuation system?	There are no obvious material systemic risks in the system.

While there are no material systemic risks (chapter 10), characteristics of the current system are constraining, and will continue to limit, healthy competition and improvements in efficiency — arguments for modernising the system are strong. A package of recommendations supporting this outcome is presented in chapter 13.

12 Competing for default members

Key points

- In a world of compulsion the onus is on government to ensure that default superannuation is the system exemplar, eliminating the costly (and highly regressive) twin risks for a default member — defaulting more than once, or into an underperforming fund.
- A degree of longstanding underperformance is manifest in all segments of the superannuation system. While the default segment has on average outperformed the system as a whole, and worked well for the majority of default members, it fails to ensure members are placed in the very best funds and places a sizable minority in underperforming funds, at a pernicious cost to these members (a reduction in their retirement balance of 45 per cent or \$502 000 for a typical new job entrant today).
- The key problem with current default arrangements is tying the choice of default fund to the employer, rather than the member — inevitably resulting in unnecessary account proliferation. These arrangements are ill-suited to today's workforce where employees increasingly move between industries and occupations when they change jobs.
- Current arrangements may also expose members to conflicts of interest and poor quality decisions made by third parties, including employers. Even with the best of intentions, many employers are not well equipped to choose default funds, and most do not want to do so. The current system also places great emphasis on the role of industrial parties that are not free of their own conflicts — having themselves sponsored the joint development of funds and sometimes having commercial arrangements with funds to promote them to workforces.
- Assisted employee choice represents a modern approach to default superannuation and would provide better outcomes for members than the existing system. Its design is inspired and informed by behavioural economics — how people actually behave, not how they 'should' behave, with a shortlist of best in show funds, and a longer list of good funds for more engaged members to consider. It fosters direct member engagement, in contrast to current arrangements that stifle it. 'Lopping off the tail' of persistent underperformers alone would produce better outcomes, but not the best outcomes
- The best in show approach has a number of features that would further benefit members beyond an approach of just lopping off the tail:
 - a shortlist of funds most likely to provide good member outcomes and which supports safe and simple employee choice
 - rivalry to be on the best in show list creates an ongoing dynamic of competition *for* the market, which would be expected to further drive competition *in* the market
 - encouragement for even relatively high-performing funds to improve as the list provides 'role models' for funds to emulate
 - creation of a readily identifiable 'if not why not' comparator for financial advisers and their clients
 - acceleration of desirable industry consolidation by providing underperforming funds with an objective benchmark of good performance.
- Once there is a best in show list, there is no rationale for employers to be involved in choosing defaults— employees are capable of making their own choice of fund when well supported to do so. And removing employers from the process removes any risk of conflicts of interest from employer decision making which have been difficult to address under current default arrangements.

Although most employees have been able to choose their own fund¹⁰³ since July 2005, many (possibly up to two thirds of new job entrants) do not do so. Where employees do not make a choice, employers are required to make Superannuation Guarantee contributions into a default (MySuper) product on their behalf.

Around half of all superannuation accounts are in these MySuper products — designed to be particularly suitable for default members. Default arrangements are therefore important for a large proportion of the workforce. This importance is reinforced by the fact that many employees who default are disengaged from superannuation and typically have relatively low balances. In view of the compulsory and complex nature of superannuation, default arrangements reflect the duty of government to ensure the interests of these employees are protected.

Improvements to default arrangements, therefore, have the potential to benefit the many Australians holding default products and, by making default the exemplar, further benefit members across the entire system. They would also facilitate greater member engagement.

This chapter builds on the stage 3 draft report in which the Commission determined that the assisted employee choice model would produce better member outcomes than the other alternative default models developed in the stage 2 inquiry.¹⁰⁴ It contains an assessment of the current default settings and compares them to the assisted employee choice model.

12.1 How does the current default system perform?

Background

Current default arrangements sit within the workplace relations (WR) system. Many employers are required to choose a default fund from those listed in the relevant modern award (or sometimes, alternatively, a default fund specified in an enterprise bargaining agreement). Funds have traditionally been included in modern awards on the basis of consensus between employer and employee representatives (and modern awards typically reflect those funds listed in earlier award-based instruments).

In making decisions about which funds to list in awards, the Fair Work Commission (FWC) and predecessor organisations have drawn heavily on precedent, and viewed themselves as dispute solving bodies — not as arbiters of the quality or merit of funds put up for inclusion. The Australian Industrial Relations Commission (a predecessor organisation to the FWC) explicitly noted that it had not considered financial outcomes for employees in determining funds to be listed in modern awards:

¹⁰³ Technically, default members are placed into MySuper products (rather than funds), but use of the word fund in this chapter reflects the reality that members or employers often choose a fund (rather than the underlying product), and that it is funds (as an entity) that compete both for members and default status.

¹⁰⁴ The other models considered in stage 2 (*Superannuation: Alternative Default Models*) were the assisted employer choice (with employee protections), multi-criteria tender and fee-based auction models.

We do not think it is appropriate that the [AIRC] conduct an independent appraisal of the investment performance of particular funds. Performance will vary from time to time and even long term historical averages may not be a reliable indicator of future performance. We are prepared to accept a fund or funds agreed by the parties, provided of course that the fund meets the relevant legislative requirements. (AIRC 2008, p. 6)

Members' interests were a secondary consideration to questions of standing and history, and determinations regarding the merit of funds were largely left to industrial parties.

Persons or organisations generally required standing before the FWC in order to apply to have a default fund listed in an award. Standing has typically been restricted to industrial parties such as employer groups and unions. Retail funds, or industry funds without the backing of industrial parties, often had difficulty putting their case for inclusion (PC 2012).

In 2012, the Australian Government legislated a number of changes to the system for listing default funds in awards, based on recommendations in the Commission's 2012 report *Default Superannuation Funds in Modern Awards* (PC 2012). The FWC full bench was empowered to make decisions for each award every four years based on an advisory Default Superannuation List chosen (on the basis of merit) by an Expert Panel within the FWC. The requirement for standing disappeared and *all* funds were enabled to appear before the Panel to make a case for inclusion, although not to appear before the *final* decision maker (the FWC full bench) (Shorten 2012).

An Expert Panel was set up in January 2014. However, following concerns about conflicts of interest, the Federal Court in June 2014 declared the Panel was not correctly constituted under the *Fair Work Act 2009* (Cth) (Fair Work Act). The Panel stopped dealing with default listings (Ross 2014), and the system put in place by the new legislation effectively stalled. The revised system is dormant and the funds currently named in awards are overwhelmingly based on historical decisions (although there have been minor amendments based on individual applications by industrial parties).

The introduction of MySuper (also in 2012) was intended to ensure the suitability of default products and to reduce some of the variation in member outcomes in default by requiring all funds to obtain MySuper authorisation. But this has demonstrably not proved as effective as envisaged (chapters 2 and 10).

The Commission's assessment of the current system considers both the manner in which the system is operating in practice (*as implemented*), and how the Commission considers it would be operating were the post-2012 reforms in force (*as legislated*). The assessment is conducted against the criteria developed in stage 2 (PC 2017d): namely member benefits (assessed as outcomes), competition, integrity, stability and system-wide costs.

Assessment of the current system

Participants expressed a diverse range of views on the system's performance (box 12.1).

Box 12.1 A small sample of participants' views on the current system

Some viewed the default system favourably

The existing industrially based system is highly efficient in selecting a universe of default funds, which reduces the search costs for employers and members, and reduces the administrative cost to employers. ... The current system has proved efficient for government in that it has selected, on average, high-performing funds and reduced the cost of the Aged Pension. (First State Super, sub. 37, p. 13)

The cumulative evidence from two decades of performance data demonstrates current default arrangements have delivered the most efficient component of the system, charging lower fees and delivering better net returns than other sectors. (AustralianSuper, sub. 43, p. 19)

The ACTU maintains the view that the system provides widespread coverage for the workforce (and any deficiencies in this coverage are easily overcome), the system has proved highly efficient in delivering cost effective superannuation arrangements to Australian workers ... and is world class in providing investment returns as part of an internationally highly rated retirement policy system... (ACTU, sub. 50, p. 4)

The current default fund provisions of the Fair Work Act have not yet been implemented including because of some initial problems with the composition of the FWC's expert panel. These problems are surmountable. The relevant provisions of the Fair Work Act address many of the issues of concern raised by the Productivity Commission. (Australian Industry Group, sub. DR181, p. 8)

While others highlighted flaws

The current FWC model for allocating default contributions results in demonstrably poor outcomes for consumers. (FSC, sub. 69, p. 4)

Australia's current mandatory and default superannuation system risks perpetuating issues around member apathy and disengagement, in addition to missing out on opportunities from fostering more choice and competition. (ANZ, sub. 73, p. 6)

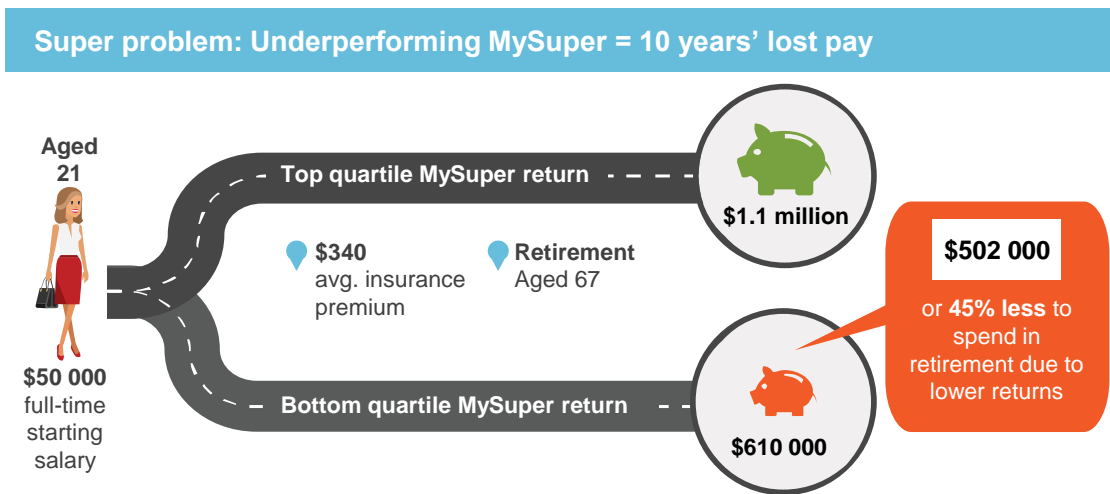
[The default allocation process] has been a qualified success, in that it has resulted in most employees being defaulted into high quality funds. But it has failed a significant number of members by defaulting them into sub-scale and/or poor-performing funds. Significantly, we estimate that more than 500,000 employees have been defaulted into such funds — a small percentage of the total workforce but enough in our opinion to say that overall the current system has failed. This is not the only failing, because there are many employees who are defaulted into funds (some of them strong performing and some poor performing) and because of EBAs are not able to exercise choice and switch to a different fund. (Chant West, sub. DR191, p. 9)

In terms of **member benefits**, the current system (as implemented) has placed most default members into funds that have delivered relatively good outcomes for members (chapter 2). The segment generated average net returns of 7.3 per cent per year over the 13 years to 2017. It has not, however, always delivered members into the *very best* funds available. In the 11 years to 2018, 32 (of 53 for which longer term data are available, incorporating precursor products) MySuper products (representing nearly 10 million member accounts and almost \$440 billion in assets) performed above a benchmark tailored to their own asset allocation (chapter 2), and generated a median net return of 5.5 per cent. Over the same period, 17 MySuper products (representing 1.6 million members and \$57 billion in assets)

underperformed their tailored benchmark by more than 0.25 percentage points and returned a median return of 3.8 per cent a year to their members.

Differences in performance matter a lot to member outcomes. A typical full-time worker who is in a median bottom-quartile MySuper fund is projected to retire with a balance 45 per cent (or \$502 000) lower than if they were in the median top-quartile product (cameo 12.1).

Cameo 12.1 MySuper returns can be a lottery for default members^a



^a The assumptions underpinning this cameo are set out in chapter 1.

The lack of prioritisation given to merit in the process used to determine which funds receive award listing, and a structure that restricts contestability between funds to obtain default members, have been key factors in some members being placed in funds that have not delivered good outcomes. Poorly performing funds have not been weeded out of the system. Of the 17 underperforming MySuper products discussed above, 11 are offered by funds that appear in at least one award (across various segments: 6 products from industry funds, 4 from retail funds and 1 from a public sector fund). And the system has ‘propped up’ some sub-scale funds at a large cost to those members through lower net investment returns (chapter 2). The system can be viewed as a ‘lottery’, with outcomes for employees dependent, at least to some extent, on the financial acumen of their employer — which will be highly variable. As ACCI noted:

... many, if not most, employers feel inadequate to select the best default for their employees, don’t have the time or capacity to do so or are influenced by non-relevant criteria. It is not a job which they want, nor one they are equipped for. ... There is no systemic reason why employers should choose their employee’s default fund. (stage 2, sub. DR79, p. 6)

And ASIC highlighted that:

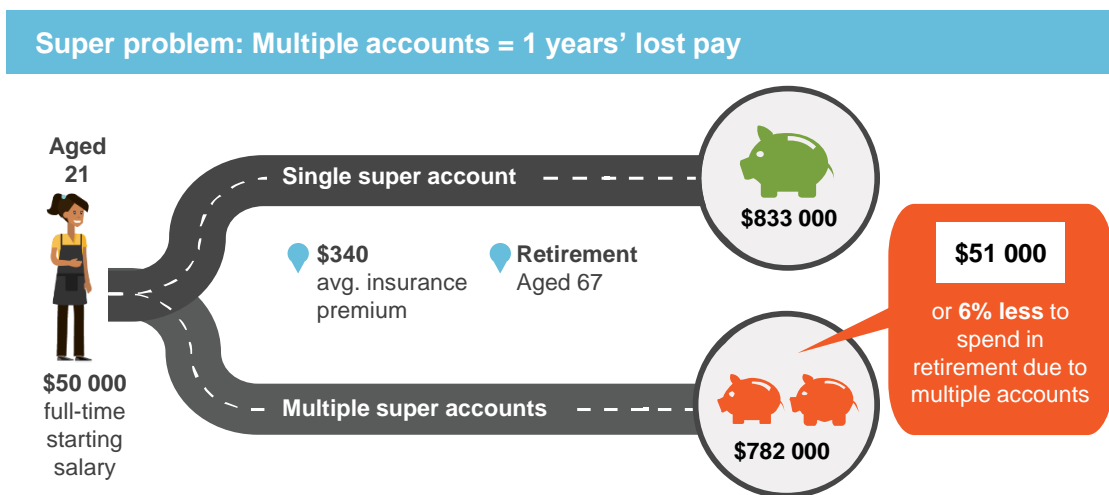
... employers are of varying sizes and sophistication and, as outlined above and in the Draft Report, comparing and choosing between superannuation funds can be challenging. Accordingly, even if an employer wishes to choose the best fund for employees the employer’s knowledge and

capability when it comes to the superannuation system may inhibit good choices. A poor choice then has significant consequences for any disengaged employees. (sub. DR206, pp. 4–5)

Another problem is that the linking of default funds to employers and thereby jobs means workers often change funds when they change jobs, contributing to unintended account proliferation (chapter 6). This comes at a high cost. An average earner with two accounts rather than one between the ages of 22 and 41 would be 3.5 per cent (or \$29 000) worse off in retirement. This would worsen to 6 per cent (or \$51 000) if the two accounts were held over the entire accumulation phase (cameo 12.2). And the costs of multiple accounts are even higher for low-income workers or those with intermittent work histories (chapter 8).

Further, restrictive clauses in some enterprise bargaining agreements prohibit employees from choosing their own fund.

Cameo 12.2 Multiple accounts reduce retirement balances^a



^a The assumptions underpinning this cameo are set out in chapter 1.

The current system (as implemented) does not rate highly from a **competition** perspective. The fact that funds have had to rely on industrial parties with standing before the FWC for inclusion in awards creates an anticompetitive barrier to entry (chapter 7). And the fact that an employer's choice of fund is limited to those listed within the relevant award or enterprise bargaining agreement (including, in some cases, to only one fund) further reduces competitive pressure on funds. This would not be a major concern if the list of eligible funds had been determined through a genuinely competitive process emphasising merit. But this is manifestly not the case.

From an **integrity** viewpoint, the current system (as implemented) has a range of third-party involvement that can result in decisions which are not necessarily in a member's best interests. The fact that employers choose default funds on behalf of employees creates an incentive for funds to offer benefits to employers to influence this choice. And some funds

do, as highlighted by evidence to the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Financial Services Royal Commission (FSRC)) (chapter 9). The FWC acts as an agent of employees in determining eligible default funds. But, as noted above, its methods have not traditionally been those of an entity seeking to ensure the funds likely to deliver the best outcomes for members were preferred. And industrial parties play a key role in determining the eligible funds into which defaulting employees are placed. While these parties are likely to have considered, to varying degrees, the respective merits of funds before seeking their inclusion in awards (and recommended funds they consider to be in the interests of employees), they have also sponsored the development of particular funds and, as highlighted in evidence provided to the FSRC,¹⁰⁵ sometimes have commercial arrangements with funds to promote them to workforces — so they are not immune to conflicts when reviewing other funds' requests to be registered. This is not to imply these parties have acted improperly, but rather that the system inevitably embeds such potential conflicts and on that basis needs to be rated less favourably.

The current system (as implemented) rates highly from a short-term **stability** viewpoint. Yet a desire for stability also promotes inertia and props up some poorly performing funds. There is no active FWC process for reviewing and delisting funds in the absence of the expert panel (although the Australian Prudential Regulation Authority (APRA) is now pressuring some poorly performing funds to justify their MySuper authorisation). From a long-term stability perspective, the existing system rates less favourably because many members are in underperforming funds (and therefore have an incentive to switch, but no mechanism to guide them to better funds).

The **costs** associated with *operating* the current system (as distinct from any costs that might potentially stem from underperformance) are reasonably modest. There is no real cost for defaulting employees as they are not required to do anything. Employers face costs associated with choosing funds, although these vary depending on the approach taken to selection (a tender process, for example, will be more costly). There are costs for funds associated with participation in the FWC process.

Had the 2012 reforms been implemented ...

Had the reforms legislated in 2012 been fully implemented, member benefits and competition would have likely improved to a degree, albeit in the absence of competition for default. A quality filter would have been applied, a potential mechanism to remove funds delivering poor outcomes for members from awards would have existed and all funds would have been able to apply directly to the FWC Expert Panel for inclusion in awards. The quality filter would have likely mitigated *somewhat* against concerns about employers choosing defaults, by providing greater information to employers about the quality of funds. But the

¹⁰⁵ For example the Energy Super and Electrical Trades Union Queensland and Northern Territory Partnership Agreement 2017-18 (exhibit 5.132.1), Hostplus and United Voice Partnership Agreement May 2016 (exhibit 5.322.1) and Hostplus and Australian Hotels Association National Partnership Agreement November 2015 (exhibit 5.322.22).

2012 reforms would not have prevented unintended account proliferation nor the associated costs to members — and would have preserved the status quo of separate fund listings for each industry.

Overall conclusions

In summary, while the default segment has *on average* performed relatively well in terms of returns to most members, it also structurally supports many poorly performing funds by directing default members to them, while putting little or no competitive pressure on them to improve outcomes for members. These members are not well treated by the system and nor are their interests adequately guarded by government.

Moreover, the current default system prevents healthy (or effective) competition between funds and leads to the costly (and highly regressive) risks for members of creating multiple accounts or being defaulted into an underperforming fund. The system also relies too heavily on third party decision makers, thereby ingraining member disengagement. Those least likely to engage with super, and so most likely to rely on the default system, are the young, people with lower education and those on lower incomes (chapter 5).

Tying default fund choice to the employer is anachronistic, and — given its role in unintended account proliferation (which is not typically a feature of default systems internationally) — is particularly ill-suited to a workforce where employees often change jobs or hold multiple jobs (chapter 1). In addition, many employers feel ill-equipped to make a choice, and incentives are created for funds to offer benefits to employers to influence their choices.

The good member outcomes seen in parts of the current default system are owed to a combination of trustee and management goodwill and endeavour. But over time (and given the total number of funds), variation in performance by both funds and regulators is inevitable. Sustaining good member outcomes, and spreading them to more members, is only achievable by providing incentives to adapt to better ideas or new needs. And absent policy change the cost borne by those ill-served members — although likely to be mitigated considerably by the adoption of the elevated outcomes tests recommended in this inquiry (chapter 10) — will grow as the system matures. The case for architectural change is therefore strong.

Some participants suggested the current legislated system should effectively be ‘given the benefit of the doubt’ because it has not been able to proceed as envisaged by legislation. However, in undertaking its analysis the Commission has assumed the legislated system would have functioned as intended (effectively affording the legislated system the benefit of the doubt), and concluded it would have likely resulted in better member outcomes than the system as currently implemented. That said, the Commission is confident the employee choice model would deliver significantly better outcomes for members than either the currently implemented or legislated systems.

FINDING 12.1

While the default segment has *on average* provided better outcomes for members than the system as a whole, it fails to ensure members are placed in the very best funds and places a sizeable minority in funds delivering poor outcomes. For example, focusing on investment performance (an important aspect of member outcomes), products that performed above their benchmark generated a median return of 5.5 per cent a year in the 11 years to 2018, whereas the 17 underperformers generated a median return of 3.8 per cent a year (and represented about 1.6 million member accounts and \$57 billion in assets).

Current arrangements also lead to unnecessary account proliferation, rely heavily on third-party decision making and deny some members any ability to choose their own funds. Default arrangements need to be modernised and recrafted to harness the benefits of competition *for* default members. The interests of members (not funds) should be paramount.

Should default selection remain in the WR system?

In its stage 2 draft report, the Commission recommended that the selection of eligible default funds should be decoupled from award determination and, in its stage 3 draft report, recommended new default arrangements (assisted employee choice — described below) that would remove employers and the FWC from the process of selecting default funds.

In response, a number of participants suggested it was important and appropriate for default fund selection to stay within the WR system. For example, the ACTU said:

... it does not matter that the quantum of superannuation paid is the primary focus of this application; what remains a principle is that the claim by a Union for workers to have their superannuation contributions paid into appropriate (default) funds is still an issue which is in connection with employment and the general principle of matters relating to employment being able to be regulated as industrial matters still applies. Workers have a longstanding and legitimate right to bargain for the conditions of employment that apply to them, and to do so on a collective basis. (sub. DR185, p. 5)

While Cbus Super stated:

Superannuation is generally a work-financed benefit and should remain in the ambit of the existing industrial-based default super system providing a sound safety net for workers. The need to retain a strong connection with the industry makes it logical to retain the link with the existing industrial framework for the allocation of default funds. (sub. DR177, p. 7)

On the other hand, the National Association for Australian Women argued that:

The connection between a particular industry and a fund is now largely irrelevant as public offer funds will generally accept members from outside a particular industry. The status of default funds in industrial agreements is historical, originating from the employer fund model under which employers and employees both engaged with the fund. This then extended out to the establishment of industry based schemes to facilitate portability. (sub. DR127, p. 2)

The Commission recognises the historical significance of negotiations through the WR system that eventually led to universal superannuation, and the importance of employee and employer representatives in that process. Further, there is undoubtedly a need to protect the interests of disengaged members in default superannuation funds (a theme that runs throughout this report). However, neither of these considerations implies a requirement for default fund eligibility to be determined within the institutional constructs of the WR system.

Introduction of the Superannuation Guarantee, making superannuation compulsory for all workers, removed the requirement for bargaining on an award or enterprise agreement basis. Payments now reflect government policy to defer 9.5 per cent of salary into superannuation. And one outcome of remaining negotiations around superannuation in enterprise agreements — conditions restricting fund choices by members — represents another negative feature of the system.

To the extent that there are benefits from tailoring products to groups across the workforce, they appear limited to relatively few workers, and generally relate to insurance rather than the default superannuation product *per se*. In the future, products maintaining an element of specialisation could be developed by any fund and selected by employees — and any fund could customise insurance to fit the specific needs of particular workers where necessary.

Moreover, many employees are not covered by awards, which only prescribe earnings for about 20 per cent of the workforce and provide a broader safety net for up to an estimated 60 per cent of employees (ABS 2016). Future default arrangements need to cater for all employees, and take account of individual circumstances (not necessarily related to their industry of employment). In any case, in the modern workforce, it would not be expected that most workers would spend their entire working lives in a single occupation or industry, and default arrangements need to reflect this.

A shift to assisted employee choice would remove employers, and any associated need for involvement of the WR system, from default fund selection. And the introduction with SuperStream of electronic data and money transfers to a common standard, and the widespread adoption of clearing house arrangements in recent years, means employers no longer need to fear the administrative complexities associated with dealing with multiple funds. There is no rationale for employers to be involved in default fund choices — as discussed below, with the right supports in place, employees are capable of making their own choice of fund.

Finally, maintaining an expert panel (within the WR system would risk creating a perception that the panellists should have some awareness of the WR system or expertise in it. As noted by ISA, ‘most people appointed to the [FWC] have had a ... career in law, public service, or industrial relations’ (sub. DR231, p. 12). However, expertise in the WR system would be superfluous to the exercise of determining the best superannuation funds based purely on member interests.

In summary, there is no compelling case for default fund selection to remain in the WR system.

12.2 Assisted employee choice — an introduction

Assisted employee choice — the Commission’s preferred default allocation mechanism for the future — has a number of key features (table 12.1), including:

- choice of fund by employees who are assisted via information of higher quality and accessibility than is currently available
- a best in show shortlist of up to 10 funds to guide members to better quality funds and reduce the risk to those who do not make a choice (backed up by elevated authorisation standards for all MySuper products)
- a process of shortlisting products that, on the supply side, focuses on factors that are particularly beneficial to members.

Table 12.1 Key features of the assisted employee choice model

Best in show shortlist

A list of up to 10 superior funds.

New workforce entrants (initially) presented with the shortlist in random order.

Existing members of shortlisted funds would benefit from product enhancements induced by the selection process. Shortlisted funds would need to offer the same conditions to new and existing members.

Independent shortlisting process

Shortlist selected by an independent expert panel every four years following a rigorous competitive process.

MySuper authorisation list

MySuper authorisation provides protection and comparability for employees choosing beyond the shortlist.

APRA administers MySuper authorisation to ensure only suitable products are offered.

Standards for MySuper authorisation are elevated.

Funds require MySuper authorisation to be eligible for the shortlist or to maintain existing default members.

Employees can choose any fund, regardless of whether it is MySuper authorised.

High quality information on products

Information provided to members is simple and covers investment performance, risks and fees (with the specific metrics to be based on detailed consumer piloting).

Simple one page dashboards provided for each product in a consistent format to help employees choose the product that best suits them.

Transparency and accountability

Funds apply to have products on best in show list. Submissions are publicly available.

Expert panel decisions are clearly articulated and transparent.

Allocation where no choice made

Existing workers (or people re-entering the workforce) who do not nominate a fund on changing jobs are allocated to their most recently active account.

New workforce entrants who do not nominate their own superannuation fund are sequentially allocated to a shortlisted fund.

Ongoing monitoring, enforcement and reassessment

Annual self-reporting by fund trustees backed up by independent auditing by, or on behalf of, APRA.

Periodic review of the criteria to assess default status (every 10 years).

The model recognises that competition *in* the market is problematic given many employees are disengaged, and many would struggle to make good decisions even if they were to become engaged (chapter 5). Instead, it sets up competition *for* the market (that is, competition through a formal process to earn the right to access default members). This would generate significant competitive pressures. Moreover, creation of a set of strong, high quality products for members to choose from would ultimately drive competition *in* the market as well.

The model design is also influenced by behavioural economics and the concept of ‘nudges’ and member ‘attention’ (Gabaix 2017; Thaler and Sunstein 2009) (box 12.2). The shortlist asks members (initially first time workforce entrants) to choose from only the very best funds, while addressing the problem that ‘having more options can impede choice’ (Barr and Diamond sub. 74, p. 12).

Box 12.2 The Commission’s thinking — inspired and informed by behavioural economics

Several studies have found that presenting people with too many options can overwhelm them and cause them to make poor choices, especially in a financial context (Abaluck and Gruber 2011; Iyengar, Huberman and Jiang 2004; Keim and Mitchell 2016; Morrin et al. 2012; Samuelson and Zeckhauser 1988). Restrictions on the number of options presented have been put forward as one way to reduce choice overload and help people to make better choices (Abaluck and Gruber 2011, p. 22; Ketcham, Kuminoff and Powers 2016, p. 2).

The degree of choice overload depends on the complexity of the decision and available choices, how certain people are in their preferences, and how much effort they are willing to put into the decision (Chernev, Böckenholt and Goodman 2015). Providing too much information risks confusing people or deterring them from reading it, and people can be overwhelmed when presented with too many different attributes (Johnson et al. 2012, p. 495). People are typically guided by a few considerations in decision making, ignoring the myriad of components considered too minor and firms need to compete for consumer attention in a world of limited attention spans (Gabaix 2017).

The order in which choices are presented to people matters. In a well-known experiment, Benartzi and Thaler (2002, p. 1610) found that people were averse to picking extreme options when selecting from a set of investment portfolios ordered from low to high risk, to the extent that their preferred option among two alternatives changed when a third option was presented either to the left or right side of the pair.

In summary, the model would make for safe and simple employee choice, increase member engagement, solve the problem of unintended multiple accounts and drive better member outcomes.

Participants expressed a broad range of views about the model (box 12.3).

Box 12.3 **Participants expressed mixed views about the assisted employee choice model**

CHOICE strongly supports the merits based “best in show” proposal in the Draft Report. This allocation process will allow people to choose their own product, but it controls the choices available so that any fund chosen should be high-performing. While linking the allocation process to the industrial relations systems may have made sense decades ago, it now fails to fully support people that change jobs, industries and increasingly hold multiple jobs. (CHOICE, sub. DR184, p. 3)

... The proposed assisted employee choice model is an excellent step towards improving retirement outcomes for everyday Australians. The model protects members from multiple accounts by only defaulting them once when they enter the workforce. The curated short-list of ‘best in show’ products ensures disengaged members are not defaulted into underperforming products by employers either ill-equipped to select a fund, or conflicted and failing to act for the sole benefit of employees. (Roll-it Super, sub. DR113, p. 1)

BTFG supports the PC recommendation for a short list of approximately 10 funds to be presented to all employees who are new to the workforce (or do not already have a superannuation account), from which they can choose a fund. We also agree with the recommendation that Australians are presented with clear and comparable information on the key features of the shortlisted products and that they should not be prevented from choosing any other fund (including an SMSF) if they wish to do so. (BTFG, sub. DR149, p. 3)

Presenting employees with a subset of the best funds would ensure that they are only defaulted into one of those funds. It would also direct member choice to a range of very good funds. And that should really be the main purpose of the default allocation process. Overall, it would achieve the purpose of the allocation process very well, indeed much better than the current system. For this reason, we support this approach in principle. (Chant West, sub. DR191, p. 16)

QSuper wholeheartedly supports the PC’s intent to lift the standard of default products and, in fact, we contend the criteria for assessing default fund status, when you combine it with the requirements of the fund’s default investment option, will fundamentally shift members’ retirement outcomes. We therefore support the holistic approach in proposing a diverse range of measures as part of the default selection process. (QSuper, trans. p. 335)

The creation of a ‘best in show’ list risks encouraging disengagement and inertia in the decision making process from a consumer’s very initial interaction with the superannuation system. It risks sending a message to consumers that it is acceptable to be disengaged from your financial affairs. (Financial Planning Association of Australia, sub. DR146, p. 6)

AustralianSuper believes that the diverse needs of the Australian workforce cannot optimally be met by only 10 default products across the entire superannuation system. Funds have a responsibility to develop investment options, insurance arrangements, products and services that reflect the needs of their membership. AustralianSuper cautions that the Commission’s top ten default products would result in a market concentration to only 10 funds, homogenise the superannuation landscape, and may result in behaviour that may not be in the interests of superannuation fund members. (AustralianSuper, DR150, p. 4)

... A shortlist of 10 funds has the strong potential, in our view, of promoting an uncompetitive market with those funds selected having an almost guaranteed growth and source of new members while those funds not selected for the top 10 will face growth pressures that means they will struggle to remain competitive over time. As they will struggle to remain competitive, it will be difficult for them to supplant any of the initially chosen “top ten”. Thus, in our view, rather than promoting a competitive superannuation system the proposal has the highly likely result of a concentrated and less competitive system. (Deloitte, sub. DR172, p. 2)

Given ... past investment performance is not a reliable indicator of future performance, using past performance as a key criteria in allocating future default contribution flows, appears fundamentally flawed. ... The top 10 performing funds in one 10 year period are very unlikely to be the same top 10 performing funds over the next 10 year period. (IFAA, sub. DR136, p. 4)

A best in show list is critical to improving member outcomes

'Lopping off the tail' alone would produce better outcomes, but not the best outcomes

A number of submissions considered that an elevated outcomes test (chapter 10) — by removing underperforming funds ('lopping off the tail'), and therefore leaving employees with a pool of relatively high performers to choose from — would obviate the need for a best in show list. For example, Geoff Warren stated:

The performance benchmarking analysis is notable for revealing what appears to be a tail of poorly performing funds. It is not clear that the remainder of the industry is delivering anything different from random variation around their benchmarks. ... Some of the PC's proposals will reinforce other regulatory developments currently underway to raise the bar for all default funds. These relate to the outcomes test, MySuper registration, governance, facilitating and encouraging mergers, and so on. Meanwhile, anointing a handful of funds has risks as well as benefits, related to the difficulty of identifying the 'best' funds, and the possibility [of] unintended consequences. (sub. DR118, p. 2)

The elevated outcomes test is a significant change, and is likely to be highly beneficial in improving member outcomes by weeding out poor performing funds or encouraging elevated performance.

But best in show delivers five further and distinct benefits beyond 'lopping off the tail' — benefits that are critical to an enduring improvement in member outcomes.

First, *a shortlist of superior funds supports safe and simple employee choice*. Many participants effectively (and legitimately, given prevailing levels of member disengagement) asked 'how can people be expected to choose a very good fund?' The list provides the reassuring answer: 'there's only 10 (or so) very good funds to choose from'. Relatedly, the shortlist responds to the problem of 'choice overload'. Presenting members with too much choice would make choosing a fund difficult or result in 'random' choices.

Further, the best in show list supports members to identify and choose the better performing funds. This is consistent with the view, as expressed by ISA, that 'the main priority for public policy should be to ensure employees are connected to good quality funds' (sub. DR232, p. 3).

Second, *competition to be on the list creates an ongoing dynamic of effective competition*. The elevated outcomes test is about dealing with the worst funds; best in show is about encouraging even highly performing funds to be better. Simply 'lopping the tail' would not deliver the benefits that potentially lie in funds actively competing to be on the list — and on what matters to members.

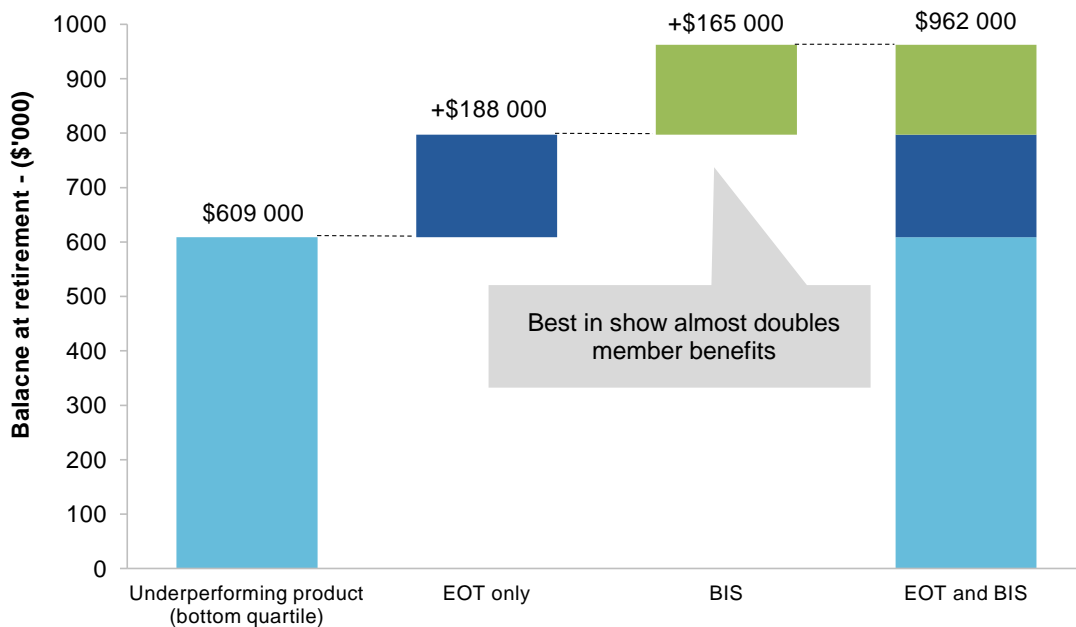
Results from the Commission's cameo model suggest that the elevated outcomes test (by removing the risk of a member ending up in a persistently underperforming product) and best in show shortlist (by shepherding members to the better products) would together increase retirement balances by 58 per cent for the millions of new workforce entrants that

would otherwise have ended up in persistently underperforming products (figure 12.1). Notably, nearly half of this 58 per cent increase is attributable to best in show in and of itself.

This cameo is based on conservative assumptions about the impact of these twin policy measures. First, it assumes that the elevated outcomes test would see new workforce entrants that would otherwise have ended up in underperforming MySuper products (the bottom quartile) default into the third quartile. And second, it assumes that best in show funds would remain in at least the second quartile of performance over the very long term.¹⁰⁶

Figure 12.1 **Why ‘lopping off the tail’ alone is not enough^{a,b}**

Cameo model simulations for the elevated outcomes test (EOT) and best in show (BIS)



^a The potential impact of the elevated outcomes test is estimated as a new workforce entrant defaulting into the median third quartile product, rather than an underperforming product (the bottom quartile). The further impact of best in show is estimated as a new workforce entrant defaulting into the median second quartile performing MySuper product. ^b The more general assumptions underpinning these cameo results are set out in Chapter 1.

Third, *the shortlist identifies role models for others to emulate*. As QSuper noted:

Importantly, the selection process ... will define industry best practice and set the design of the industry’s future products and services. Consequently, the qualities and features of funds selected as ‘best-in-show’ will be seen as the benchmark for all funds to manage towards. (sub. DR168, p. 5)

¹⁰⁶ This cameo is distinct from cameo 1 (Overview) and cameo 2.3 (Chapter 2), which generically depict the ‘unlucky lottery’ associated with the large dispersion of performance among MySuper products.

Fourth, as a readily identifiable ‘if not why not’ comparator for financial advisers and their clients *the list creates pressure for better performance in the choice segment*. It should provide members with some protection against conflicted advice (chapter 9). As ASIC noted:

... we envisage that the ‘best in show’ concept would if implemented provide a useful baseline around which financial advice in respect of superannuation can be formulated. (sub. DR206, p. 13)

Fifth, *desirable industry consolidation is accelerated* because underperforming funds have an objective benchmark of good performance (‘how far is our fund from the top 10?’).

Furthermore, reliance on simply lopping off the tail also means reliance on a regulator, raising the possible risk of regulatory failure and associated member harm — a far from remote prospect given recent history (chapter 10). The relatively objective nature of the elevated outcomes test (chapter 10) developed by the Commission provides some reassurance, but it still relies on superannuation regulators (particularly APRA) enforcing it.

12.3 Features of the shortlist

What criteria should determine shortlisting?

The current Fair Work Act criteria, with some modifications, represent a solid starting point for determining the criteria to guide the best in show list. In view of the importance of investment returns to member outcomes, most weight should be afforded to the **likelihood of the fund continuing to produce high net returns for members** (taking into account the **risk profile for the types of members who typically default**) over the long term.

The expert selection panel (discussed below) should also give heed to the fund’s track record on innovation, and identifying and meeting member needs (including design of superannuation products).

Innovation in developing post-retirement products should also be considered (particularly given the maturing of the superannuation system and that all funds will have a material cohort of members close to retirement). Notwithstanding that retirement will be decades into the future for new entrants to the workforce, there are always likely to be members close to retirement who would be ‘nudged’ or allocated to a best in show fund. And the Commission’s cameo modelling shows that even a 55 year old could be \$75 000 better off in retirement as a result of changes to the system dealing with entrenched underperformance in MySuper and unintended multiple accounts. The inevitable presence of a near retirement cohort was noted by the Financial Planning Association of Australia:

The stated purpose of the proposed ‘best in show’ list is to assist disengaged new workforce entrants. The superannuation needs of this cohort would be quite specific and also vary to the superannuation needs of ‘mid-career’ or ‘nearing retirement’ cohorts. Therefore it is

recommended that any ‘best in show’ list be fit for purpose and come with very clear disclaimers as to its intended audience and appropriate use by that cohort. (sub. DR146, p. 8)

Assuming well-designed (newer generation) life-cycle products have a role in default settings (chapter 4), ‘smart’ defaults could potentially be included in future best in show lists. Comparisons between life-cycle and single strategy products are more complex than comparisons across single strategy products. However, such comparisons are feasible, especially by an expert panel, and can build on this inquiry’s established methods.

Some participants suggested it would be important that the best in show list enabled a diversity of funds. For example, QSuper said:

QSuper contends that any selection process must take care to avoid inadvertently stifling industry innovation through a homogenous selection, as all funds manage/design products to be competitive with a ‘best-in-show’ criteria. ... the criteria should set a high standard that will elevate members’ best interests and while comparability is important it should not be simplified or come at a cost to member outcomes. There will be many ways for member outcomes to be achieved and therefore any ‘best-in-show’ suite of funds should include a diversity of product designs and features as opposed to a similar group of options from different funds. (sub. DR168, p. 5)

Recent evidence before the FSRC (chapters 9 and 10) has reinforced the importance of good governance arrangements to deal with conflicts of interest and ensure the best interests of members are placed first. Governance should be an important consideration for the expert panel in determining the suitability of a fund for incorporation on the best in show list.

The Commission anticipates funds would provide detailed applications to the expert panel to assist it in ascertaining the best funds. This would include provision of data on the funds’ performance by asset class, and their performance attribution analysis using these data.

Given the potential for best in show funds to obtain an influx of new members (including, potentially, from other funds having lost their authorisation with the elevated outcomes test), funds applying to be on the best in show list would be required to demonstrate that they had the capacity to absorb these members in an orderly manner.

How should insurance be dealt with?

One concern raised by a number of participants relates to insurance in superannuation under the Commission’s proposed changes to default arrangements. The proposed arrangements in impacting the composition of a fund’s membership, may consequently impact the group insurance pooling for high-risk cohorts.

Under existing arrangements, many funds (particularly industry funds) have large pools of members in the same industry, and even with the same employer. This can potentially assist in designing and pricing insurance products by enabling better identification of members' risks and preferences. Cbus Super stated:

[Cbus Super tailors] ... insurance products which use the group buying power of the fund to provide value for money cover to cohorts who would be unable to obtain affordable cover individually, conditionally or at all. The terms of Cbus' insurance are unique in the insurance market in Australia and has been negotiated to respond to the needs of our membership, including age definitions, coverage of high risk working conditions and occupations, more generous definitions, generous acceptance of pre-existing conditions, and non-conditional coverage of suicide. (sub. DR177, p. 4)

The key concern raised is that a fund with relatively significant pools of higher risk members (due to occupational risk), or other cohorts of members with particular insurance needs, has developed its insurance offering to meet these needs. However:

- the insurance offerings are not well suited to members with other characteristics, limiting their appeal to new members exercising individual choice
- members that traditionally would have joined the fund may choose another fund with insurance that is less suited to their needs, potentially with exclusions that can leave them without suitable cover, or paying for junk insurance
- dilution of their existing pools may compromise the fund's capacity to serve the needs of its existing membership.

Changing to an assisted employee choice model, rather than an employer-based default system, could result in active choices by members to capitalise on their individual risk characteristics to purchase additional or cheaper insurance. This could see adverse selection increasing the risk of the pool, and/or administrative costs increasing due to increased risk control screening or underwriting prior to accepting self-selecting members into a fund's group insurance pool. Another outcome could be a shift to offer a more generic insurance offering, and a convergence of automatic default insurance offerings across funds.

However, there are factors that limit the extent of these risks, and specific insurance requirements do not represent a compelling reason to lock members into a particular fund, particularly given the relatively greater importance to members of getting the best returns. The insurance 'tail' should not wag the superannuation 'dog'.

- First, while high-risk workers are an important component of the workforce, they represent a relatively small cohort of Australian workers — and the proportion of the workforce in traditional 'blue collar' jobs has fallen from about 40 per cent in 1986, to about 30 per cent in 2018 (ABS 2018f). Further, insurance cover is not restricted to work-related illness and injury, and many sources of risk of death or disability are independent of members' occupations. Cover would also typically be available through State and Territory based workers compensation schemes, for which about 89 per cent of the workforce is eligible (that is, virtually all workers excluding the self-employed) (SWA 2018).

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- Second, most members are relatively disengaged and insurance arrangements will not be the only, or perhaps even a primary, consideration in members' decisions around a choice of fund. Therefore, the number of potential members that consider themselves to have high risk factors that would shop around to maximise their insurance cover, including by exploiting any perceived cross subsidies within a particular fund's insurance arrangements, is likely to be relatively small and have modest effects on group insurance pools.

The scale benefits associated with being a best in show fund would also potentially provide funds with considerable bargaining power to negotiate good insurance outcomes for members (including for the small cohort in high-risk occupations, akin to larger funds like AustralianSuper).

That said, it is important that mechanisms are put in place to prevent adverse outcomes under revised default arrangements, and particularly that new members do not pay for unsuitable insurance (for example, because of exclusions on the basis of occupation) or that cover is inequitably priced. Some funds currently focused on particular cohorts might be able to provide highly suitable offerings for these members, and should be free to market their offering as such. Ultimately, and for the purposes of the best in show list, the litmus test should be that the cover offered is suitable for all new members to a *reasonable* degree.

Accordingly, the expert panel should ensure that funds applying for inclusion on the best in show list are evaluated on the terms and conditions of their automatic insurance offering, including that all occupations are appropriately catered for (see below). While this might be seen as disadvantaging some funds in the best in show process, the Commission's focus in this regard is unambiguously on members, and members should not be placed into funds lacking the scale to provide good member outcomes, including for insurance.

How much weight should be given to past performance?

As discussed above, the Commission expects most weight would be afforded to the likelihood of the fund continuing to produce high net returns for members (taking into account the risk profile for the types of members who typically default) over the long term, not just the next four years. Demonstration by the fund of product innovation throughout the members' life cycles would also be a key consideration.

In response to the draft report, some participants raised concern about perceived over-reliance on past performance by the expert panel. The proposed criteria, however, see performance history as *only one* factor in determining the likelihood of producing high *future* returns. The expert panel would have a remit to consider a much wider range of criteria than historical investment returns. In any case, the age-old adage that past performance is no guarantee of future performance is only true of investment markets in a narrow sense. The adage is also incongruent with the evidence in this inquiry that good long-term performance is associated with low fees, good governance, and sufficient scale. That is not to say that judgment will not be required — and thus an expert panel is much better placed to identify

likely future outperformers than employers (under current arrangements) or individual members themselves (particularly default ones).

Moreover, when determining likely future performance, the expert panel would be expected to have insight into the investment strategies employed by funds, their risk tolerance, and the relative merits of their trustee board and key staff, rather than just naively extrapolating past performance.

Geoff Warren noted past performance was just one of a number of factors typically considered when choosing investment managers, and this was a similar exercise:

... how does the panel choose? I've done some research not on this specific problem but how do managers, super fund managers and whatever, choose [investment] managers. What we have is an equivalent problem here. ... often investment performance doesn't become the pre-eminent thing ... because past performance is revealing but it's not indicative of necessarily what's the best. So they try to understand it. But the most important ... question is, do I trust this manager with my funds? Will I give it to them? It gets down to things like people, confidence in them, governance, all [these sorts of issues]. (trans. p. 90)

The Commission considers the expert panel should be provided with high-level guiding principles to be considered by the expert panel in compiling the best in show list, and these should be legislated. However, the expert panel should be given discretion over the factors (and precise selection criteria) it uses to determine the list. The full set of factors to be considered by the expert panel, together with three high level guiding principles, is contained in box 12.4.

Box 12.4 Guidance on criteria for inclusion on best in show list

The Commission considers the panel should be provided with high-level guiding principles reflecting its core objective. These would be:

- Funds should be chosen based on their likelihood of providing the best outcomes for members in the accumulation phase, taking account of risk.
- Products chosen should be particularly suitable for members that had typically defaulted but also based on being highly suitable products for all members (that is, the logic behind the original development of MySuper should continue).
- The panel should always seek to ensure a competitive dynamic exists between funds, without compromising the integrity of the best in show list. This might involve changing the number of best in show funds chosen from time to time, while continuing to ensure only the highest-quality funds are awarded best in show.

(continued next page)

Box 12.4 (continued)

The overall criteria guiding the expert panel in developing the best in show list should include:

- the record of alignment between the MySuper product's long-term investment return target and risk profile for the types of members who typically default (with funds required to provide modelling and evidence of this match, with the quality of that modelling and the information on members used to develop such models being a criterion in its own right)
- the expected ability of the fund to deliver on the product's return target, given its performance track record (in superannuation or related institutional investment) and risk profile
- value for money fees and costs, given the product's stated long-term investment return target and risk profile
- the fund's investment performance at an asset-class level and track-record at attributing asset-class performance to relevant drivers
- the fund's governance practices and track record, including ensuring the fund has effective mechanisms to ensure a high-calibre trustee board, to deal with conflicts of interest and to ensure the members' best interests are placed first (with consideration to be given to any recent regulatory breaches)
- the fund's record of innovation, including in the use of member-related data, and in developing products over time (including in retirement)
- the fund's record and capacity to identify and meet member needs (including in the design of superannuation products)
- the quality of advice given to a member of the superannuation fund relating to the member's existing interest in the fund and products offered by the fund
- the administrative efficiency of the fund and the pass through of economies of scale over time
- the fund's prospective ability to take on new members in an orderly way
- that insurance arrangements are appropriate for members, including that members of all occupations are appropriately catered for — with occupational risk factors to be reflected in premiums based on appropriate risk rating factors, not opaque exclusions or variations in eligibility definitions
 - acceptance conditions and processes are appropriate
 - automatic cover is competitively priced and set at appropriate levels to cater to the range of potential new members
 - the fund is fully compliant with its insurance obligations and adheres to industry best practice, including its compliance with the industry code of practice.

To ensure flexibility, the selection panel determining the shortlist would be able to consider any other factors they considered relevant.

What is the optimal length of the list?

There are twin perspectives for considering the length of the best in show list.

First, from the perspective of employees, behavioural economics — and particularly the work of Xavier Gabaix — suggests that in a world where people have limited attention resources they must make decisions about what to allocate their attention to and what to ignore. When the consequences of decisions are well into the future, people are more likely to focus on more immediate concerns. Therefore if members are being asked to make decisions about their retirement, the choices provided must be simple and safe. A long list of options would be overwhelming and make choice difficult (box 12.2). A list that is too short could mean many worthwhile funds are left off, and the lack of options might drive employees to relatively unsuitable choices.

Second, from the perspective of funds, if a list is too long, the incentive to pursue listing will likely be muted because the reward of making the list is low. There is also a risk mediocrity might be tolerated, with lower-quality funds making the list. However, if a list is too short, funds might not apply because they consider the probability of making the list is relatively low.

The ideal length of the shortlist would be up to 10 funds. This is based on the Commission's analysis of fund performance — which suggests there has been historically and is currently more than 10 good funds in the market, providing a level of reassurance about the quality of the funds that will be on the list, and reassurance that there will always be quality rival funds 'nipping at their heels' — and in consideration of the need to provide members with a relatively short list to avoid choice overload.

Not all members would choose from the list

Some engaged new workforce entrants would invariably choose funds from beyond the shortlist, with the likelihood that a range of good products would be maintained or developed to cater for particular member circumstances — and unions and employers would be likely to 'nudge' members towards funds considered particularly suitable to individual workplaces (including corporate funds). Elevated MySuper authorisation (chapter 10) would mitigate against the risk of poor fund choices, and see existing default members removed from underperforming products. And funds would require this enhanced MySuper authorisation to continue receiving Superannuation Guarantee contributions for existing default members.

Will the list inspire deleterious behaviour change by funds?

Some participants considered the introduction of the best in show list, combined with the emphasis on the likelihood of producing high net returns for members as its key focus, would create incentives inconsistent with members' best interests. In particular, concern was expressed that funds on the shortlist would seek to emulate the strategies of their peers ('peer

risk’), and that funds just outside the list would increase the riskiness of their investment strategies hoping this would see their short-term performance improve and increase their chances of success in the next selection process. For example, AustralianSuper stated:

AustralianSuper believes the implementation of a “Best in Show” top 10 ... will also provide incentives for funds to act in ways that may not be in the interests of superannuation fund members including:

- Short termism over each four year block, including “window dressing” to manage performance leading into tender dates.
- “Herding” behaviour by those MySuper options selected into the ‘Best in Show’, around a particular asset allocation or strategy, in order to retain position within the top 10.
- Increased risk-taking or alternative strategies by funds nudging the bottom of the top 10 list.
- Product providers running multiple extreme portfolio strategies, so that one will have very high performance and one very low, the goal of having one of those selected in the next tender. (DR150, p. 5)

While Mercer suggested:

It is almost inevitable that, once selected, these funds will adopt similar behaviour to reduce the probability that they will be removed at the next selection panel decision. ... they will not want to be significantly different from the other selected funds. ... On the other hand, there is a distinct risk that funds that are just outside the top tier (at least from their perspective) may behave in a manner that is detrimental to their current members. For example, they may limit services or innovation to reduce fees or adopt a higher risk strategy in respect of their investments to increase the probability of being selected in the next round. (sub. DR175, p. 8)

Funds are likely to modify their behaviour in response to the introduction of a best in show list — that is the primary *raison d’être* of introducing it — and generally in ways that will boost their performance and returns to members over time.

Good design of the selection process (chiefly the criteria) and astute assessment by a suitably qualified expert panel should remove any incentive for funds to adopt strategies inconsistent with members’ best interests (including mediocrity herding). In particular, the criteria should include a focus on long-term returns considering the risk profile of members. Short-term variations in performance should not significantly influence panel decisions and, given the expertise the Commission anticipates will be on the panel, it should be well placed to detect any short-term ratcheting up of risk and account for it when making decisions about listing. Sunsuper stated:

Ensuring an appropriately long-term investment performance filter is applied to any best in show criteria will be necessary to guard against this potential as well as ensuring the expert panel assesses whether funds are operating ‘true to label’ against purported investment strategies. (sub. DR197, p. 27)

Likewise, the panel should be well placed to spot, and question, herding behaviour. Indeed, a best in show process would reward quality emulation (the ‘role model’ effect cited by QSuper discussed earlier), not mediocrity herding. Selection onto the list will represent an

implicit endorsement of funds' previous investment strategies, and funds would have to be able to explain any pronounced shifts in strategy, if so requested, to the panel. Funds outside the list will have an incentive to develop, and argue for, strategies that they consider will best fit members' interests. Any quality emulation (as distinct from herding) among shortlisted funds would provide extra incentive for this effort, presenting funds competing to get onto the list with the opportunity to demonstrate points of difference. And, given shortlisted funds will have to demonstrate the appropriateness of their strategy and performance, inter alia, within four years, the prospect of them merely resting on their laurels is unlikely to represent a major concern.

Will the list lead to market concentration?

A number of participants expressed concerns that the adoption of a best in show list could increase industry consolidation to a point where an oligopolistic industry structure could emerge. For example, IFAA stated:

The detrimental impacts on ... funds [outside the top 10] and their members has not been sufficiently examined in the Report. It is conceivable that funds which are 'unsuccessful' in achieving top 10 status may have no option but to wind-up or merge, in the medium term. Implementation of this recommendation could irreversibly and in our view, unjustifiably, alter the structure of the industry. The consequence of this could be that in the medium to long term, the superannuation industry could resemble the banking industry, with a small number of large dominant players. In this scenario, there would be reduced competition in the market, and less pressure on funds to reduce costs and innovate. If this was to eventuate, we consider this would not be in the best interests of members. (sub. DR136, p. 3)

And ASFA stated:

There is a significant risk that a Top 10 'best in show' would add to market concentration and systemic risk. In the absence of long-term default fund flows, funds that are unsuccessful in even a couple of Top 10 'best in show' rounds might no longer be viable. (sub. DR148, p. 5)

Whilst greater fund consolidation in the super system is an intended consequence of the best in show initiative, there are a number of reasons why it will not culminate in undue market concentration. First, the initial focus of best in show would be on new workforce entrants and those moving from poor performing funds. New workforce entrants represent half a million members each year with about \$1 billion in annual contributions (albeit growing quickly from that starting base). In the absence of significant increases in switching rates, only about \$20 billion out of the \$148 billion in annual contributions would potentially flow to the best in show funds.

Many of the largest superannuation funds target the choice market (containing the bulk of funds under management) rather than the default market. What proportion of their members would move to a best in show fund (particularly in view of the Commission's recommendations to lift the choice performance bar) is unclear. However, the overall size of the system — projected to grow from \$2.7 trillion in assets today to \$4.3 trillion (in today's

dollars) by 2032 (Rice Warner 2017f) — has the capacity to support considerably more than just 10 best in show funds. (Indeed, assuming APRA-regulated funds maintained about 75 per cent of total superannuation assets, this would imply room for over 30 funds equivalent to the current size of AustralianSuper.)

Participant comparisons with the ‘big four’ banks are misplaced. Even based on the unrealistic assumption the introduction of a top 10 list would see the number of funds shrink to around 10, this would not represent an oligopoly and would provide considerable capacity for competition. Currently, lack of member engagement means competitive outcomes are not being achieved, and a number of persistently underperforming funds survive (chapter 2) — that is, fund consolidation is an essential ingredient of a more efficient superannuation system. The Commission is confident the adoption of best in show, with its focus on competition for the market, would lead to a *more* competitive and efficient environment, with better outcomes for members.

That said, there are obvious commercial advantages to being on the list (such as guaranteed cash flow from the members joining the fund in the four-year listing period, and reputational benefits). These potential benefits to funds represent a key driver of competition to be on the list. However, they do create potential for at least some of the funds in the best in show list to become entrenched over time, thereby potentially compromising the desired competitive dynamic. For this reason, various options (including many suggested by participants) have been considered to ensure a competitive dynamic, including staggering listings and adjusting the number of funds listed over time.

For each round, the expert panel should be tasked with considering the optimal competitive dynamic over time (without compromising the quality of the funds chosen) when determining the number of funds (up to 10) to list.

The Commission’s proposed biennial *State of Superannuation* report card (chapter 10) would inform a long-term perspective of the impact of the best in show arrangements on overall competition. The Australian Government should also commission an independent review of the superannuation industry, focusing on the impact of policy settings, every 10 years (therefore within three best in show cycles).

12.4 The mechanics of assisted employee choice

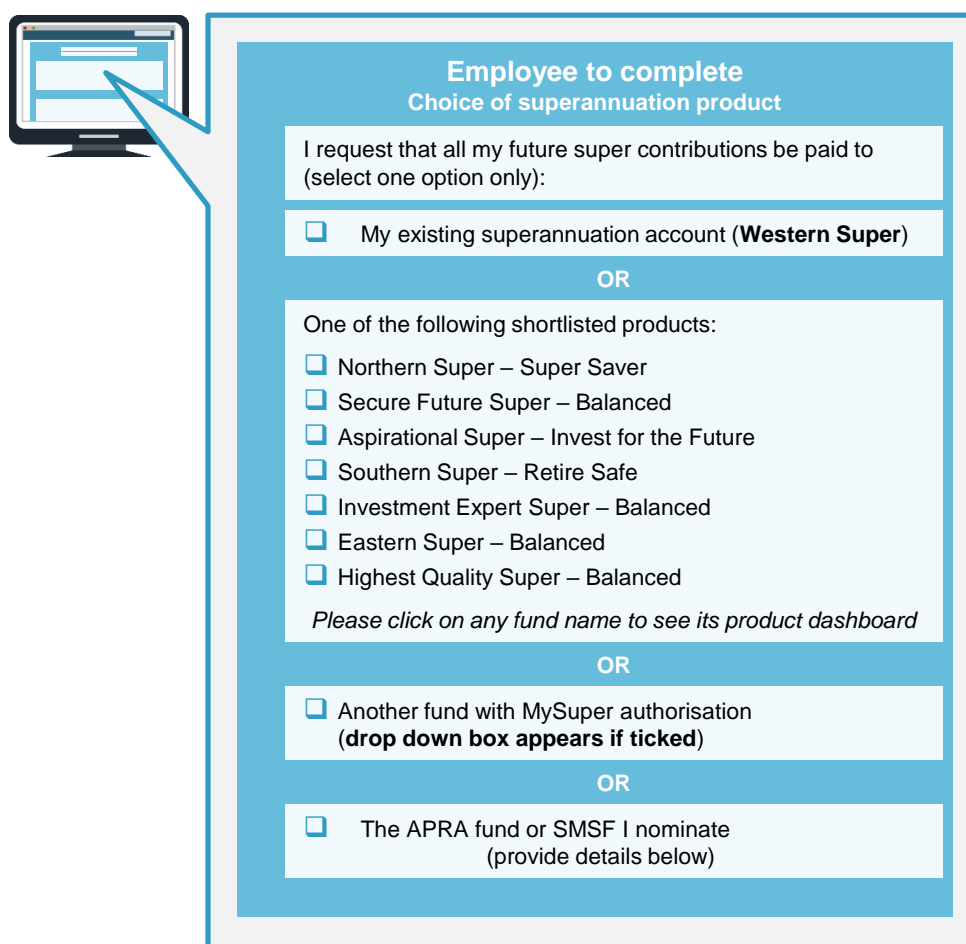
Future arrangements for allocating default members should both be simpler and focus on the best interests of *all* such members. But no existing member of any fund should be made to change their fund (absent the fund losing authorisation). The system should also first and foremost ensure that an employee should only be placed in a default fund if they fail to exercise choice *and* do not have an existing superannuation account.

An online standard form will support choice

On starting their first job, new workforce entrants (the first-timer pool) would be presented with the shortlist via an online standard choice form (figure 12.2; chapter 6). The ordering of funds on the shortlist should be randomised for each employee to remove ordering biases. A dashboard showing clear, easily understood metrics on the key features of each fund would be provided (chapter 5) to support choice. New workforce entrants could choose any other fund in the market, or self-manage their super, but the presentation of information would steer them towards the shortlist. The adoption of the model would not preclude employers or unions from providing information to their employees if they choose to do so, or employers from maintaining corporate funds.

New entrants would then retain the fund they choose (including after a change in employer) unless they actively switch. This is a critical circuit-breaker to the current system's propensity for costly account proliferation (chapter 6).

Figure 12.2 **Sample: online choice form for an employee with an existing fund^a**



Employee to complete
Choice of superannuation product

I request that all my future super contributions be paid to
(select one option only):

My existing superannuation account (**Western Super**)

OR

One of the following shortlisted products:

- Northern Super – Super Saver
- Secure Future Super – Balanced
- Aspirational Super – Invest for the Future
- Southern Super – Retire Safe
- Investment Expert Super – Balanced
- Eastern Super – Balanced
- Highest Quality Super – Balanced

Please click on any fund name to see its product dashboard

OR

Another fund with MySuper authorisation
(**drop down box appears if ticked**)

OR

The APRA fund or SMSF I nominate
(provide details below)

^a Where the drop down box appears, access to the product dashboards for each fund can be obtained by clicking on the fund's name.

Existing (and previous) workers would remain with their current fund unless they choose to switch (subject to their existing fund meeting elevated authorisation standards) — which they would be able to do upon changing jobs or at any time (figure 12.2). On changing jobs (or re-entering the workforce), their existing fund(s) would be preselected in the online standard choice form (chapter 6), and presented alongside the shortlist and the option of choosing any other fund. The service would enable identification of employees do not already have an existing account, and the standard employee choice form, combined with the Tax File Number process, would facilitate members consolidating their accounts.

Employees who fail to choose will be allocated to best in show funds

Regardless of how straightforward the process is for choosing a fund, some new workforce entrants will inevitably not make a choice. The Commission's experimental survey work undertaken during stage 2 suggests relatively few people will fall into this category — with over 95 per cent of respondents who received a recommended shortlist of 4 to 8 funds making a choice, and over 80 per cent of respondents selecting a fund from the shortlist (PC 2017a).

Following the stage 2 draft report, some participants suggested sequential allocation of members (sometimes known as 'cab rank' allocation) to the funds on the best in show list would represent the best way of determining a default fund for these members. For example, Dixon Advisory said:

Dixon Advisory suggests [allocating] members sequentially into the shortlisted default fund if they do not exercise a choice from the default shortlist within a designated period (i.e. 60 days). The sequential allocation of members across a wide but well filtered and appropriately considered shortlist, may also help reduce some of the issues with the ordering of the shortlist and concentration risk amongst certain funds. (stage 2, sub. DR76, p. 2)

The Commission has adopted this suggestion as it guarantees that employees who do not make a choice within 60 days are placed in one of the superior funds. Allocating people to the best in show funds is also consistent with the Commission's view that a good default model should seek to ensure defaulting employees are placed in the *very best* funds.

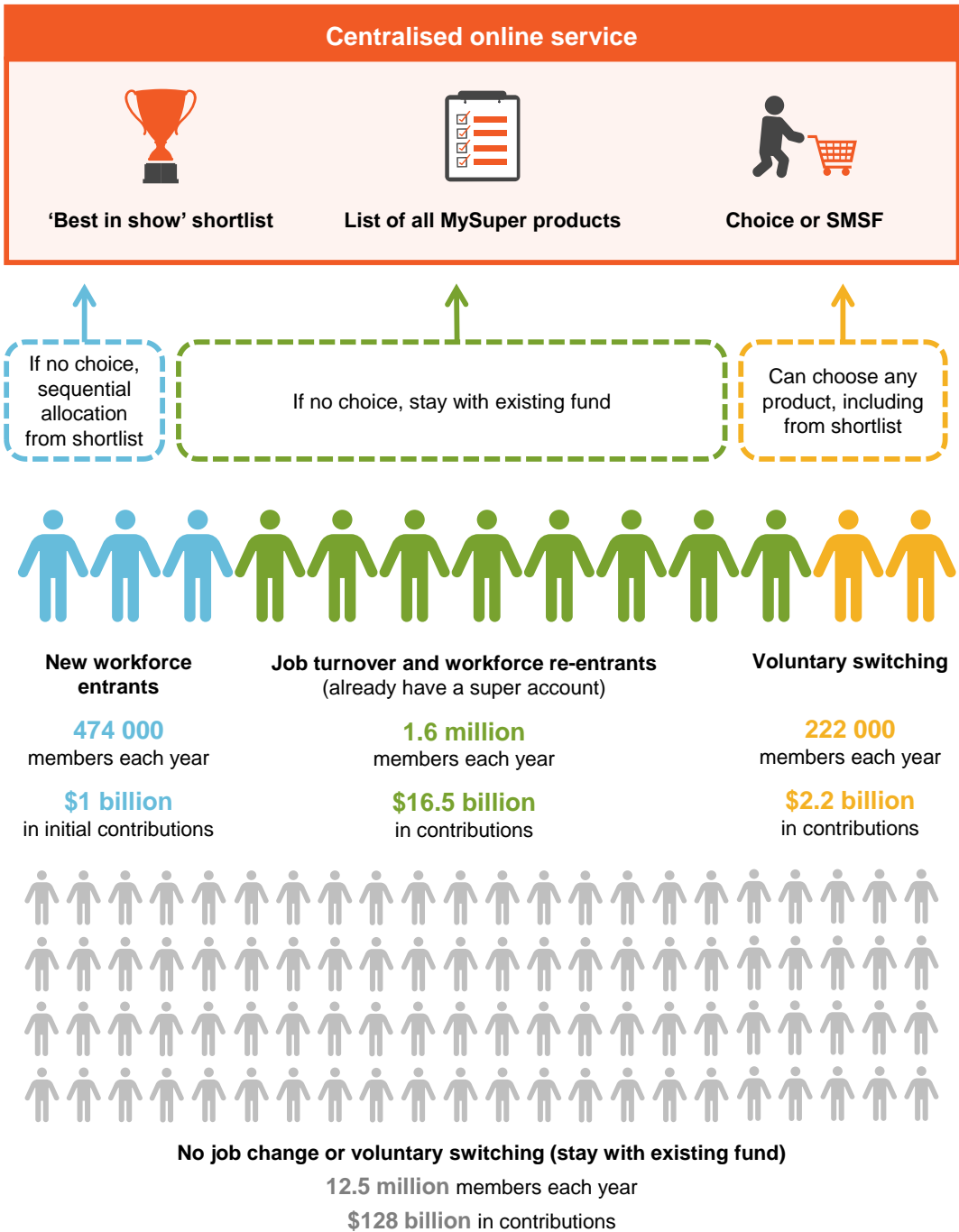
In response to the draft report, IOOF suggested that members, at the time they are to be sequentially allocated, should be informed of the fund they are to be allocated to:

If a member does not make a choice, allocating the member to one of the best in show funds on a sequential basis is appropriate. We would suggest that members are advised (if possible) of the fund they would be 'defaulted' into if no choice is made, however this may not be possible given multiple members may be making this choice at the same time. (sub. DR138, p. 6)

The Commission considers this suggestion represents a desirable addition to the assisted employee choice model. Members should be informed of the fund they are to be allocated, and asked if they wish to choose another fund. In addition to the benefit of keeping members informed, this measure would be beneficial for members who might be indifferent between most of the funds in the top 10, but not indifferent between all of them.

Figure 12.3 summarises the mechanics of assisted employee choice and the dimensions of each group potentially affected by the changes.

Figure 12.3 Summarising how the new allocation model would work^a



^a Indicative estimates of the number of members in each category and only intended to provide an order of magnitude of the effects.

Sources: Commission calculations based on the Commission’s members survey, ABS (*Participation, Job Search and Mobility, Australia, February 2017*) (Cat. no. 6226.0); APRA (2018b); ATO (2017d); ATO (pers. comm., 24 January 2017, 15 February 2017).

Any system instability will be manageable

While the number of new workforce entrants being prompted to choose from the shortlist in any year will be relatively small (about 474 000 with about \$1 billion in annual contributions initially¹⁰⁷), all members of the workforce would benefit from the introduction of the list.

Shortlisted funds would have to offer the same conditions to new and existing members — meaning existing members and new choice members of the fund would benefit from lower fees or fund enhancements induced by the selection process. Existing members would also benefit from the signalling effects of the best in show list, and would be able to utilise the new mechanism upon changing jobs (while still being free to remain in their existing fund).

For funds, the initial size of the first-timer pool potentially understates the significance of being shortlisted (which is important to members because this impacts on the likelihood of funds seeking to be on the shortlist). The pool is initially relatively small in dollar terms because of the relatively low level of average incomes for people first joining the workforce. However, as the incomes of each year's first-timer cohort increased over time, so would their significance for funds. Obtaining these new starters would be more attractive for funds otherwise facing net outflows in the face of an ageing membership base. But more importantly, attaining default status would also be more attractive to funds given the potential for many other members in the system to voluntarily switch to them.

In considering the case for policy change, the Commission has also been cognisant of placing the needs of members first. While this invariably means ensuring members are in the best possible funds, either through their own decisions or shepherding, it is important to avoid short-term instability in the system that would have a deleterious effect on members. Reform that significantly increased member churn could have adverse consequences for system stability. The pool for total MySuper superannuation contributions in 2017 was \$55 billion (APRA 2018a) (with total overall contributions of \$148 billion) (APRA 2018b). The estimated first-timer contributions pool was \$1 billion. Therefore, while there would be a clear equity rationale in ensuring that all existing members were guaranteed the *full* benefits of a new default model from day one, the Commission considers that initially only new workforce entrants should *automatically* utilise the new default allocation mechanism. That said, all members would benefit from 'lopping the tail' — the elevated authorisation implemented by APRA.

The Commission is also cognisant of the recent uptick in switching following media coverage of the Commission's draft report and even more so following the revelations of poor conduct and performance in the hearings of the FSRC, with APRA data showing nearly \$10 billion has flowed into industry funds in the year to September 2018, compared with \$2 billion in the previous year (chapter 5).

¹⁰⁷ These numbers are approximate and should be seen only as providing an order of magnitude regarding the impact of the policy changes considered.

Only new workforce entrants (about 474 000 members accounting for about \$1 billion in annual contributions, in contrast with existing members who start a new job and account for about 1.6 million member accounts and \$16.5 billion in contributions) will be automatically prompted to select a shortlisted fund (although people switching jobs will also be presented with the shortlist presented alongside their existing fund on the online choice form). Sudden large-scale movements in fund balances are not expected, with the exception of funds that lose MySuper authorisation, where APRA would need to ensure an orderly transfer of balances to other funds. Any switching to shortlisted funds by existing members of non-shortlisted funds would be expected to occur gradually and over time. And the *long-term* stability of the system will be *enhanced* with members more likely to be placed in well performing funds.

Modelling by the Commission suggests that even if existing members switched at much higher levels than currently apply (chapter 5), investment returns on remaining balances and continuing contribution inflows from remaining members would support liquidity for the large majority of funds, and therefore not impact or discourage long-term investment strategies.¹⁰⁸ The modelling estimated the potential impact on funds' MySuper member accounts and assets of varying shares of new workforce entrants and existing members (whether at job change or workforce re-entry or unrelated to these events) choosing a shortlisted fund versus alternative MySuper offerings. Details about the modelling approach and assumptions adopted are presented in technical supplement 7.

Regarding the likely impact of the reforms on stability, APRA stated:

APRA expects that the implementation of the Commission's proposed new model of allocating default contributions to a shortlist of funds is likely to have limited immediate impact on any RSE, allowing sufficient time for the RSE licensee to change strategies ... including potentially improving the delivery of member outcomes and competing to regain default status. In particular, APRA has analysed the potential change in an RSEs' net cash flow ratios over a five year period as a result of loss of the estimated share of the 'first-timer pool' of default contributions, and the loss of both the first timer pool and the 'turnover pool' of default contributions. This analysis indicated that the estimated short term impact of the loss of the first timer pool and the turnover pool of default contributions would be limited for most RSEs, suggesting that RSE licensees would have some opportunity to develop and implement strategies to mitigate potential impacts and ensure appropriate outcomes for members of the RSE. (sub. DR204, p. 11)

ISA asked whether the expected increase in member engagement stemming from the introduction of the assisted employee choice had the potential to result in higher costs associated with members moving more frequently between products:

Presumably one measure of this increased engagement would be many more members moving more frequently between funds and products. The costs of this movement will likely take many forms: reduced investment in illiquid assets, increased marketing spend to secure more mobile

¹⁰⁸ The Commission asked APRA to review its approach to modelling the potential impacts of alternative default models and APRA confirmed that the methodology and underlying assumptions were reasonable and consistent with APRA's understanding of the industry. However, the views and conclusions in this report based on the modelling undertaken are solely those of the Productivity Commission.

members, and the higher fees/lower returns associated with many choice products. (sub. DR232, p. 2)

Better member engagement does not simply take the form of higher switching. Importantly, member engagement also takes the form of the member knowing the ‘basics’ of their own superannuation account — such as who their fund is, the order of magnitude of their balance and fees, whether they have insurance or not.

Where the engagement does take the form of a decision to switch, the Commission considers the improvement in member outcomes through switching to better funds is likely to far outweigh any potential transition costs. Greater switching stemming from increased member engagement or information provision (members moving to *better* funds) should not be equated with members ‘churning’ through underperforming or simply *different* funds.

As discussed earlier, future switching rates in any case could be higher than previously expected (a welcome development), due to the recent elevation in member engagement (and ultimately switching) stemming from recent revelations at the FSRC of poor conduct and performance. The Commission’s proposed introduction of an outcomes test for choice products can also be expected to further raise switching rates — by shepherding members to better performing funds. These anticipated higher switching rates elevate the need for a considered transition and implementation strategy (chapter 13) that delivers outcomes that are in members’ best interests whilst managing system stability. Notably, system stability should solely be seen through the *long-term* lens of members being shepherded from poor to better performing funds with those members bearing no further erosion of balances by way of poor transition.

APRA stated:

While APRA does not expect the Commission’s [draft report] recommendations to lead to broader system instability, there would nevertheless be a need for APRA to work with individual RSE licensees to ensure they appropriately addressed strategic issues, including considering whether an orderly wind-up of the impacted RSE may be the most appropriate course of action. (sub. DR204, p. 11)

12.5 Other features of the proposed arrangements

Dealing with corporate funds

Some participants questioned the ongoing viability of corporate funds following the implementation of the best in show list, particularly if they did not feature prominently in the display of the online choice form. For example, Chant West said:

In addition to showing the ‘best in show’ list on the online service, employees could be also be presented with any fund that specialises in their particular industry ... as an option alongside the ‘best in show’ list. Such a specialised fund should be highlighted as such to make it clear that it is not part of the top 10 but has been included because it caters for workers in that particular

industry. ... The ability to include such specialised funds would need to be approved by APRA based on the particular characteristics of the industry. ... This approach would extend to employers that have negotiated tailored arrangements with an industry fund or corporate master trust that provides lower fees and/or tailored insurance that may be salary-based. (sub. DR191, pp. 16–17)

Corporate funds can be beneficial for employees, particularly where employers have been able to negotiate good deals on fees. On the other hand, there are also poorly performing corporate funds — three of the 29 long-term underperforming funds with MySuper products identified in chapter 2 were corporate funds (23 per cent of corporate funds in the sample). While some participants suggested listing corporate funds in a separate category between the best in show list and the list of other funds with MySuper authorisation, the Commission considers such an additional list to be unnecessary (and potentially confusing for members about the status of corporate funds *vis a vis* the best in show list).

Corporate (or ‘non-public offer’) funds for which members are eligible should feature in the second list of other funds with MySuper authorisation, although members should be automatically alerted to their presence on the online choice form (without being required to tick additional boxes). ASIC and the Australian Taxation Office should undertake research to determine the best way to present these funds to employees in a way that works best for the members making a choice.

Although corporate funds can be beneficial while members remain with the employer sponsoring the fund, members shifting to other employers and therefore becoming ineligible for employer sub-plans provided by retail funds will typically face less favourable terms and conditions where they choose to stay in the general division of the same fund (without the benefits negotiated by their former employer). ISA submitted:

A further problem of continuous membership arises in the context of corporate funds. When employed by a corporation a member may be a member of a sub-plan provided by a retail fund with advantageous fee and insurance arrangements for corporate employees. However, when they leave employment by the corporation they will not be entitled to remain in the sub-plan for corporate employees and may be ‘flipped’ into another part of the retail plan that has higher fees and more expensive insurance. Under the AEC model this will be their ‘existing fund’ in the online system, the proposed screen design will likely encourage continuity of membership, and they will remain in that fund until they act. They may engage and decide otherwise. Or they may assume that their prior fee and insurance arrangements, to the extent they are aware of them, will continue. (sub. DR162, pp. 26–27)

ASIC also noted the potential consequences of members being transferred to inferior options:

... if the member leaves the employer and is transferred into a personal plan from an employer plan in the fund the member may find themselves in an expensive superannuation product. Consumer inertia and disengagement as well as the challenges of leaving an employer means that the member may not properly act upon revised terms and conditions disclosed to them about their superannuation. This has the result that the member may remain in the fund for the long term and find their retirement savings compromised. (sub. DR206, p. 5)

The Commission has considered how to deal with the presentation of existing funds on the online choice form for these members changing jobs. Where the terms and conditions applying to fund members will change at the time of a change of employer, it would be important for the online choice form to highlight this, but also in this circumstance for fund trustees to write to members at the time of changing jobs informing them of the looming fee increases or other changes to terms and conditions, and to prompt members to visit the online service to review their fund arrangements.

Dealing with the risk of upselling or inappropriate advice

A number of participants raised concerns that shortlisted funds might encourage their MySuper members to switch to higher-cost, less-suitable choice products. ISA stated:

The Draft Report envisions a system where private sector, for-profit financial institutions can bid for and win pools of default superannuation members. Such an outcome will deliver to the for-profit part of the super system a ready-made, government sanctioned, customer base at a very low acquisition cost. Once this customer base is acquired, these institutions will up-sell and cross-sell other products. (stage 2, sub. DR78, p. 20)

ISA also raised the potential for members to be placed into poor-quality products through other means:

The risk that disengaged and low-information members will be sold, nudged or defaulted into poor quality funds by their bank, their employer or through inappropriate advice is too great. To fulfil the collective social policy purpose of compulsory superannuation, it is appropriate for government to intervene strongly to ensure members are protected from such risks. (sub. DR232, p. 3)

The Commission considers the risks of upselling and inappropriate advice need to be alleviated, particularly in a world where members are more likely to make their own decisions. Further, the Commission agrees with ISA that it is appropriate and essential in a world of compulsion for the Government to intervene to protect members. The Commission's proposal to elevate the outcomes test in both the MySuper and choice segments (through a 'right to remain' test) would significantly reduce both the potential for members to be sold into poor products, and any potential disadvantage to those members that were upsold into choice products. And given recent revelations at the FSRC and enforceable undertakings entered into by two banks for similar behaviour (chapter 9), these issues will be on the radar of regulators for the foreseeable future and that the Commission would expect them to monitor the behaviour of funds closely. In response to the draft report, ASIC agreed measures would need to be taken to deal with the threat of upselling:

ASIC agrees with the PC that care would need to be taken to ensure that trustees with funds in the 'best in show' list do not seek to use the default arrangements inappropriately as a means to distribute more expensive products. (sub. DR206, p. 8)

To assist further in this regard, funds should be required to annually inform ASIC and APRA about the number of cases of intrafund movements from MySuper to choice products. This

information could also be passed on to the expert panel for consideration in future default selection processes. ISA has questioned the effectiveness of this proposed measure:

... policing the accuracy of switching data reported to APRA would be very difficult and time-consuming to undertake. The scope for manipulation and misreporting of figures by sales, counter and advice staff – responding to intense pressure from senior managers, and whose pay is strongly dependent on meeting targets – would be considerable. (sub. DR162, p. 23)

And the Association of Financial Advisers questioned whether such arrangements were required:

We raise the question of the requirement to report annually to ASIC on the number of MySuper members who have chosen to switch to a choice fund. Is this because the Productivity Commission believes that we need to guard against this happening or whether they think that this is a warning trigger? As stated above, we support members having choice and if they choose to move from one investment option to another then that is their choice. We are not convinced that there is any policy benefit in reporting this to APRA on an annual basis. (AFA, sub. DR173, pp. 6–7)

However, the Commission considers such a measure would undoubtedly be justified, particular in view of the FSRC revelations, and would be effective (particularly working in combination with other measures discussed below). The provision of data to regulators should provide a ‘red flag’ in the event of any systematic efforts to upsell, and the requirement should provide a strong disincentive for the promotion of inferior products, or for their take-up. Regarding the possibility of inadequate or misleading data being provided to regulators, regulators would be expected to view such an event seriously and act accordingly.

Further, the Commission has highlighted the need to relabel ‘general advice’ to ensure that the word advice should only be used to encompass advice relating to people’s personal circumstances. Selling of superannuation products should only be undertaken by qualified financial advisers and subject to the requirements of the Future of Financial Advice (FoFA) laws (chapter 9). As discussed earlier in the chapter, the best in show list would provide a point of ‘if not, why not’ comparison for financial advisers and their clients, which the Commission sees as a powerful weapon against upselling and empowering ASIC to supervise and enforce FoFA in superannuation.

To improve transparency to members, where a fund encourages members to move from MySuper to choice products, it should be required to disclose comparative information (costs, fees, net returns, future return targets and risk) to them using product dashboards (chapter 13).

These processes would also be guided by the requirements of the proposed product design and distribution requirements and product intervention powers for ASIC, assuming these pass into law (chapter 10). These include a requirement for offerors of financial products to make a target market determination for most products. These determinations should provide information about the appropriateness of switching people between products. MySuper

products should be subject to the product intervention powers, and APRA and ASIC should work together to ensure there is no conflict in the regulation of poorly performing MySuper products. The elevated MySuper outcomes test, and the product intervention powers, both represent valuable tools for protecting MySuper members.

Restrictions on moving people out of MySuper products, as suggested by some participants, are impractical given many members would deliberately and entirely voluntarily make such a choice and should not be prevented from doing so.

It should also be remembered that, from the introduction of best in show, the governance records of funds would be considered by the expert panel and funds with a track record of encouraging members into products that were unlikely to be in their best interests would have this history considered in deciding whether they were worthy of inclusion on the best in show list.

The concerns raised by ISA about employers defaulting members into poor-quality products are shared by the Commission and, while the elevated outcomes test and best in show list would, of themselves, assist in alleviating these concerns, the only effective measure to deal with this risk is the logical one — to remove employers from the default fund allocation process entirely.

Dealing with unexpectedly poor performance

Where a fund performed below required performance benchmarks (chapter 10), the fund would lose MySuper authorisation and members would move to a different fund. However, some participants also raised the issue of funds that suffered deterioration in their performance over time, without ever performing poorly enough to lose MySuper authorisation. For example, Barr and Diamond stated:

Across the economy generally, many large, successful firms fade over time. If that were to happen to some top-ten MySuper funds, the government would not be taking continuing direct responsibility for people relying on the government to keep them in a good MySuper. (sub. DR154, p. 5)

The Commission acknowledges it would be unrealistic to assume that every fund that was ever placed on the best in show list would continue to outperform rival funds throughout the lifetime of members. However, the elevated standards for MySuper authorisation should mean all funds would be at least within striking range of the best in show funds (or else lose authorisation). The biennial report card and the ten yearly reviews of policy settings would represent suitable opportunities to ensure this outcome. They will also provide a regular reporting mechanism on APRA's enforcement of elevated authorisation requirements.

In the (unlikely) event that a fund lost MySuper authorisation while on the best in show list, APRA would be required to promptly set in train arrangements for an orderly transfer of their default members (and their balances) to other best in show listed funds.

Fund mergers to obtain best in show status likely to be a positive

To obtain (or maintain) a significant presence in the default market, some funds that miss out inclusion on the best in show list could seek to merge with funds that are on the list. Such mergers should be allowed, provided that the same terms and conditions continue to be offered to all MySuper members of the merged shortlisted fund.

Given the desirability of fund mergers (chapter 9), the potential for a best in show list to promote them is both an intended outcome and anticipated to be positive for fund members — particularly in view of the requirement for the selection panel to ensure a competitive dynamic favourable to members. The best in show list also provides a self-correcting mechanism against funds becoming excessively large (that is, exhibiting diseconomies of scale) because funds suffering from such inefficiencies would lose their best in show status (and within four years). There is currently no such mechanism in place and reliance on lopping off the tail alone would only provide such a mechanism once an oversized fund had become so inefficient that it would lose its MySuper status entirely.

In response to the draft report, some participants raised concern that funds that had recently merged could be disadvantaged in the best in show process due to lack of performance history for the merged fund. For example, AIST said:

There is also the issue [for merged funds] of being able to retain historical investment returns for comparability purposes. This is crucial and directly affects a ‘best in show’ comparison where it is likely that one of the criterion will be net returns for say 10 years. Retaining the historical return data of most relevance to members is essential. The risk that no figures at all will be referenced for years prior to a merger must not be entertained. (sub. DR130, p. 56)

The Commission considers it essential that recently merged funds not be disadvantaged as part of the best in show process — particularly in view of the benefits of fund mergers to members. Where a fund has recently merged, the panel should (and would intuitively) consider the past performance of the *higher performing* of the merged funds for best in show purposes (unless this fund is considerably smaller than its merger partner or the panel considered this approach was likely create a perverse outcome), and should consider any potential improvements regarding administrative efficiency, governance and personnel. Given that trustees must focus on the best interests of members when considering fund mergers, a merger that would negatively impact on member outcomes would not be expected to obtain trustee support. It would be anticipated that it would be rare for a voluntary merger to negatively affect fund performance. That said, in the event that a merger had been poorly executed and shown to have reduced member outcomes (or led to a loss of key personnel in the opinion of the panel), it would be necessary and appropriate for the panel to consider this when developing the best in show list.

In the event that a fund had accepted ‘stranded’ members at the encouragement of APRA under circumstances where an underperforming fund had lost its MySuper authorisation or been directed to withdraw an investment option (chapter 10), and this led to lower short-term performance, the expert panel would be expected to recognise that the regulatory

intervention had adversely affected the fund and account for this when considering its performance in future best in show selection rounds.

12.6 Evaluation of the assisted employee choice model

Assisted employee choice represents a modern approach to default superannuation and offers many advantages over the current system, including providing better outcomes for members in the choice segment.

Member benefits would be higher under assisted employee choice than current arrangements. Based on the Commission’s choice experiment, most new workforce entrants would choose from the shortlist. And those who did not make a choice would be defaulted to a best in show fund. This highlights a key strength of the model: new members are encouraged to make good choices, but are protected whether they make a choice or not. As submitted by ISA, for many members, disengagement is rational. Poor decision making cannot be solved by simply nudging people into making choices and offering them more dashboards’ (sub. DR232, p. 3). The model encourages decision making from a best in show list of the highest quality funds — but it also seeks to ensure those members unwilling or unable to make a choice have a greater level of protection than is currently available by defaulting them to one of the highest quality funds. Some existing default and choice members would switch to best in show funds due to the best in show list’s signalling effect. The best in show list also acts as an ‘if not, why not’ guide for financial advisers and their clients, meaning choice members (as well as default members) would be more likely to be guided to superior products.

Further, existing members of shortlisted funds would benefit from any improvement in the product offering as funds on the shortlist would need to offer the same conditions to new and existing members (meaning existing members would benefit from lower fees or fund enhancements induced by the selection process). Elevated MySuper authorisation would eliminate poor performers, and funds that were not shortlisted (including those in the choice segment) would have an incentive to lift their performance to retain members. In addition, by removing the link between employers and default fund selection, the model would reduce account proliferation and its associated costs to members (chapter 6).

Competition would be stronger. Competition to make the best in show list (which would be expected to provide a significant competitive advantage) would be particularly robust. In addition, the ‘loss’ of new workforce entrants from non-shortlisted funds to shortlisted funds, and the potential for existing members to be attracted to shortlisted funds, would create a stronger incentive for other funds to work to retain existing members. By encouraging employees to interact with their superannuation and make an active choice, it could potentially drive member engagement and encourage some competition *in* the market. In summary, there would be more vigorous competition both *for* the market and *in* the market.

The assisted employee choice model performs well from an **integrity** perspective by removing employer decision making on behalf of employees. However, there would be

potential for greater marketing and advertising to promote brand recognition that was not in the interests of employees — although given the best in show process would require the production of readily comparable performance information through product dashboards, this would encourage advertising *more* focused on fund performance and the needs of members. The risk of upselling would need to be mitigated (and can be, as discussed above). The expert panel’s role in choosing the shortlist creates a risk stemming from third-party involvement that would need to be mitigated through the panel selection and accountability process (see below), although overall this process should unambiguously *enhance* the integrity of decisions about default funds.

As discussed above, the assisted employee choice model (especially with considered transition under the proposed implementation program) (chapter 13) is not expected to pose short-term system **stability** risks.

Costs associated with the operation of this model would be low for employers relative to current arrangements, as employers would not have a role in default selection. Costs for new entrants who choose a fund from the shortlist or who do not exercise choice would be similar to those under the current model, while costs for those choosing from a broader product range would likely be lower than those incurred by members currently, given the provision of additional straightforward information.

There would be costs to Government in administering the shortlist, MySuper authorisation and online choice, costs in the ongoing monitoring of fund behaviour, (presumably small) costs of setting up a sequential allocation mechanism for members not making a choice, and the costs of information provision. Funds would also incur costs associated with these processes, and might engage in higher levels of marketing activity. However, the costs to Government and funds would not be expected to be significantly different from those currently incurred — or that would be incurred as a result of adopting the system improvements recommended elsewhere in this report, regardless of default changes.

FINDING 12.2

Current default arrangements do not promote member engagement. Survey evidence reveals that when members are provided with a simple and accessible list of superannuation funds, only a small minority would not choose their own fund. This evidence aligns with the lessons of behavioural economics.

12.7 How best to establish the expert panel

Ensuring an objective and accountable shortlisting process for the best in show funds is critical to ensuring the anticipated better member outcomes. Feedback highlighted differing participant views about the difficulties associated with finding a suitable selection panel (box 12.5). A number of participants have suggested finding suitable candidates for the

expert panel that are free of conflicts will be difficult, particularly in view of the polarised and highly partisan nature of the superannuation industry. However, other participants consider these concerns are significantly overstated. Based on our three years of endeavour, consultation and analysis on the super system, we are confident there are many suitable, expert candidates that are free of conflict and well placed to assess and determine relatively superior funds for listing.

Box 12.5 Participants' views on an expert panel

Some participants highlighted perceived difficulties in appointing an objective panel. For example, the ACTU observed:

It is ... true to say we live in a partisan political world where many senior political figures have avowed prejudices against one sector or another. ... In such an environment, how could any objective observer believe that the selection process — its terms of reference and its appointees — won't be corrupted. (stage 2, sub. DR71, p. 6)

Anthony Asher noted the likely political pressures on the panel:

It will be very difficult to construct a truly independent panel. The industry is already highly politicised and the panel will inevitably be subject to political pressure, exacerbated by the rent seeking that will arise from the huge economic benefits of making the list. (sub. DR151, p. 6)

ASFA foreshadowed difficulties in finding suitable panel members free of conflicts:

... if it was to be implemented, ASFA considers that the selection panel for the 'Top 10' should comprise individuals with considerable expertise in superannuation (and the investment industry), and be independent of government. ASFA considers that both would be required for the public to have confidence that the decisions of the panel were in the best long-term interests of consumers. That said, ASFA considers it may prove difficult to find individuals who have the required depth of skill, and are free from conflicts of interest. (sub. DR148, p. 18)

The FSC expressed similar concerns:

We remain concerned that it would be difficult to appoint a panel of individuals who have sufficient knowledge and expertise to undertake the role without having a (real or perceived) conflict. Conflict is partly about perception. The often-politicised nature of the superannuation industry means that someone who has worked for a superannuation fund in any capacity, even retired, is likely to be seen to be conflicted. The same will be true for anyone who has advised a fund, worked for an industry association or even advised an association. (sub. DR199, pp. 11–12)

Others were more confident about the capacity to find suitable panel members. For example, Sunsuper stated:

A robust and transparent process is needed to protect the integrity of the panel appointment. There is considerable depth and breadth of expertise within the market that could be drawn upon. There are experienced researchers from key independent research houses currently operating within the industry that could bring a varied range of views, methodology and expertise in the assessment of quality. (sub. DR197, p. 28)

While REST Industry Super said:

If a shortlist is adopted, Rest supports in principle the appointment of an expert panel, noting the need for industry consultation on both the criteria for selecting the panel members, and the selection criteria the panel will apply in shortlisting funds. Rest believes panel members should be nominated by and drawn from the industry and Government, and have technical expertise in the core offerings of investments, insurance, engagement and advice. (sub. DR171, p. 14)

Is an existing body suitable?

The Commission identified five defining characteristics of the best in show expert panel (in the stage 2 draft report). The expert panel must:

- have a strong focus on member interests
- have sufficient expertise to evaluate funds and products
- be independent and free of real or perceived conflicts of interest
- have processes that are transparent and afford procedural fairness
- be accountable to government (as a proxy for members) for its decisions.

Principles go only so far. Institutional arrangements are needed to allow panel members to function effectively in their role. One essential component would be fixed appointment terms for any panel member, as this would ensure ongoing expertise as the frontier of finance shifts, avoid groupthink and provide a failsafe in the event of declining performance by any member. Another central issue is the *type* of body that houses the panel, because regardless of the attributes of the panel, the ethos, capabilities and public perceptions of the supporting body will inevitably affect the capacity of the panel to undertake its functions. There are two obvious candidates by virtue of their current roles in the system — APRA and the FWC — the first because it authorises MySuper products and the second because it has a role in determining the funds specified in industrial awards.

APRA should be ruled out — particularly in the context of a highly competitive process — given its primary regulatory roles for superannuation (of licensing, authorisation and supervision) (chapter 10). It is important APRA not be seen to be ‘backing’ funds or products that represent a subset of those it regulates.

The FWC has some strengths because it is an independent body, provides protected tenure to its members, has fixed appointment terms, and already undertakes its functions through a self-described ‘panel system’. Under that system, its various specialist panels make independent decisions across various domains (such as, in addition to the dormant expert panel for selection of default superannuation funds, the anti-bullying panel and the expert panel for annual wage reviews). As noted by the relevant Federal Court judges in the FSC’s challenge to the expert panel process,¹⁰⁹ the ‘expert’ panel was more a name than an actuality, with no requirement that all members have the requisite expertise. Further, although the FWC expert panels have the power to undertake or commission their own research, the process publicly described by the FWC for the initial default listing round provided no indication that the FWC expert panel would do this beyond an assessment of submissions by would-be funds.

A precipitating factor behind the dormancy of the panel was the disqualification of two ‘conflicted’ panel members, and the subsequent legal difficulties that arose from various

¹⁰⁹ *Financial Services Council Ltd v Industry Super Australia Pty Limited* [2014], FCAFC 92.

directions given by the FWC president. The FWC suffers too from its key function as the industrial umpire with the centrality this gives to law, conflict resolution, and the tendency for partisan appointments that, over the political cycle, balance employer and employee interests. ISA did not see the nature of this process as leading to politicisation:

... appointments are required to be based on merit and experience, rather than political favour. The fact that ... appointing governments have sought to balance appointments with a union background and appointments with a business background does not undermine the conclusion that the appointment process has ... not generally been politicised. (sub. DR231, p. 13)

However, the recent history of superannuation in the FWC provides two lessons — ‘experts’ must be genuine experts in the relevant subject matter and they must not be conflicted or open to lobbying, underlining the importance of a rigorous panel member selection process.

Moreover, submissions to this inquiry highlighted the polarised views about the FWC’s suitability (box 12.6), whereas widespread acceptance by the industry and community of the legitimacy of the body housing the panel would be desirable. Such acceptance is problematic when the FWC process has become mired in controversy.

In sum, as *currently structured*, the FWC is not a technocratic decision-making body in ethos, governance or appointment processes, though that is precisely what is required for a member-focused panel with widespread public credibility.

It is possible that some of the present deficiencies in the FWC could be addressed were an expert panel to be an *entirely independent* entity within the FWC, be the final decision makers ceding no role to any other FWC members, and with all appointees being retained on a fixed term basis and with a requirement for demonstrated expertise. The FWC would effectively represent a convenient umbrella organisation. That said the Commission acknowledges that achieving such independence within the FWC will more likely than not prove institutionally elusive.

The Commission does not, even with intra-institutional independence, consider the FWC to be ideally suited to the role. The default selection process would give no weight to its core areas of expertise — in workplace relations and industrial precedent. Putting its historical involvement in default fund selection to one side, it is far from clear it would otherwise be the most obvious or suitable body for such a task.

Ultimately, the Commission views the best in show panel’s role as both new and distinctive and thus no existing institution is highly suitable to assume the role of the expert panel to select the best in show funds.

Putting aside the organisational location of the panel, managing the risks associated with lobbying by vested interests would need to be addressed through the regulations and legislation surrounding the selection of the panel members and the principles they are legally required to follow.

Box 12.6 Views on the suitability of the Fair Work Commission fell on largely partisan lines

For example, Cbus Super said:

FWC has the necessary skills, experience, independence and transparency, as well as the existing architecture, to apply a quality filter to support the selection of default funds. The appropriate judicial and legislative framework is already in place and the expert panel at the FWC could be reconstituted to short list the best performing super funds. (sub. DR177, p. 7)

While the ACTU stated:

The national workplace relations tribunal is the only place to deal with issues about what is in workers' best interests. It does this beyond the traditional notions of pay and conditions, including dealing with issues such as flexible working arrangements to support caring, parenting and victims of domestic violence. Given the success of the Fair Work Commission in distributing defaults, any gaps which are found in its processes or gaps in the universality should be filled through improving the system — rather than throwing it out and starting again. This Commission's distaste for the Fair Work Commission is baseless ... (sub. DR185, p. 5)

And the FSC saw the FWC process as giving too much power to trade unions:

The FSC is concerned, however, that the FWC process and enterprise agreement model discourages consumer engagement by delegating decision-making responsibility to trade unions. This is particularly a concern considering only 15% of all employees are members of a trade union, resulting in unions making decisions on behalf of consumers who are not their members, and with no legal obligation to act in the interest of those consumers. (stage 2, sub. 38, p. 21)

Some participants saw the FWC as representing a protective mechanism against the lobbying influence of the finance industry. For example, ISA stated:

... a panel member with a long prior career in retail finance may regard upselling and cross-selling by funds to be an inevitable and desirable feature of 'good business' and delivering for shareholders. ... The existing Expert Panel system within FWC guards against domination by any particular set of perspectives and interests. (sub. DR162, pp. 31-32)

Chant West questioned whether the FWC was the best body for the task:

Indeed the criteria for choosing defaults through awards and EBAs have not generally been merit-based. The changes to this process that were legislated but not implemented would have addressed this problem to some extent, but it is still unclear why the Fair Work Commission, a body that is expert in industrial relations matters, is considered best equipped to make these assessments. Further, the importance of industrial parties in this process advocating for particular funds on behalf of their members is problematic, as these parties are also often sponsors of particular funds. (sub. DR191, p. 9)

Importance of best-practice panel appointment

Best-practice appointment procedures should seek the appointment of the most suitable candidates to the expert panel and provide the public with confidence in the default fund selection process.

It is important that the selection of the expert panel determining the best in show list be apolitical, with both regard to national politics and the political dynamic of the superannuation industry, and that it be seen as such. In public hearings, the Commission posited a concept of the selection committee recommending appointments being comprised

of individuals holding institutional positions of such an independent and non-partisan nature that they would be deemed as beyond reproach.

Therefore, heads of government agencies that are noted for their independence, judgment and intellect should comprise the selection committee, together with a representative of consumers. For example, the process could be overseen by the Governor of the Reserve Bank of Australia (as committee Chair), with the Chair of the Australian Competition and Consumer Commission and the Parliamentary Budget Officer. The consumer representative could be decided by the selection committee Chair.

Some participants supported this approach. For example, BTFG said:

We agree with the recommendation that the panel should be comprised of independent experts who are appointed through a robust selection process and be held accountable to the Government. There is a range of examples where independent panels of experts can be convened to make commercial decisions where there are robust processes in place to ensure that conflicts of interest are disclosed or effectively managed, such as the Foreign Investment Review Board, Takeovers Panel and the Board of Guardians of the Future Fund. (sub. DR149, pp. 4–5)

PwC stated:

I think that would be a really good model because it has to get taken out of the political system. I think that would be really good. I think what [you said and] we also had promoted was using the Australian Government Actuary to provide the technical support to that group is also a good idea. ... that would be a good system because ... it's only one appointment they are making, it's only every four years [and] there's lots more other things they are dealing with [that are] much more political than that ... you would expect that they would take a fairly rational view. (trans. pp. 174–75)

In addition, selection for an expert panel should follow a fully transparent process reflecting contemporary best practice. This would include:

- public advertising of panel positions
- candidate interviews to prepare a candidate list
- appointment for a fixed term.

To further ensure independence, the expert panel appointment procedures could follow those used to appoint the Parliamentary Budget Officer. The Parliamentary Budget Officer is appointed for four years by the presiding officers of the parliament (that is, the Speaker of the House of Representatives and the President of the Senate), with the approval of the Joint Committee of Public Accounts and Audit required prior to the appointment.

Once appointed, the expert panel would meet periodically after the initial selection period to ensure panel members were aware of ongoing industry trends. Every four years, a new selection panel would be appointed. In the draft report, the Commission suggested that, to encourage the panel to approach each selection process with an open mind, no more than one third of the panel should ever carry over from one selection period to the next, and this

should be a legislated constraint. The Commission received mixed feedback on this proposal. For example, Geoff Warren said:

The aim should be to strike the right balance between the need for renewal, and retention of knowledge. Short and strictly limited tenures can also chip away at the incentive to take a longer-term view, which would be encouraged if the potential exists to be associated with decisions for some time to come. The PC has suggested ‘no more than one-third’ of the panel carry-over. This contains a hint of over-emphasising renewal. A better approach may be to structure the panel so that (say) 50% of the panel stays for a second term, but with a two-term limit. (sub. DR118, p. 4)

First State Super also expressed doubt about reconstituting the panel every four years:

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. (sub. DR165, p. 14)

The Commission agrees the proposed arrangements in the draft report probably, as Geoff Warren (sub. DR118) put it, overemphasised renewal. An arrangement by which 50 per cent of the panel, assuming they had the support of the selection panel for ongoing appointment, could be reappointed would strike a good balance between the need for long-term thinking and knowledge, and the need for renewal and avoidance of capture.

As its decisions about listing could provide significant commercial advantages to funds on the shortlist, the panel should be established as a statutory decision-making body. Conflicts of interest (or perception of that) would all need to be publicly disclosed prior to decision making. Decisions about inclusion on the shortlist should be made public. The Minister should not have powers to change the decision of the expert panel once it is made.

Decisions of the panel would be subject to judicial review (available under general administrative law provisions), but not merits review (to avoid the process being undermined by continuous litigation). Members of the panel would have a Commonwealth indemnity against litigation by aggrieved parties.

It would be important to ensure the panel had a highly skilled Secretariat to assist them in their task. Given the irregular nature of the assessment task, this Secretariat would not be standalone in nature. The Commission considers the Australian Government Actuary (AGA) could be well placed to fulfil this role given its expertise and independence. The AGA is located within Treasury with a high degree of independence and provides actuarial and related policy advice to the Australian Government and its departments and agencies. It typically advises government agencies on a Memorandum of Understanding basis (independent of Treasury) with funding for individual assignments provided by the commissioning agency. Its secretariat role working for the expert panel should be specified in the legislation establishing the panel, and the AGA should be given an explicit budget by the Australian Government to ensure it is adequately resourced for the task (including

commissioning any expert consulting support). The AGA would be likely to draw on input and support from consultants.

Geoff Warren highlighted the need for the panel to have its own research capability:

Basing decisions on ‘pitches’ from a ‘beauty parade’ of funds may lead to poor outcomes. Rather, identifying appropriate funds for the list should be seen as a process requiring a research capability. The panel needs to be able to extract the information it needs, and follow lines of inquiry. Research should ideally be performed by the secretariat with oversight and involvement by panel members, but might be outsourced in part to independent research houses. (sub. DR118, p. 4)

The independent panel should also have not just the capacity to undertake research, which the FWC expert panel has under current legislated arrangements, as noted by ISA (sub. DR162, pp. 29–30), but should actually do so. Active research is an imperative given the changing nature of financial services and the complexity in determining the best funds when there are multiple dimensions to performance.

In between selection rounds, the panel Secretariat would continue to undertake research into fund performance, the superannuation industry and policy developments. The panel would also be able to commission other research as it saw fit. This research would inform the expert panel’s meetings. The Commission also anticipates that APRA and ASIC would also appear at these meetings to provide industry updates from a regulator’s perspective.

12.8 Some propose a government monopoly provider

Barr and Diamond (sub. 74) recommended that all default contributions should be allocated to a government-owned entity that could then take advantage of the economies of scale stemming from its status as a monopoly default provider. Other advantages Barr and Diamond highlighted included:

- avoidance of diverse returns within the system (viewed as unfair, and generating dissatisfaction and political hostility)
- a simpler picture for employees of the consequences (negative or positive) of not actively choosing a fund
- avoidance of account proliferation and regular moving of assets between different funds when employees switch jobs.

A similar idea has been suggested by the Chairman of the Future Fund (and former Commonwealth Treasurer) Peter Costello (Costello 2017).

The Commission is not supportive of all default contributions being allocated to a government-owned fund. Similar considerations to those identified by Barr and Diamond have been factored into the Commission’s assisted employee choice model, and into other recommended policy changes in the report (including the use of an online standard choice

form (chapter 6)). The assisted employee choice model would make fund choice straightforward — and protect members who did not choose — while promoting the creation of relatively generic products and dealing with account proliferation and the potential movement of assets with job change.

If allocated all default contributions, a government monopoly fund would fail to harness the benefits of competition for better member outcomes (as identified by the Financial System Inquiry (Murray et al. 2014), and implied in the terms of reference for this inquiry).

Moreover, there are material risks associated with government ownership of pension schemes, which the assisted employee choice model largely side-steps. The OECD has previously highlighted the many conflicts at the heart of the governance of government-owned pension schemes.

These funds are exposed to particular risks related to the multiple roles played by the state in the regulatory, supervisory and operational fields. The state is, at the same time, sponsor, regulator, supervisor, service provider, fiduciary agent and recipient of pension fund investments. Specific government-related agency problems can arise with respect to these funds which differ from those frequently analysed in the private sector. (Pinheiro 2004, p. 1)

The biggest risk associated with a government-owned monopoly default fund in the Commission's view is political (and associated fiscal) risk. In the event of poor performance by a government-owned defined contribution fund there could be significant political pressure to 'top up' returns. The risks associated with losses or poor performance could potentially be shifted from members to taxpayers creating an implied guarantee, even if only perceived. This political risk could also manifest via a more conservative investment strategy (in order to avoid negative returns), ultimately harming members by locking them into lower investment returns.

Impediments for non-incumbent funds in the best in show process

In the draft report, the Commission sought feedback on whether there were any material impediments to high-performing non-incumbent funds participating in a 'best in show' selection process, including foreign funds or a government-owned fund. Responding participants broadly agreed there should be no impediments to such funds participating, provided it was on the same terms as other funds. For example, the Association of Financial Advisers said:

As long as there are rigorous and defined selection guidelines then we do not believe that there is any reason to reject an application from a foreign fund or a government fund. They would need to demonstrate that they have the capacity to meet the requirements, and this includes knowledge and capability to operate within the Australian legislative regime. (sub. DR173, p. 5)

Sunsuper stated:

Conceptually, we believe that both government owned and foreign funds should be able to participate in the best in show selection process, provided the assessment is on the same basis as any other fund. (sub. DR197, p. 23)

The FSC questioned whether a new government-owned fund could provide a useful role in the superannuation market:

It is unclear why it would or should be necessary to have a government sponsored body competing in a private sector market. ... If existing businesses are not operating efficiently in a particular market, then the addition of a government-sponsored competitor will not have a clear impact on this efficiency and could be detrimental. In many other markets, privatisation of government-owned businesses combined with increased competition ... resulted in industries becoming more efficient. ... In almost all situations, the government has privatised businesses operating in markets with private sector participants, even when the markets are quite concentrated. ... This proposal would run counter to this trend. (sub. DR186, p. 29)

The Commission is of the view that all funds (subject to meeting more rigorous authorisation provisions) should be free to participate — on equal terms — in the best in show process regardless of ownership or sponsor. To ensure arrangements enable the inclusion of new entrants, the panel should consider past performance in similar investment products or offshore markets for new entrants (as they relate to all the criteria).

While government-owned funds (whether existing or new) should be free to compete to make the best in show list, there is no reason to anticipate this would tap a unique and elevated competitive dynamic. Indeed, government-owned funds would be expected to behave in a similar manner to other funds and there is no inherent reason to consider their performance would be superior. Participation of government-owned funds in the best in show process would, however, potentially raise competitive neutrality concerns, and concerns about the potential risk to current and future taxpayers in the event of poor performance (which might encourage them to adopt a more conservative investment strategy that might be sub-optimal for members).

13 Modernising the super system to work better for all members

Key points

- The super system is increasingly central to funding Australians' retirements, but its performance has been mixed. Current arrangements only chip away at entrenched problems. The package of improvements set out in this inquiry will simplify choice, boost investment performance, better match products to members' needs and strengthen governance.
- Government needs to ensure default is the exemplar — for all members.
 - Members should only be defaulted once, to stop creating unintended multiple accounts.
 - Members should be empowered to choose from a simple list of 'best in show' products — and to switch products only when *they* choose to. This list should be short (to work for members) and set via a competitive and independent process (to drive the best outcomes).
 - The benefits will be immediate for all members. A best in show process would simplify choice for members, stimulate healthier competition (including by presenting role models for other funds), accelerate industry consolidation and provide a discernible point of reference for members, financial advisers and regulators.
- All products (MySuper and choice) should be subject to an elevated outcomes test that makes them earn the 'right to remain' in the system. Trustees should have 12 months to improve or withdraw underperforming products. This will make choice safer for all members.
- It should be easier for members and advisers to evaluate and compare products in the market, via simple product dashboards that are easy to compare with best in show products.
- Members need more assistance to find the retirement products that suit them best. They should not be nudged into risk-pooled products. They need access to impartial, quality advice.
- Super funds and government need to do more to ensure that members get value from insurance in super. The recent voluntary code of practice needs to be strengthened, universally adopted by funds and made enforceable (with concerted regulator direction).
- Governance standards should be raised, including more robust appointment of skilled and experienced board members, better management of unavoidable conflicts, stronger vetting and disclosure of related-party arrangements, and by removing impediments to fund mergers.
- Regulators need more clearly defined roles, stronger powers and firmer expectations to strategically regulate misconduct. The Government (on behalf of members) should enact existing but arguably dormant accountability processes to hold regulators to account. It should also fund an independent member research and advocacy body and insist on more comprehensive, member-relevant data collection and analysis.
- A staged implementation of these recommendations is needed to 'clean up' underperforming funds and products, and to put new systems in place to empower simpler, safer member choice. This should take no longer than three years from the passage of legislation.

The workforce is evolving. Australians are increasingly moving between industries and occupations, women are participating in the labour force in greater numbers than ever before, and the number of people holding multiple jobs has been rising (chapter 1). The gig economy and technologies such as automation are changing industry and occupational boundaries. Incomes will be higher for many workers — meaning that they will be contributing more to their superannuation — but, for some, those incomes will be potentially more volatile.

Retirement is evolving too. The average retirement age is on the rise, and future cohorts of retirees will be wealthier than those of today. By the time the super system reaches maturity in the 2040s, most Australians reaching retirement will have contributed a substantial portion of their income to super for their entire working lives. Many will also continue to work — and contribute to super — past the age at which they could access their super or the Age Pension. How well the system caters to their financial needs in retirement will be the ultimate test of its efficiency and competitiveness — and will have consequences for wealth inequality, given the growing role of superannuation in intergenerational wealth.

Yet the super system remains stuck in the past. It is a creature of a workplace relations system that provides a new super account to workers whenever they change jobs or industries (unless they actively choose otherwise — and most do not). In most respects, it is opaque, with members finding it difficult to understand how their super fund stacks up against others. Evidence has been accumulating that parts of the system are ridden with conflicts of interest, unpunished misconduct and a disconcerting lack of focus on members' best interests. And the investment performance of the system has been mixed.

It is time to modernise the super system to make it work better for *all* members, especially those who are not well served by it. This chapter sets out a package of recommendations to do this (figure 13.1). Defaults are at the centre because, in a compulsory system, the Government has a duty to protect members from ending up with poor outcomes. Government also has a duty to help people make good decisions about their super, and to get the policy and legislative settings right so that the super system works for members first, not for the interests of funds and their suppliers.

13.1 Healthier competition in the default segment

Default arrangements are a necessity in a compulsory super system. They act to protect members who do not or cannot make their own investment decisions. Government's duty to protect members is of heightened importance in a defined contribution system where most financial risks lie with the individual in relation to investment performance, fees and ultimately their benefit in retirement (though financial risks also lie with the Government itself via Age Pension liabilities and the concessional taxation of super).

In practice, default super has led to good outcomes for many members (chapter 12). But not all members have been looked after, with many being defaulted into underperforming products or accumulating unintended multiple accounts.

Figure 13.1 How will a modern super system work for me?



The Commission is thus recommending a new mechanism for allocating default members to products. It is designed in a way that will make funds compete *for* the default market (on what members value), and to deliver the best outcomes for members. It will also empower members to be more involved in their super by making it safer and simpler for them to make choices. This will drive better outcomes across the super system by making default the exemplar that other funds, including in the choice and self-managed superannuation fund (SMSF) segments, are driven to follow. It all begins with bringing a welcome injection of healthy competition into the default segment.

Remove employers from selecting defaults

One of the biggest failings of the current default allocation mechanism is the proliferation of accounts and insurance policies that it generates (chapter 6). This is a product of listing different sets of default funds in different awards, which itself is an outcome of embedding default super in the workplace relations system and attaching the member's account to the job, not the member. The current default mechanism has also helped to sustain many low-scale industry-based funds (with higher costs that ultimately erode member balances) and posed barriers to new funds entering the default market (chapter 7). And the current set-up has egregiously permitted enterprise and workplace agreements to restrict an estimated 1 million individuals from exercising their own choice of fund.

The current system also fails to mitigate the risk of defaulting a member into a poor performing product (chapters 2 and 12). In a modern super system, members should not be at the mercy of their employer to choose a default product. While some employers are capable and well-intentioned when it comes to choosing a default, many struggle or do not have sufficient incentive to find the best product for their employees. It is an historical oddity that employers can select financial products for their workers without needing to hold an Australian Financial Services Licence or indeed any financial advice qualifications at all.

To better serve the needs of members, they should not be defaulted into a new super fund whenever they change jobs or industries. Existing members should automatically remain with their current (most recently active) account when they change jobs, rather than being defaulted into their new employer's fund — unless the member makes their own active choice. Only members who do not already have an existing account and do not exercise choice themselves (mainly new workforce entrants) should be defaulted.

In other words, once members are in the super system, they — not someone else — should choose when they switch funds or open a new account. This 'default once' proposition is an overdue circuit breaker to the multiple-accounts problem that was recommended by the Financial System Inquiry (Murray et al. 2014), but has not been taken up. It is also superior to a model of 'auto-rollover' — proposed by some inquiry participants — where members see their balances moved between different funds as they change jobs. This auto-rollover model appears to suit funds more than members, would further exacerbate disengagement and would saddle members and their employers with unnecessary transaction costs (chapter 6).

Default once will be an architectural change from the arrangements in place today. Moving to this model will require stronger protections for members when they exercise choice — inadvertently choosing a poor performing product cannot be an option (section 13.2 sets out new safeguards). Default once will also require systems to facilitate the flow of information when members change jobs. The process should draw on the online 'standard choice' form being developed by the Australian Taxation Office (ATO) for use by new job starters in choosing where their super contributions will go — which should be backed by universal participation by employers and employees. As explained below, employees who are new to

the workforce would use this centralised online service to choose a super product for themselves. It will also make it easy for all members to switch funds and consolidate multiple accounts. The ATO should configure the service in a way that gives a clear nudge to support and encourage member engagement.

RECOMMENDATION 1 DEFAULT ONCE: ONLY DEFAULT MEMBERS WITHOUT AN ACCOUNT

Default superannuation accounts should only be created for members who are new to the workforce or do not already have a superannuation account (and who do not nominate a fund of their own).

To facilitate this, the Australian Government and the ATO should continue work towards establishing a centralised online service for members, employers and the Government that builds on the existing functionality of myGov and Single Touch Payroll. The service should:

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

There should be universal participation in this process by employees and employers. It should be fully in place by no later than the end of December 2021.

Introduce a ‘best in show’ shortlist

Members should be both supported and empowered to choose their own super product when they first enter the super system or choose to engage with it — without having to rely on their employer to choose a product for them. To assist them, and reduce the risk of poor choices, a shortlist of ‘best in show’ products should be developed using a competitive process. This shortlist is designed to ‘nudge’ members towards good products while still allowing them to choose something different. It would offer members much greater opportunity to engage with and make decisions about their super — and thus increase member engagement — without members being overloaded with choices or information that is too difficult to navigate (chapter 12).

The design of this model is inspired and informed by evidence from behavioural economics on how people actually behave, not how they ‘should’ behave. This evidence suggests that the shortlist should be short — with no more than 10 products — and be accompanied by simple and comparable metrics on each product’s features in a way that competes for and captures members’ attention. A substantial body of work by several international pension experts also supports a simple choice environment, where members who do not choose end up in good defaults, and those who do exercise choice are able to do so simply and safely.

The shortlist should be incorporated into the centralised online service so that all members can use the shortlist whenever they want (but none will be compelled to). Members should also be able to easily choose from the larger set of MySuper products via the online service, subject to there being a much higher standard (an elevated outcomes test) applied to all MySuper products to better protect members (section 13.2). Information should be provided through the online service to allow members to easily compare the features and performance of the available MySuper products (section 13.3). This would mean more flexibility for members wanting to be more engaged in their choice of product, but with much lower risk of making a bad choice. Members would still be able to choose to have their super paid into a choice product or SMSF.

The shortlist would also support a default mechanism for new workforce entrants and other members who do not already have a super account. These members would be assisted, but not forced, to choose. Any such member who did not make a choice within 60 days — and the Commission’s survey evidence suggests this would likely be fewer than 5 per cent of people under the proposed arrangements — would be sequentially allocated to a fund from the best in show shortlist, and thus become a member of that fund. This would eliminate the risk that completely disengaged members are defaulted into a poorly performing product. It also means that relying on member decision making can be safe, even for new workforce entrants.

RECOMMENDATION 2 A ‘BEST IN SHOW’ SHORTLIST

A single ‘best in show’ shortlist of up to 10 superannuation products should be presented to all members who are new to the workforce (or do not have a superannuation account), from which they can choose a product. Clear and comparable information on the key features of each shortlisted product should also be presented. The shortlist should also be easily accessible to all members at any time, including when starting a new job.

Members should not be prevented from choosing any other fund (including an SMSF). Terms in enterprise and workplace agreements that restrict member choice should be invalidated.

Any member who does not have an existing account and who fails to make a choice of fund within 60 days should be defaulted to one of the products on the shortlist, selected via sequential allocation.

The ATO should embed the shortlist and accompanying information into the centralised online service.

The first ‘best in show’ shortlist should be in place by no later than the end of June 2021.

Importantly, there should only be one shortlist across the entire workforce — not a separate list of default funds for each industry, as under the current modern award structure. In the modern workforce, the majority of members are unlikely to spend their entire working lives in a single occupation or industry sector — and continual moving in and out of various funds would be undesirable. Indeed, the Commission has not been presented with any compelling evidence as to why a small set of high-performing funds would not be able to cater to the

needs of all default members in the super system, including their insurance needs (chapter 12).

Members should still be able to join any applicable corporate plan or job-specific product through the online service (and be alerted to the availability of these tailored offerings), but this should require active consent by the member. Such products should not form part of the best in show shortlist or serve as a default for members who make no choice at all.

How will products be shortlisted?

A competitive process is essential to compile the shortlist. Funds seeking to have their products shortlisted would need to vigorously compete *for* the default market by applying to an independent expert panel (which is accountable to government). This panel would evaluate applications based on clear criteria focused on the fund's likelihood of delivering the best outcomes for members over the long term, with a high weight placed on investment strategy and performance. Box 13.1 sets out the types of criteria the expert panel would need to consider, as well as the principles that should guide it. While the panel would have discretion over the precise selection criteria, the guiding principles should be legislated.

Following feedback on the draft report, the Commission has further advanced and prescriptively articulated these criteria and principles in greater detail. The expectation is that the expert panel would primarily focus on funds' abilities to deliver the best outcomes for default accumulation members in the long term, not just over four years. This would include evaluating aspects of the fund overall rather than narrowly focusing on its MySuper product, as set out in box 13.1. The panel should be attuned to funds seeking to 'game' the process, for example, by taking excessive short-term risks or mimicking the investment strategy of funds already on the list where this is not in the long-term interest of their members.

No decision maker has the benefit of hindsight. While there may be occasions where a product picked by the expert panel goes on to *not* be one of the best performers in the market years or decades in the future, an expert panel can still identify funds most *likely* to outperform over the long term — and is far better placed to do so than employers (as under current arrangements) or individual members themselves. Moreover, all members will be protected by the elevated MySuper outcomes test (section 13.2), in that funds that go on to persistently underperform will be required to transfer their default members to a better product.

The best in show shortlist would contain up to 10 products, with the expert panel determining the precise number based on the merits of products. In doing so, the panel should consider what is most tractable for members while maintaining a strong competitive dynamic between funds for inclusion. To support this task, the panel should have a dedicated independent secretariat, access to a wide range of information, and the willingness and capacity to undertake its own research.

Box 13.1 **The best in show selection criteria**

To be eligible to apply to the expert panel, funds must offer a product that has obtained MySuper authorisation from the Australian Prudential Regulation Authority and is open to all new members.

In choosing between MySuper products that apply for selection, the expert panel should be guided by three legislated principles.

- Products should be chosen based on the fund's likelihood of providing the best outcomes for members in the accumulation phase, taking account of risk.
- Products chosen should be particularly suitable for members who have typically defaulted but should also be highly suitable products for all members.
- The panel should always seek to ensure a competitive dynamic exists between funds, without compromising the integrity of the best in show list.

The panel should have discretion over the precise selection criteria it uses to determine the list, as well as how the criteria are weighted, contingent on doing so in a transparent manner and publishing the criteria and indicative weights prior to funds submitting their applications.

In general, the criteria should afford most weight to the likelihood of each fund continuing to produce high net returns for members over the long term, not just the following four years (taking into account the risk profile of the types of members who typically default). This would entail a focus on the expected ability of the fund to deliver strong returns into the future, given its long-term performance record, risk profile, fee structure and governance practices.

The panel is also expected to give heed to the fund's track record on innovation and identifying and meeting the needs of default members when formulating investment strategies, including through the use of data and modelling.

As well as criteria relating to superannuation, the panel is expected to evaluate how well the fund's default insurance arrangements can cater for new members of all occupations, at competitive prices, with appropriate levels of cover, and with no opaque exclusions or variations in eligibility definitions. The fund should also be assessed on how well it complies with the insurance code of practice, and the trade-off it has articulated between insurance premiums for current and prospective members and their future retirement balances (section 13.4).

Source: Chapter 12.

Expert panel members should collectively possess super system and financial expertise and acumen, with insights into consumer behaviour and the skills required to undertake the evaluation task. Appointed panellists should be free of direct conflicts of interest, and seen to be so by the public. To strike the right balance between expertise and independence, not all members would need to have a high degree of expertise in super: some could be accomplished individuals with experience in collecting and evaluating evidence and advice, but who are also able to see beyond it (such as academics).

It is imperative that the panel be seen to be above the political fray. Panellists should be appointed through a robust selection process, with a selection committee comprising the heads of respected, independent government agencies (such as the Reserve Bank, the Australian Competition and Consumer Commission and the Parliamentary Budget Office) and a consumer representative. The subsequent appointment of expert panel members should

follow those used to appoint the Parliamentary Budget Officer, whereby appointments are made by the presiding officers of the Parliament and with the approval of the Joint Committee of Public Accounts and Audit. A clear process should also be in place for terminating and replacing appointments to the expert panel.

Many participants expressed scepticism that a suitably expert and independent set of people can be found to identify default products for a best in show shortlist. But the same challenge exists under *any* default arrangement, including where decisions are made in the workplace relations system. Based on three years of endeavour, consultation and analysis of the super system, the Commission is confident there are many suitable, expert candidates that are free of conflict and well placed to assess and determine relatively superior funds for listing.

As compulsory super is a creation of the Australian Government — and it is the Government, and ultimately taxpayers, that bears some of the financial cost of poor default allocation by way of increased Age Pension outlays — the panel should be accountable to it, and specifically to the relevant Minister (on behalf of members). The relevant Minister should not have powers to change the decision of the panel. The panel’s decisions would be subject to judicial review (available under general administrative law provisions), but not merits review.

Widespread acceptance by the community (including members and industry) of the legitimacy of the body housing the panel would be desirable. As such, the panel should not sit within the Fair Work Commission (FWC). The selection of best in show products should give no weight to workplace relations and industrial precedent, the FWC’s core area of expertise. The FWC is not a technocratic decision-making body, which is what is required for a member-focused panel with widespread public credibility.

The shortlisting process should be conducted every four years (though the panel would meet regularly to ‘keep a finger on the pulse’ of the super system as a whole, with briefings provided by regulators). No more than half of expert panel members should carry over from one selection period to the next, and no individual member should remain on the panel for more than two terms.

Each fund selected for the shortlist would be required to extend any benefits offered to new default members in the course of competing for and securing the right to act as a default fund to all its existing MySuper members. Other members who voluntarily join a product on the shortlist should receive the same benefits as existing members.

Funds that fall off the shortlist will be able to retain their existing default members provided they maintain their MySuper authorisation — which, going forward, should be subject to a more rigorous elevated outcomes test (section 13.2). The Australian Prudential Regulation Authority (APRA) should not be involved in shortlisting or appointing the panel, but any fund that materially underperforms would be at risk of losing its MySuper authorisation, and if this occurred the fund would naturally also lose its place on the shortlist.

RECOMMENDATION 3 INDEPENDENT EXPERT PANEL FOR 'BEST IN SHOW' SELECTION

The Australian Government should establish an independent expert panel to run a competitive process to develop the 'best in show' shortlist. This panel should select from products submitted by funds that meet a clear set of criteria (established and published beforehand by the panel) and that are judged as likely to deliver the best outcomes for members over the long term, with high weight placed on investment strategy and performance. All APRA-regulated superannuation funds should be free to participate in the 'best in show' selection process, regardless of ownership or sponsor (including government-owned funds).

In setting the criteria and selecting products, the expert panel should be guided by three legislated guiding principles:

- Products should be chosen based on the fund's likelihood of providing the best outcomes for members in the accumulation phase, taking account of risk.
- Products chosen should be particularly suitable for members who have typically defaulted but should also be highly suitable products for all members.
- The panel should always seek to ensure a competitive dynamic exists between funds, without compromising the integrity of the 'best in show' list.

The panel should have flexibility to select up to 10 products, with the exact number at the discretion of the panel based on the merit of each product and what is most tractable for members, while maintaining a strong competitive dynamic between funds for inclusion on the shortlist.

The panel should be comprised of independent experts who are appointed through a robust and independent selection process and held accountable to the Government through adequate reporting and oversight.

The process should be repeated, and the panel reconstituted, every four years. No more than half of expert panel members should carry over from one selection period to the next, and no individual member should remain on the panel for more than two terms.

How will members benefit?

The best in show shortlist is about putting members first (regardless of their employer or industry of employment). The evidence from behavioural economics shows that nudging people to make a decision from a small set of choices is an effective way to compete for their attention and engage them in making an active decision.

At the same time, the thorough process for shortlisting products will act as a safety net. Where members pick from the shortlist (or do not make a choice and are sequentially allocated to a product on the list), they are likely to end up in a high-performing superannuation product. They would also receive default insurance cover at a reasonable price (regardless of their occupation) — with much less variation in the types and levels of default cover than is observed today.

The competitive dynamics generated by wanting to get onto, or remain on, the shortlist, will drive funds to deliver strong outcomes to members and innovate to better meet their needs. The shortlisted funds will effectively serve as ‘role models’ for other funds that miss out, which will have a clear incentive to beat their competitors the next time around. In the course of doing so, their existing default members will benefit just as much as prospective new members. And those funds that are not well placed to serve a broad cohort will be encouraged to better define and serve their niche cohort.

Some inquiry participants suggested that a best in show list would give funds that get on the list an unfair advantage in future rounds that would lead to excessive market concentration and an oligopolistic industry structure (chapter 12). The Commission disagrees. The overall system is projected to grow from \$2.7 trillion in assets today to \$4.3 trillion by 2032 (Rice Warner 2017f) — equivalent to over 30 funds the current size of AustralianSuper. This means the system has the capacity to support considerably more funds than those on the best in show shortlist. And while the model will likely lead to much needed consolidation in the industry, scale and access to default members are not the sole drivers of good long-term performance. Funds that are not on the shortlist can always choose to compete, and only a small number of funds ‘hot on the heels’ of the best in show funds every four years is needed to maintain strong competitive discipline. As stated above, the expert panel would give heed to this competition in its deliberations, including in deciding how many funds to shortlist in each iteration.

Ultimately, a best in show process will lift performance across the entire super system, including in the choice segment, to the benefit of all members. It would bring five unique benefits that are over and above the gains that would arise from simply cleaning up the long tail of underperformers in the system (section 13.2), or from introducing ‘default once’ in isolation. It would:

1. support simple member choice, as well as safe choice, by making it easy for members to compare and select from a set of good products
2. stimulate competition between funds to get on the shortlist, and thus drive healthier competition to deliver for members
3. present clear ‘role models’ for other funds to emulate
4. accelerate desirable industry consolidation
5. serve as a discernible point of reference for financial advisers and their customers (section 13.3).

Moreover, moving to a system where employees select their super product from a pool of highly performing funds will extricate superannuation from workplace relations, and focus it on value and worker agency. The absurdity of unintended multiple accounts becomes undeniable once super is conceived as anchored to the member, not to a job or an employer. And stepping away from a system where regulatory structures that shelter subscale employer- and industry-tailored funds from member-driven competitive forces will likely see a long-overdue increase in average scale, to the benefit of millions of default members.

Removing employers from the process will also sidestep the potential conflicts of interest that go hand in hand with the current system. But this would not preclude employers or unions from playing a role. As noted above, corporate and industry-specific products can remain in the system, as long as members actively choose such a product (without obligation) rather than having it imposed upon them by default. Employers and unions can still provide information (as distinct from advice) to employees if they wish, and willing employers will still have scope to bargain with super funds on behalf of their employees to secure group discounts on fees or to develop tailored insurance policies.

13.2 An elevated outcomes testing regime

While the super system has delivered reasonable performance on average, a material tail of entrenched underperforming MySuper and choice products is a clear sign that the system has not delivered good outcomes for many members (chapter 2). Many members would expect government to ensure that their fund is looking after them, but there has been no regulatory disposition nor effective mechanism for weeding out underperforming funds and products.

Elevate the MySuper outcomes test

At the time the authorisation process for MySuper products was introduced, it was intended to set strong safeguards to protect disengaged default members, while also helping more engaged members to compare products and thus exert competitive pressure on funds. But MySuper authorisation has not lived up to expectations. Regulators have shown little appetite or ability to revoke authorisation where MySuper products underperform, in part because of the ineffectiveness of the legislated annual scale test (chapter 10).

The Government has legislation before Parliament to replace the MySuper scale test with a more comprehensive ‘outcomes test’, and to give APRA increased powers to revoke a fund’s MySuper authorisation. This outcomes test will require funds to annually determine whether they are promoting the financial interests of their MySuper members, in two steps:

1. an assessment of the appropriateness of the investment strategy, level of risk and insurance offering for the member cohort, and whether the scale of the MySuper product presents problems
2. an assessment of the product’s investment performance against other MySuper products, based on fees and costs, return targets, actual returns and the level of investment risk (chapter 10).

Passage of this legislation should be expedited. However, for the test to be truly effective, it needs to be elevated. In particular, clear standards should be set for how investment performance is to be benchmarked, and a clear, objective performance threshold should be established that funds must meet each year to retain their MySuper authorisation (a ‘right to remain’ test described below). Funds should also be required to obtain independent

verification — to an audit-level standard — of their MySuper outcomes test analysis at least every three years.

Extend outcomes testing to choice

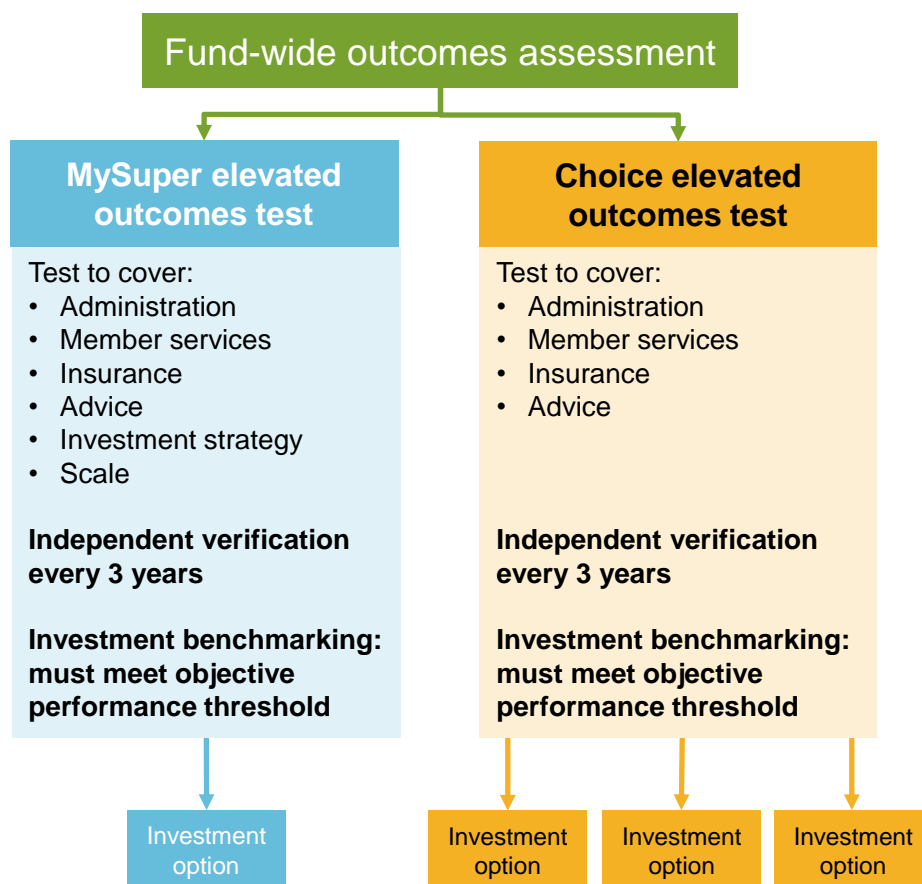
There is little (enforced) regulation of member outcomes in the choice segment or of the products and investment options that are offered to choice members — and yet this is where many of the worst member outcomes occur. The prevalence of persistently underperforming choice products in the super system shows that existing safeguards — in relation to financial advice and product disclosure — have been inadequate (chapters 2 and 5).

An outcomes test should thus be extended to the choice segment, along similar lines to the elevated MySuper outcomes test. This should also include clear standards for benchmarking investment performance, an objective performance threshold — a ‘right to remain’ test — for each individual investment option, and a requirement to obtain independent verification of the outcomes test analysis at least every three years.

The choice outcomes test would complement the new prudential standard recently released by APRA that will legally require trustees to undertake a fund-wide ‘outcomes assessment’ from January 2020 (chapter 10). Under this standard, trustees of all large APRA-regulated funds will need to assess the member outcomes being delivered across all their products and investment options and identify how these outcomes can be improved (and to share their assessment with APRA) (figure 13.2). The elevated MySuper outcomes test should form one part of it, as should an assessment of each of a fund’s choice products (covering administration fees, member services, insurance and financial advice provided by the fund).

Compliance with the outcomes test regime should also be a condition of funds retaining their Registrable Superannuation Entity (RSE) licence. Individual choice products and investment options would not be subject to a direct authorisation process before they can be offered (as distinct from MySuper), although they would be subject to the forthcoming ‘design and distribution’ obligations to be enforced by the Australian Securities and Investments Commission (ASIC) (which will require funds to ascertain that the options are being provided to a suitable target market) (chapter 10).

Figure 13.2 Earning the ‘right to remain’: elevated outcomes testing^a



^a Elements in bold font are in addition to draft legislation (MySuper outcomes test) and APRA standards (fund-wide outcomes assessment).

Impose a clear performance threshold for all investment options

Central to the elevated MySuper and choice outcomes tests would be a clear, objective investment performance threshold — which would effectively serve as a ‘right to remain’ test designed to ensure funds have to earn their right to stay part of the compulsory super system. Such a ‘right to remain’ test is a natural extension to, while strengthening the effectiveness of, the envisaged outcomes tests for both the MySuper and choice segments.

Specifically, funds should be required to benchmark each option to a portfolio of listed market indexes that reflects the asset allocation of the product — a listed benchmark portfolio (BP1), as applied by the Commission in chapter 2. This benchmark represents a ‘counterfactual’ set of assets that members could have been passively invested in, and which funds should at least be matching in performance over reasonable timeframes. It should include an allowance for reasonable costs incurred in the provision of investment options through superannuation (consistent with the Commission’s developed method).

Investment options that fall below this benchmark by at least 0.5 percentage points a year, on average, over a rolling eight-year period should be subject to remediation or withdrawn from the super system (chapter 10). Assessing performance over an eight-year period would abstract from much of the year-to-year volatility of investment markets, and thus not discourage funds from long-term investment strategies or from making investments that differ from those that constitute the market indexes.

Because a benchmark portfolio is tailored to (and thus agnostic of) the asset allocation of each investment option, it can be flexibly applied to a range of product types, including life-cycle products. This means that most investment options (with very limited exceptions) can be subject to the ‘right to remain’ test. Applying the test at the investment option level also negates the common refrain that trustees cannot be held responsible for outcomes given members are making their own asset-allocation decisions.

The adoption of a dispassionately objective performance threshold will send a clear signal to fund trustees that persistent investment underperformance is not to be tolerated, and will be much harder to dispute than the more qualitative parts of the proposed outcomes tests. Indeed, it would make the enforcement task easier by providing greater clarity and certainty about when regulator action should be expected. It will also assist in cleaning up the large stock of high-cost legacy products hitherto remaining in the system for an estimated 3 million member accounts (chapter 2). By putting the onus on funds to justify why they should remain in the system, the thresholds will help to hold them more accountable for member outcomes — an accountability that has been lacking to this point. The thresholds will also put a stronger onus on APRA to take timely and decisive action against underperformance, and thus help to hold the regulator to account too.

APRA should issue clear and specific guidance on the construction of the benchmark portfolios (informed by the Commission’s work in this inquiry), and revise the parameters over time as necessary. The Commission envisages that the ‘right to remain’ test can be applied in full by 2022, when enough high-quality data on investment options have been collected, by both funds and the regulator for the previous eight years.

Inevitably, benchmarking relative to asset allocation would not provide a direct measure of whether the investment strategy itself is appropriate for the member cohort. This would need to be assessed through other parts of the outcomes tests and fund-wide outcomes assessment. In particular, trustees would need to justify to APRA that their MySuper product has an appropriate investment strategy for the member cohort, and be able to justify to ASIC that their choice investment options are appropriate for the relevant target market (with ASIC’s proposed product intervention powers giving it scope to intervene).

Take decisive action to clean up the tail

Where an investment option fails to meet its ‘right to remain’ performance benchmark, the fund should be given no more than 12 months to remediate performance, and demonstrate to APRA that this will likely result in a timely improvement to member outcomes. The

Commission envisages that effective remediation within that timeframe could typically only be achieved by fee reduction. It would be unlikely to be achieved through changes in investment strategy or outsourced providers (unless the latter involves material fee changes).

Careful oversight of the remediation process by APRA will be essential, and APRA should have the power to sanction funds during this process (such as by directing a particular course of action, or prohibiting the fund from accepting new members into the affected option until remediation is complete). In parallel, ASIC would have product intervention powers to ward off ‘phoenix’ behaviour, whereby trustees attempt to replace the affected option with a new one that is substantively the same but superficially different.

Where remediation cannot be achieved within 12 months, the fund will need to withdraw the investment option and transfer members to a better performing option (either in their own fund or a different fund), or enter into a merger arrangement with another fund (with the merger to be completed within 2 years).

And if this does not happen, APRA should then be compelled to revoke the fund’s MySuper authorisation or direct the fund to withdraw the affected choice investment option (and may need to limit balance withdrawals during this period to avoid a ‘run’ by members). APRA will also need to ensure a suitable recipient fund was found for the affected members — which in the first instance should be a successor fund identified by the trustee (which APRA could approve or reject), but otherwise could be a fund on the best in show shortlist. This will need to be done on the basis that the affected members are better off in the long term, even if their exact ‘bundle of rights’ differs (chapter 10).

A careful implementation of the elevated outcomes tests will be necessary to ensure the process is manageable for APRA and the receiving funds (section 13.7). It can be expected that many funds would seek to lift their game, rationalise their products (including legacy products) or merge with another fund — and would have a strong incentive to do this ahead of the tests’ introduction. Inevitably, elevated outcomes tests will also likely see much needed consolidation in the super system (as evidenced by unrealised economies of scale (chapter 7)). Indeed, that is the *raison d’être* of the changes: to significantly reduce the incidence of member harm by lifting fund performance and, where funds cannot achieve this, to encourage and, if necessary, compel mergers or exits. But this would be achieved in a much more targeted way than blanket prohibitions on particular types of funds or service providers.

Elevated outcomes tests would also act to both counter and deter poor conduct (that results in poor performance) and make the enforcement task easier for regulators by providing greater clarity and certainty about when regulator action could be expected. Whether poor performance is due to poor competence, poor conduct or a combination of both is irrelevant — poor performers would be weeded out (but with a ‘red flag’ being raised to help ASIC focus its investigation of conduct at affected funds). This will also help to hold the regulators to account and will complement other accountability mechanisms being proposed for the regulators (section 13.6).

RECOMMENDATION 4 ELEVATED MYSUPER AND CHOICE OUTCOMES TESTS

The Australian Government should legislate to require all APRA-regulated superannuation funds to undertake annual outcomes tests for their MySuper and choice offerings. These outcomes tests should include:

- a requirement for funds to obtain independent verification, to an audit-level standard, of their outcomes test determination, at least every three years (starting with the first test)
- clear benchmarking requirements for all MySuper and choice investment options.

This benchmarking should include a requirement for all investment options to be compared with a listed investment benchmark portfolio tailored to their asset allocation (with exceptions only to be granted on an ‘if not, why not’ basis). APRA should issue clear and specific guidance on the construction of these benchmark portfolios (drawing on the methodology established by this inquiry). Options that fall short of this benchmark portfolio by more than 0.5 percentage points a year, on average, over a rolling eight-year period should be subjected to a 12-month period of remediation or, if remediation is not possible, withdrawn from the market, with members transferred by funds to a better performing option. Any remediation or transfer activity should be subject to close oversight by APRA.

The Government should provide APRA with the power to stop a fund from launching new investment options or accepting new members into existing options subject to remediation until that remediation is complete.

APRA should also be given the power to revoke the fund’s MySuper authorisation or direct the fund to withdraw the choice option where remediation is not successful in the required timeframe or a voluntary withdrawal of the product from the market does not occur. In these circumstances, APRA should oversee a process of transferring the affected members to another suitable fund, including on a temporary sub-fund basis where necessary, provided that APRA has determined that the transfer is, on balance, likely to be in the best long-term interests of the members of both funds. Should no fund be willing to accept the members, APRA should appoint an independent acting trustee with a remit to wind-up the fund.

The outcomes tests should form part of the new APRA standard to require fund-wide assessments of member outcomes.

Funds should be required to complete their first (annual) elevated outcomes tests by no later than the end of December 2020 for MySuper products, and no later than the end of June 2021 for choice investment options.

13.3 Products that meet member needs

A high-performing super system requires funds to strive to meet the needs of individual members. Robust competition between funds is essential, because competition is a driver of performance and innovation. With ongoing advancements in technology, funds need to be continually improving their products and services to meet the needs of existing and

prospective members — and many are already doing this. Yet many members struggle to find the right products, and the system — and government — has made engagement harder than it ought to be. Even where members do get engaged this has not always led them to better outcomes.

Making it easier for members to get engaged and to compare products should thus be a priority. There is scope for much improvement in how funds disclose information on their products, and in regulators' efforts to make this happen. Fees that unnecessarily erode member balances or pose a barrier to switching should be removed. And more can also be done to protect members (especially those with low levels of engagement) by cleaning up unintended multiple accounts and making impartial advice and guidance easier to access.

Clean up the legacy stock of unintended multiple accounts

The proliferation of unintended multiple accounts and insurance policies is a perverse side-effect of the current way default members are allocated to products, and imposes large and regressive costs on many members (chapter 6). As noted above, the recommendation to default people only once (when they enter the super system for the first time and do not make a choice of fund) will effectively stop the creation of unintended accounts in the future.

However, a large legacy stock of multiple accounts will remain. On average, members hold 1.7 accounts each — many more than can reasonably be expected to result from deliberate and informed choice. The number of unintended multiple accounts has been coming down, but not fast enough. These still represent 10 million member accounts, over a third of the total.

Government and industry have attempted to clean up these unintended accounts over the years, but progress has been disappointing. More direct intervention is warranted. The Government is in the process of legislating that all accounts under \$6000 that have been inactive for 13 months or more (and do not have insurance attached) be sent to the ATO, for auto-consolidation with an active account held by the same member. Where another account cannot be found, the balance stays with the ATO, incurring no fees and effectively earning a return equivalent to the rate of consumer price inflation. Funds will also be required to cease any insurance on these low-balance inactive accounts.

This new process will reduce the administrative costs of funds holding lost accounts and stem the erosion of these balances by fees and insurance premiums. It will also reduce trustees' ability to delay or prevent rollovers of these balances. And in addition, the process should capture most (if not all) accounts within Eligible Rollover Funds, some of which have questionable fee structures and do not appear to have achieved much success at reuniting members with their lost super. The ATO should be the sole operator of 'holding accounts' for lost super, with APRA overseeing the wind-up of Eligible Rollover Funds.

The legislation should be passed as soon as possible, combined with new requirements for all fees (including exit fees) to be levied on a cost-recovery basis (see below). In addition, the balance threshold at which auto-consolidation occurs should be increased over time unless

there are compelling reasons not to (therefore allowing more accounts to be auto-consolidated). More broadly, the labyrinthine system for handling lost and unclaimed accounts should be reviewed and turned into a more streamlined reunification framework that works in harmony with the auto-consolidation mechanism.

RECOMMENDATION 5 CLEANING UP THE STOCK OF UNINTENDED MULTIPLE ACCOUNTS

The Australian Government should seek the passage of legislation to require the auto-consolidation of superannuation accounts with balances under \$6000 and 13 months or more of inactivity. Trustees should be required to transfer these accounts to the ATO for auto-consolidation with a member's matched active account.

The Government should make explicit that this process should capture accounts held in Eligible Rollover Funds. These funds should be wound up within three years, with APRA oversight.

The Australian Government should increase the balance threshold for auto-consolidation over time, unless there are compelling reasons not to. The Government should also review the policy framework for lost and unclaimed superannuation accounts with the aim of streamlining the framework and ensuring it works in harmony with the auto-consolidation mechanism.

Make it easier for members to make decisions

Many members find information on super to be too complex and overwhelming. In the choice segment, there has been a proliferation of little used and complex accumulation products — tens of thousands in total (chapter 4). But much of the complexity around super products is unnecessary. Behavioural economics research points to the importance of 'less is more' in funds competing for the meaningful attention of members. Voluminous amounts of data are available, but all too often key data are missing or difficult to compare across funds.

The super system needs to be easier for people to navigate when they want to get engaged — and they should be able to choose their degree of engagement. Information needs to be accurate, easily understood and readily comparable across funds. When products are easy to compare, members are more likely to exercise informed engagement by switching to better providers or to products that better cater to their individual needs. Even where just a subset of members — a critical mass — is thus engaged, they can drive stronger competition that leads to improved outcomes for everyone.

Above all else, engagement needs to be safer for members — in a modern super system, engaged members should be getting better outcomes, not worse.

Dashboards for all products

The spirit of product disclosure needs to be re-oriented from risk aversion to helpfulness, with regulators taking the lead to make disclosure meaningful and digestible. Foremost, clearer, simpler and more widely applied product dashboards are needed to help members compare the returns, fees and risks associated with all super products.

Steps have been taken to improve product comparability with the mandating of product dashboards for MySuper products (from 2014). Similar dashboards were originally scheduled to be mandatory for choice investment options (products) from July 2015, but industry resistance has led to ASIC pushing back the implementation deadline to July 2019. The Government has also presented legislation to Parliament to narrow the scope of these dashboards to just the 10 largest choice products within each fund.

The slippage of timelines and narrowed scope of dashboards will hurt members, and needs to be rectified. Funds should be required to publish a dashboard for *all* superannuation investment options — with ASIC to only grant exceptions on a truly exceptional basis. ASIC should prioritise achieving full compliance by the end of 2019. Any cost to funds of providing dashboards will be clearly outweighed by the long-term benefits of more comparable products and improved member decision making. (Regulators can also do more to collect member-relevant data, as discussed in section 13.6.)

Summarising a complex financial product in a single page is challenging. But perfection should not be a barrier to the possible, nor an excuse for perpetual delay. ASIC should seek to revise the content and format of dashboards to simplify them and provide more easily comprehensible metrics (by the end of 2019). In doing so, it should consult with independent experts and consumer organisations, and draw on the lessons from recent studies that have looked specifically at how members react to superannuation dashboard disclosures (chapter 5). There is also scope to make much greater use of behavioural testing and evidence to inform this process, such that the focus of any changes is squarely from a member's perspective. This would be a much more fruitful approach to designing dashboards than seeking industry consensus on every detail, which past experience has revealed to be futile.

In addition, ASIC should make all product dashboards available on a central website (such as its MoneySmart website). This will make it easier for members to access dashboards for a range of products, while also offering a degree of validation that would bolster member trust in the dashboards. Links to this information should be made clearly available to members from the area of myGov that allows for account consolidation, to proactively 'nudge' members towards the dashboards.

Dashboards should also be linked to the new centralised online service for the best in show shortlist (recommendation 1), to allow for salient comparisons of a member's current super product with those on the shortlist. This would make it easier for members to see how their product is performing and, if desired, switch to a new product. It will act to increase member-driven competition in the market.

Funds should also be required to provide their dashboards to members who have requested to switch from a MySuper product to a choice product (within the same fund). This will assist members to make informed decisions (by comparing the dashboard for each product) and provide an opportunity to better understand the implications of switching.

RECOMMENDATION 6 A MEMBER-FRIENDLY DASHBOARD FOR ALL PRODUCTS

The Australian Government should require funds to publish simple, single-page product dashboards for all superannuation investment options.

ASIC should:

- prioritise the implementation of these dashboards for choice investment options to achieve full compliance by the end of 2019
- only grant an exemption for an option or set of options from the dashboard requirement on the basis of evidence under the principle of ‘if not, why not’
- revise the dashboards to simplify the content and provide more easily comprehensible metrics (drawing on robust consumer testing) by the end of 2019
- immediately publish all available MySuper and choice dashboards on its MoneySmart website, with the information clearly and readily accessible from the area of myGov that allows for consolidation of accounts.

The Australian Government should also require all superannuation funds to provide their members with the corresponding dashboards when a member requests to switch from a MySuper product to a choice option within the fund.

RECOMMENDATION 7 DELIVERING DASHBOARDS TO MEMBERS

The Australian Government should require the ATO to provide a link to the relevant (single page) product dashboard(s) on a member’s existing account(s) via its centralised online service. Links to each single-page product dashboards for the ‘best in show’ products should also be presented on the centralised online service.

More generally, there is much scope for ASIC to more proactively set and enforce disclosure requirements for super funds (section 13.6). The overarching objective should be meaningful and digestible disclosure — information should be simple, comparable and easy for members to understand, without being overwhelmed by its volume or technicalities. In particular, a ‘key fact sheet’ is sorely needed to help members compare insurance attached to super, as is greater standardisation of cover across funds. These will likely be key areas of focus for the industry and regulators as the insurance code of practice is implemented and improved (section 13.4).

Make impartial advice and information easier to access

There is an unmet need for impartial and affordable financial advice — especially as members approach retirement and have to make significant (and often difficult to reverse) financial decisions (chapter 5). Recent work by ASIC and the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Financial Services Royal Commission (FSRC)) has revealed that conflicted and unsuitable advice pervades the super system, and indeed much of the financial services industry more broadly. The super system will not be acting in the best interests of members until this is fixed.

The best in show shortlist (section 13.1) will help members by serving as a discernible (and unavoidable) point of reference against which other products in the market can be compared (using the product dashboards). This shortlist can be a useful tool for helping members to question the quality of financial advice they receive and put pressure on advisers to explain why any product advice (including advice to establish an SMSF) diverges from the list. Combined with product dashboards, the best in show list would provide a point of ‘if not, why not’ comparison for financial advisers and their clients, which the Commission sees as a powerful barrier to harmful upselling. It would also strengthen the application and enforcement of financial advice laws by ASIC. The benefits of this will span more than just default members and stimulate healthier competition across the whole system.

More can also be done to improve the quality of financial advice delivered to members. Steps are already in train to lift the education and qualification requirements for financial advisers (chapter 5). And the FSRC has raised a number of policy questions in relation to financial advice, which may result in further beneficial reforms.

In addition, all financial advice in relation to super is arguably personal. The Government should rename the term ‘general advice’ defined under the Future of Financial Advice legislation, as the Commission also recommended in the report for its inquiry into *Competition in the Australian Financial System* (PC 2018a). This term has led many consumers to think they are receiving advice relevant to their personal situation when they are only being provided with product information or marketing material. The term ‘advice’ should only be used in association with advice that takes into account personal circumstances. Further, advisers should be required to disclose which products are on their approved product lists, as the Commission also recommended in its inquiry into competition in the financial system.

RECOMMENDATION 8 A CLEARER DEFINITION OF ‘ADVICE’ AND DISCLOSURE OF APPROVED PRODUCT LISTS

The Australian Government should immediately amend the *Corporations Act 2001* (Cth) to ensure that the term ‘advice’ can only be used in association with ‘personal advice’ — that is, advice that takes into consideration personal circumstances.

The Government should also immediately require Australian Financial Service Licensees to disclose to ASIC, in relation to superannuation products:

- the number of products on their approved product list (APL)
- the proportion of in-house products on their APL
- the proportion of products recommended that are in-house
- the proportion of products recommended that are off-APL.

ASIC should publish this information annually.

ASIC should also conduct selected audits of the information received to facilitate assessment of the effectiveness of advisers in meeting clients’ best interests.

More can be done to help members access impartial advice and understand financial products. Digital advice (also known as ‘robo’ advice) may offer promise here, especially as an alternative source of impartial and affordable advice. But stronger financial literacy among members themselves is also desirable. A plethora of government initiatives exist to target this worthy objective, but few have been evaluated for their success in achieving the desired outcomes. There thus should be a comprehensive and systematic review of these schemes to better target funding.

RECOMMENDATION 9 EVALUATION OF FINANCIAL LITERACY PROGRAMS

The Australian Government should comprehensively and systematically evaluate the programs it funds that aim to improve the financial literacy of Australians. Such a review would help to better target funding to those programs evaluated as effective and to defund those that are not. This could be done through a review of the National Financial Capability Strategy, which could also include State and Territory Governments evaluating such programs in their own jurisdictions.

Help for members nearing retirement

More can also be done to help Australians as they approach retirement. Members’ needs in retirement are no longer as simple as in accumulation. The large diversity of household needs, preferences, incomes and other assets means that no single product can meet the needs of everyone. The range of retirement products on offer — including account-based pensions, annuities and new hybrid annuity products — appears sufficient to meet most members’

needs (chapter 4). And the Government has already brought in policy changes to remove unjustified tax and regulatory obstacles to risk-pooled products.

However, members' capacity to make well-informed choices of retirement income products is likely to continue to be constrained by poor financial literacy and lack of affordable financial advice. In this context, taking the time to get the underpinning policy and regulatory frameworks right is key — especially if members face an elevated risk of inadvertently purchasing a product that may not suit their needs and that can be difficult or costly to exit.

The Government has announced a Retirement Income Covenant that will require all funds to offer a Comprehensive Income Product for Retirement — a hybrid product comprising access to capital and longevity risk management (chapter 4). But the way this is being done risks creating a 'soft default' where some members are nudged into risk-pooled products that are ill-suited to their needs and costly to get out of. Given that many retirement product decisions are largely irreversible, informed decision making and member protections are essential. Trustees do not always want to offer these products, and forcing them to do so may conflict with their obligations to act in members' best interests. The Government should thus reassess the benefits, costs and detailed design of these requirements — and abandon them if the flaws cannot be sufficiently remediated (by the now deferred date of 1 July 2022).

In conjunction with this reassessment, the Government should also consider extending the existing Financial Information Service (provided by the Department of Human Services) to offer members at or near retirement impartial information to help them navigate complex retirement income decisions and, where relevant, seek out impartial financial advice. In time, digital ('robo') technology could potentially be incorporated.

RECOMMENDATION 10 REASSESS THE NEED FOR A RETIREMENT INCOME COVENANT

The Australian Government should reassess the benefits, costs and detailed design of the Retirement Income Covenant — including the roles of information, guidance and financial advice — and only introduce the Covenant if design imperfections (including equity impacts) can be sufficiently remediated.

In conjunction with this reassessment, the Australian Government should also:

- consider cost-effective options, including possibly extending the Financial Information Service to provide retirees with access to a one-off, impartial information session to help them navigate complex retirement income decisions
- explore the business case for investing in digital technology that assists people's financial decision making.

In the meantime, the Government should prompt pre-retirees (when they reach age 55) to access online information to help them make decisions about their retirement. This can be done through websites run by ASIC and the Department of Human Services, in a way that builds on the Government's recent announcement that it would contact all Australians aged 45 to 65 to prompt them to assess their finances.

RECOMMENDATION 11 MORE USEFUL INFORMATION FOR PRE-RETIREEES

The Australian Government should prompt all superannuation members when they reach 55 years of age to visit the:

- ‘Retirement and Superannuation’ section of ASIC’s MoneySmart website
- Department of Human Services’ Financial Information Service website.

Stronger safeguards on SMSF advice

Members in SMSFs bear much greater responsibilities and risks than members in other super funds (which are overseen by a separate trustee), and also bear significant establishment costs. Good financial advice is therefore imperative, but the evidence points to widespread problems of poor quality or conflicted advice (chapter 5). Many SMSF owners lack even a basic understanding of their legal obligations, and over 40 per cent of SMSFs persist with low balances, high average costs and low average returns (chapter 3).

These problems must be rectified, but without prohibiting informed members from making their own decisions or strangling them with red tape. Steps are in train to lift the qualification requirements of financial advisers, and these should be extended to require specialist training for those advising on SMSFs. Only if this proves ineffective should mandatory training for SMSF owners be considered.

But more importantly, stronger regulatory oversight of financial advice is overdue. ASIC should more closely monitor financial advice in relation to SMSFs (and has recently shown signs of doing so), and take strategic enforcement action against advisers who breach their legal obligations. To back this, the Government should strengthen ASIC’s toolkit by extending the proposed product ‘design and distribution obligations’ to SMSF establishment. A minimum balance is too blunt an instrument, but advisers should be prepared to justify to ASIC why they are recommending any SMSF be established with under \$500 000 beyond the initial establishment years. They should also be required to provide any client about to establish an SMSF with a document outlining ASIC’s ‘red flags’. In addition, ASIC should undertake recurring thematic reviews in relation to advice on SMSFs, as well as member-directed investment products in institutional funds (which have many similarities to SMSFs) (section 13.6).

RECOMMENDATION 12 STRONGER SAFEGUARDS ON SMSF ADVICE

The Australian Government should:

- require specialist training for persons providing advice to set up an SMSF
- require persons providing advice to set up an SMSF to give prospective SMSF trustees a document outlining ASIC's 'red flags' prior to establishment
- extend the proposed product design and distribution obligations to SMSF establishment.

Harness data to tailor products

Data and technology are opening up new opportunities to make super work better for members — across domains as diverse as product design (such as tailoring products to individual members), member engagement (such as greater use of smartphone apps) and providing advice (such as digital advice). But the super industry lags behind other sectors of the economy in collecting and analysing data to identify customer needs and design products. In particular, super funds could make much more use of data to design life-cycle and retirement products, where there is considerable potential for tailoring to individual members' needs (chapter 4). Funds could also make greater use of data to inform insurance design and pricing for specific member cohorts (chapter 8).

These data can be derived from public sources (such as Australian Bureau of Statistics and ATO publications), as well as directly from members themselves. Funds already hold some data, but face constraints in gathering additional data from members. The new Consumer Data Right, which is initially being applied to banking, can help by enabling members to consent to their banking data being shared with their super fund (chapter 4). The Government should automatically accredit super funds to be eligible to receive such data (with the member's consent). The Government should also roll out the Consumer Data Right to superannuation itself, to empower members to take their data with them when they switch funds — which may, in turn, help funds to design better insurance products (for example, using contributions data to infer breaks from the workforce) and retirement products (for example, using data on past drawdowns).

RECOMMENDATION 13 ROLL OUT THE CONSUMER DATA RIGHT FOR SUPERANNUATION

The Australian Government should automatically accredit superannuation funds to be eligible to receive (following member consent) information held by banks under the Open Banking Initiative. The Government should also roll out the new Consumer Data Right to superannuation in parallel with implementation of the elevated outcomes tests (recommendation 4).

Restrict fees that are not in members' interests

Some super funds charge fees that appear to be well in excess of what is needed to cover the basic administration and investment operations of a fund. Sometimes higher fees bring members services that they value or stronger investment performance, but where they do not, the main effect will be to unnecessarily erode member balances.

Administration fees are a key culprit. Of particular note here is where some funds charge fees as a percentage of balances (affecting an estimated 84 per cent of products), even though their costs of administration are unlikely to vary substantially across members in line with their balances (chapter 3). Exit fees are also a concern, especially where they are unnecessarily high and impede members switching between funds and products.

Because super funds are legally obliged to act in members' best interests, the fees they charge should not exceed cost recovery levels. The Government should enforce this across all MySuper and choice products, and prohibit funds from cross-subsidising between members — which would see an end to excessive fees while also ruling out scope for some members to bear the cost of other members' decisions.

Trailing commissions are another impediment to switching, and remain stubbornly ingrained in the super system despite being banned by the Future of Financial Advice laws since July 2013. This ban was applied prospectively, with a transition arrangement that allowed funds to grandfather existing trailing commissions to financial advisers (either for the super product or insurance). Responses to the Commission's funds survey suggest that these commissions are present in about a quarter of super funds (chapter 3). Evidence presented at the FSRC has shown that trailing commissions can sometimes flow to a related-party advice business, and that some trustees have an unhealthy predisposition not to voluntarily remove these commissions even where it may be in their members' best interests.

The time for transition is over. All commissions through superannuation (including on insurance) should be banned as soon as practicable. This will reduce the fees that members pay — especially those in retail funds — and remove a clear financial incentive for advisers to discourage members switching to better products.

RECOMMENDATION 14 **LIMIT ALL FEES TO COST RECOVERY AND BAN TRAILING COMMISSIONS**

The Australian Government should require that all fees charged by APRA-regulated superannuation funds are levied on a cost-recovery basis. Using fees to cross-subsidise between members should be prohibited. These rules should be implemented and enforced by regulators in such a way that avoids gaming by funds and does not pose new barriers to member switching.

The Australian Government should ban trailing financial adviser commissions in superannuation, to take effect as soon as practicable.

13.4 Insurance that works for members

About 12 million Australians have insurance (life, total and permanent disability and/or income protection cover) through their super. Group insurance arrangements — where funds obtain an insurance contract on behalf of multiple members — deliver many members much more affordable insurance than they would be able to get through individually written cover outside of super (not least because the latter has often been subject to large adviser commissions).

But insurance provided through super is not working for members as well as it could (chapter 8). About a quarter of members do not know if they have (and are paying for) a policy. There are widespread cases of excessive balance erosion (from insurance premiums eating away at members' account balances) and members being defaulted into inappropriate policies. And there is wide variation in the types and levels of default cover (as well as premiums) across funds. Given that funds collect limited data on their members, this variation does not seem warranted as a response to inherent differences in each fund's membership cohort.

The Commission's recommendations for default super will help reduce some of these problems by stopping the creation of unintended multiple super accounts, and thus the insurance that goes with them (section 13.1). But more needs to be done to protect members, including those already in the system.

Make insurance opt-in for young and inactive members

The current opt-out arrangements for insurance do not suit all members. Many young members work in casual or part-time jobs, and have relatively low financial commitments or no dependents to support, meaning life insurance is simply not of value to them. Many members who stop making contributions end up continuing to pay premiums on a duplicate policy (because they have opened another super account), or for a 'zombie' policy they are not eligible to claim on (because they are not working).

The rules should be changed so that young members (aged under 25) need to actively opt in to receive insurance through their super (regardless of whether they are in a default or choice product). As some younger member cohorts may arguably benefit from opt-out disability and income protection insurance, an 'if not, why not' exemption should be granted to funds that can convincingly demonstrate this to APRA (for example, by drawing on directly pertinent actuarial modelling). Further, insurance cover should cease on accounts that have had no contributions for the past 13 months, unless the member explicitly informs the fund that they wish to retain their cover.

While these changes may lead to an increase in premiums for other members that remain in opt-out insurance arrangements (chapter 8), much of this increase will likely reflect the removal of inefficient (and inequitable) cross subsidies.

The Government is in the process of legislating these changes, together with making insurance opt-in for accounts with balances less than \$6000. This legislation should be passed without delay.

RECOMMENDATION 15 OPT-IN INSURANCE FOR YOUNG AND INACTIVE MEMBERS

The Australian Government should seek the passage of legislation to make insurance through superannuation opt-in for members under 25 years of age, and to require trustees to cease all insurance cover on accounts where no contributions have been made for the past 13 months (unless the member provides express permission that the cover is to be retained).

In addition to these proposed legislative changes, exemptions to the under-25 opt-in restriction should only be granted if the trustee can demonstrate to APRA that opt-out disability or income protection insurance would be in the best interests of a specific cohort of younger members.

Require clearer balance erosion trade-offs

Super fund trustees need to simply and clearly explain the trade-offs they are making when entering and designing group insurance arrangements. Trustees should immediately be required to articulate and quantify the balance erosion trade-off they have made for their members and make it available on their website, along with a simple calculator that members can use to estimate how insurance premiums would affect their balances at retirement.

Funds seeking inclusion on the best in show shortlist should also articulate this trade-off for prospective members. And, as discussed in section 13.1, these funds will also be required to have default insurance arrangements that can be tailored to new members of all occupations, without excluding any member from being able to claim on the basis of their occupation.

RECOMMENDATION 16 INSURANCE BALANCE EROSION TRADE-OFFS

APRA should immediately require the trustees of all APRA-regulated superannuation funds to articulate and quantify the balance erosion trade-off determination they have made for their members in relation to group insurance, and make it available on their website annually.

As part of this, trustees should clearly articulate in their annual report why the level of default insurance premiums and cover chosen are in members' best interests. Trustees should also be required to provide on their websites a simple calculator that members can use to estimate how insurance premiums affect their balances at retirement.

Bolster the insurance code

Other improvements are coming about from the industry's own volition, albeit only upon much prompting by the Government. The *Insurance in Superannuation Voluntary Code of Practice* has been intended to apply to all super funds from 1 July 2018, but funds have until 30 June 2021 to fully comply. Among other things, the code contains provisions for premium limits (based on a member's estimated income), obliges funds to publish a simple 'key facts sheet' on their insurance offering, and sets out processes for handling insurance claims and complaints.

This code offers many benefits to members. For example, the premium caps will limit balance erosion, as will the requirement to stop deducting insurance premiums from inactive accounts (under certain conditions). The code requirements are sufficiently flexible such that there is no obvious reason for funds not to adopt it straight away. Yet adoption of the code has not been universal, and it remains voluntary for funds. Its provisions are also unenforceable and fall well short of what is needed, and of best practice for an industry code of conduct.

The code's effectiveness will depend on the extent of voluntary take-up and the strength of its provisions (which are yet to include implementation of standard definitions and a short-form annual insurance statement for members). In its current state, it will only herald modest improvements in member outcomes. The code owners — the Australian Institute of Superannuation Trustees, the Association of Superannuation Funds of Australia and the Financial Services Council — need to do more work to enhance the code provisions in future iterations. This should include the prompt development of standard definitions for total and permanent disability insurance, moving to a short-form annual insurance statement for members, and development of more robust compliance provisions — and ensuring broad industry compliance with the spirit (not just the letter) of the code.

The regulators will also need to get involved with monitoring code adoption and compliance by funds. ASIC and APRA should establish a joint taskforce to monitor and report on adoption and implementation of the code — with ASIC taking the lead — and to direct the industry to strengthen the code's provisions such that it meets ASIC's definition of an enforceable code of conduct. ASIC should also have standing under the code to take enforcement action where necessary.

While the taskforce itself should consist only of the regulators (that can be held to account), it should establish extensive consultation processes — potentially including the establishment of ongoing consultative committees — with the focus being on consumer organisations and insurance experts, and with industry on an as-needed basis only.

The industry should be given a hard two-year deadline to make the code binding and enforceable on all signatories, at which point adoption of the code should become a requirement for all funds that offer insurance (as an RSE licence condition). The taskforce should also determine and set an appropriate timetable and interim milestones to ensure that the necessary enhancements to the code occur in this time.

RECOMMENDATION 17 A BINDING AND ENFORCEABLE INSURANCE CODE OF CONDUCT

The Australian Government should immediately establish a joint regulator taskforce to advance the *Insurance in Superannuation Voluntary Code of Practice* and maximise the benefits of the code in improving member outcomes. The taskforce should:

- monitor and report on adoption and implementation of the code by funds
- direct and monitor enhancements to strengthen the code, particularly implementation of standard definitions and moving to a short-form annual insurance statement for members
- direct the industry to take further steps for the code to meet ASIC's definition of an enforceable code of conduct, and to give ASIC an enforcement role under the code.

Both ASIC and APRA should be members of the taskforce, with ASIC taking the lead. The taskforce should annually report findings on industry progress on the code.

The code owners should be given two years to strengthen the code and make it binding and enforceable on signatories. At this point, adoption of the code should become a condition of holding a Registrable Superannuation Entity Licence for all superannuation funds that offer insurance.

Comprehensively review insurance in super

There are many changes underway to insurance in super, and the Commission's recommendations will add to these. Ultimately, what matters is that members get good outcomes: insurance that meets their needs, and does not unnecessarily erode their super balances. It is not clear whether initiatives currently underway will achieve this goal.

There should be an independent public inquiry of insurance in super within four years of completion of this inquiry. The inquiry should evaluate the effectiveness of policy initiatives to date, examine the costs and benefits of retaining current insurance arrangements on an opt-out (as opposed to an opt-in) basis, and consider if more prescriptive regulation is required. It should also look at the intersection of insurance in super with other schemes (such as worker's compensation) and answer the broader policy question of how best to provide assistance to people in the event of illness and injury, including whether opt-out insurance through super is the most efficient and equitable way to do so (which is beyond the scope of this current inquiry).

RECOMMENDATION 18 INDEPENDENT INQUIRY INTO INSURANCE IN SUPER

The Australian Government should commission an independent public inquiry into insurance in superannuation. This inquiry should evaluate the effectiveness of initiatives to date, examine the costs and benefits of retaining current insurance arrangements on an opt-out (as opposed to an opt-in) basis, and consider if more prescriptive regulation is required. It should also look at the intersection of insurance in super with other schemes (such as workers' compensation) and consider how best to provide assistance to people in the event of illness and injury, including whether opt-out insurance through superannuation is the most efficient and equitable way to do so.

This insurance inquiry should be initiated within four years from the completion of this inquiry report.

13.5 Best practice fund governance

Super funds have some similarities with listed companies, where members effectively own the equity (here assets) of the fund. But unlike listed companies, super fund members have no voting rights and little if any influence over board appointments. Members also tend to be much more disengaged than shareholders. Individual members are unable to put much discipline on funds (short of exercising their right to switch — which few do) so the regulator must act on their behalf.

Over the past 30 years the governance of super funds has improved greatly, albeit from a low 'cottage industry' base. Yet governance practices still lag behind contemporary best practice in some important ways. There is considerable room for improvement (chapter 9). The Commission is thus recommending four groups of amendments to governance rules to lift the performance of boards and make trustees more accountable to their members. Chapter 9 sets out the case for these changes in more detail.

Strengthen the focus on skilled board members

All super fund boards should have a good mix of knowledge, skills and experience, and be free from potential conflicts of interest. In most cases this will mean recruiting directors from a broad range of backgrounds — not just from within sponsoring entities or related parties.

A focus on skills would likely lead to more independent directors as boards recruit from a wider 'gene pool'. Tightening the definition of 'independence', as the Government has proposed, will help by putting a stronger focus on recruiting genuinely independent directors. But the debate over mandating independent directors has become highly polarised. Arguing only about the number of independent directors on a board loses sight of what matters: getting the right mix of knowledge, skills and experience, and managing conflicts of interest.

APRA already sets standards that require boards to have policies relating to board skills and composition, but more needs to be done to lift the rigour of board appointments and put the focus on strategically identifying and rectifying skills gaps. Trustees of all super funds should be required to have, use and disclose a process to effectively assess, at least annually, their board's performance relative to its objectives and the performance of individual directors.

Alongside this, boards should be required to maintain a skills matrix that identifies the skills and experience of each trustee director (and publish a consolidated summary each year that reflects the collective skills and experience of the board), such that new appointments can be selected on the basis of filling identified gaps in expertise. This would better align super funds with best practice for companies listed on the stock exchange.

Trustees should also be required to engage an external third party to evaluate the performance of the board (including its committees and individual trustee directors) and capability against the skills matrix at least every three years. APRA should be provided with the outcomes of such evaluations as soon as they have been completed.

Best practice also means that all new board appointees have a professional understanding of the super system and investment decision making, gained either through industry experience or formal training. This should be a regulatory requirement.

Require more rigorous management of conflicts

Evidence presented to the FSRC reveals the impacts on members of poorly managed conflicts of interest (particularly, but not only, in retail funds). Conflicts of interest raised by use of related parties need to be managed by trustees and, where found to be poorly managed, redressed decisively by confident regulators.

Stronger disclosure is needed to shine a light on conflicts of interest and put pressure on trustees to first avoid conflicts and then better manage (unavoidable) residual conflicts. While there are valid reasons for not disclosing all information funds hold (for example, where disclosure could harm members or third parties) — there are some clear gaps in current requirements for what funds must report to APRA. Prime among these is a lack of transparency on outsourcing arrangements, especially where a related party has been used (chapter 7).

APRA should require funds to conduct formal due diligence of their outsourcing arrangements at least every three years, to determine whether their arrangements are achieving value for money (section 13.6). A copy of the assessment should be provided to APRA (including the fees paid to each provider and a comparator based on other fees charged in the market). Funds should also publicly disclose to current and prospective members the proportion of costs paid to service providers that are associated with related-party outsourcing arrangements. Broader improvements to disclosure, including through better data collection, are discussed in sections 13.3 and 13.6.

Further rigour is also needed in the contracts that trustees sign with outsourced providers, regardless of whether they use related or unrelated parties. APRA should require trustees (where they do not do so already) to include in all material service contracts a clause that obliges the service provider not to do or take any action that adversely affects members' interests (section 13.6). Combined with more rigorous auditing requirements on funds, this should help trustees to ensure they have contracted rights to appropriate performance data from service providers to satisfy themselves (through regular reporting and trustee oversight) that retaining the contractor remains in the best interests of members. It would also facilitate severing a contract where members' interests are being harmed, but without diluting the trustee's ultimate responsibility to act in the best interest of members. The absence of such contractual rights, trustee oversight and enforcement was demonstrably revealed through the hearings of the FSRC.

RECOMMENDATION 19 REGULATION OF TRUSTEE BOARD DIRECTORS

APRA should amend its prudential standards to be prescriptive in:

- requiring trustees of all superannuation funds to have and use a process to effectively assess their board's performance relative to its objectives and the performance of individual directors, and to disclose this process annually
- requiring all trustee boards to maintain a skills matrix and annually publish a consolidated summary of it, along with the collective skills of the trustee directors
- requiring trusts to have and disclose a process to seek external third-party evaluation of the performance of the board (including its committees and individual trustee directors) and capability (against the skills matrix) at least every three years. The evaluation should consider whether the matrix sufficiently captures the skills that the board needs (and will need in the future) to meet its objectives, and highlight any capability gaps. APRA should be provided with the outcomes of such evaluations as soon as they have been completed
- requiring all trustee board directors to have a professional understanding of the superannuation system and investment decision making, gained either through industry experience or formal training
- defining what constitutes an 'independent director', based on the definition currently in the Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017.

The Australian Government should ensure that there is no legislative impediment to APRA defining what constitutes an 'independent director', or to superannuation funds appointing independent directors to trustee boards (with or without explicit approval from APRA). It should also give APRA powers to interpret and enforce the definition of an independent director.

Reduce impediments to mergers

The super system is populated by a large number of funds, some of which have achieved significant scale, and others that are very small — for example, about half of all APRA-regulated funds (93 funds) have less than \$1 billion in assets (chapter 7). Size is not the sole determinant of performance, but both underperformance and evidence of clear economies of scale point to scope for more fund mergers in the interest of members. A typical full-time worker experiencing the investment performance of a bottom-quartile fund over their lifetime would retire with a balance 54 per cent (or \$660 000) lower than if they experienced returns commensurate with the top quartile (based on the median fund's return in each quartile) (chapter 2).

Regulators can do more to facilitate mergers between underperforming (including subscale) funds. As described above, the elevated outcomes testing regime will require these funds to regularly assess their sustainability and put pressure on them to merge — with APRA poised to take regulatory action to facilitate or compel a merger where outcomes are not achieved (section 13.2). APRA should also have the power to relax the equivalent rights test where trustees that fail an outcomes test are unable or unwilling to transfer the affected members to a better fund.

To further support merger activity, trustees on both sides of a merger attempt should be required to disclose all such attempts (that reach the memorandum of understanding stage) to APRA, as well as the reasons why a failed merger did not proceed and the assessment of members' best interests that informed the decision (chapter 9). This will help APRA to better identify where prospective mergers would or would not be in the best interests of members. Further, APRA should be empowered to prevent mergers that would not be in members' best interests.

In addition, ASIC should proactively investigate questionable cases where mergers between super funds stalled or did not proceed. Combined with more information sharing between APRA and ASIC, the latter will be better placed to enforce the legal duties of trustees and take strategic action against misconduct. ASIC should be empowered to pursue action, if merited, against misconduct by directors in the event of a failed merger.

In addition, the Australian Government should make capital gains tax relief permanent for funds that merge, and require APRA to report annually to the Council of Financial Regulators on funds' progress in implementing the elevated outcomes tests, the extent to which the tests are bringing about fund mergers and APRA's progress in supervising and enforcing where mergers are not proceeding when they should be. ASIC should report on enforcement action against directors who breach their duties by not pursuing a merger when it would be in their members' best interests.

RECOMMENDATION 20 **DISCLOSURE OF MERGER ACTIVITY**

The Australian Government should require trustee boards of all APRA-regulated superannuation funds to disclose to APRA when they enter a memorandum of understanding with another fund in relation to a merger attempt. For mergers that ultimately do not proceed, the board should be required to disclose to APRA (at the time) the reasons why the merger did not proceed, and the members' best interests assessment that informed the decision. APRA should also be empowered to prevent mergers that are not in members' best interests.

The Australian Government should also legislate new powers and penalties to explicitly enable ASIC to pursue action against trustee directors for misconduct in relation to mergers.

RECOMMENDATION 21 **CAPITAL GAINS TAX RELIEF FOR MERGERS**

The Australian Government should legislate to make permanent the temporary loss relief and asset rollover provisions that provide relief from capital gains tax liabilities to superannuation funds in the event of fund mergers and transfer events.

Ensure a shared understanding of 'members' best interests'

Funds clearly do not always act in the best interests of their members. This may reflect a lack of clarity around the best interests duty under the *Superannuation Industry (Supervision) Act 1993* (Cth) — so that trustees are not always clear what is expected of them. Relevant case law is limited. But what is clear is that 'members best interests' need to be better defined and enforced. The Australian Government should pursue a definition that reflects the twin principles that a trustee should act in a manner consistent with what an informed member might reasonably expect and that this must be manifest in member outcomes. The Government could do this by re-articulating the definition in legislation, by providing clearer guidance in regulation, and/or by regulators confidently pursuing 'test cases' through the courts. Any action taken by the Government should also be informed by any relevant findings from the FSRC.

RECOMMENDATION 22 DEFINITION OF THE BEST INTERESTS DUTY

The Australian Government should pursue a clearer articulation of what it means for a trustee to act in members' best interests under the *Superannuation Industry (Supervision) Act 1993* (Cth). The definition should reflect the twin principles that a trustee should act in a manner consistent with what an informed member might reasonably expect and that this must be manifest in member outcomes. In clarifying the definition, the Government should decide whether to pursue legislative change, greater regulatory guidance, and/or proactive testing of the law by regulators. It should be informed by the findings of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*.

13.6 System governance that champions members

For most members, superannuation is based on trust. Members need to trust their fund to manage and invest their money wisely, and to trust that regulators will police bad behaviour in the system. But regulators have made poor use of data and let much member harm (including underperformance) go unchecked and some misconduct unpunished. And while supply-side participants have been vocal in policy and regulatory debates, a member voice has been distinctly lacking. More robust system governance is needed.

Strengthen regulator capability

The key regulators — APRA, ASIC and the ATO — mostly perform their core duties satisfactorily, but conduct regulation arrangements are confusing and opaque. The greatest confusion is in the respective roles of APRA and ASIC (chapter 10). There is significant overlap and no clear delineation between their roles, which poses the very real and ongoing risk that regulatory breaches could 'fall through the cracks' as a result of divided responsibilities (with each regulator believing the other was, or should be, dealing with a matter). This blurring of responsibilities has also led to heavy reliance on cooperation between the regulators, while detracting from their individual accountability.

The result is that strategic conduct regulation appears to be largely missing in action — especially when it comes to public deterrence. Ideally, this would involve a regulator proactively identifying actual or potential instances of material member harm, investigating the underlying conduct and taking strategic enforcement action in a way that provides a valuable public deterrent to future poor conduct. The FSRC's hearings have highlighted the deficit, to date, of public exposure of poor conduct (and associated penalties) to demonstrably discourage similar behaviour by others — now and in the future.

Regulator capability needs to be strengthened to achieve better regulatory practice, and especially better strategic conduct regulation. This requires clarifying the respective roles of APRA and ASIC and setting clear expectations of each. It also requires bolstering their regulatory toolkits to ensure they have the powers needed to confidently and effectively enforce the law.

Clearer roles and powers

The broad responsibilities of APRA and ASIC are well known and accepted, and each regulator's role should be more closely focused on its 'regulatory DNA' to be effective:

- APRA should be focused on matters relating to licensing and authorisation, ensuring high standards of system and fund performance.
- ASIC should be focused on the conduct of trustees and advisers, and the appropriateness of products (including for particular target markets) and disclosure.

Consistent with these principles, the Commission is recommending specific actions for each regulator. APRA should apply the elevated MySuper and choice outcomes tests and overseeing the withdrawal of products that fail the tests in a way that protects members (section 13.2). It should also have stronger oversight of fund outsourcing arrangements (section 13.5) and transfers or mergers proceeding where funds fail the outcomes tests.

ASIC should more proactively investigate trustee misconduct in relation to failed mergers (section 13.5), proactively set and enforce disclosure requirements, monitor fees charged to members (section 13.3), and take the lead in working with industry to bolster the insurance code and make it enforceable on trustees (section 13.4).

ASIC should also play a more prominent role as a strategic conduct regulator, especially through targeted, public deterrent enforcement action. It is well suited to undertaking public enforcement activities that provide a strong demonstration effect to all super fund trustees. This is not to imply that APRA should not also do this within its areas of regulatory responsibility — to the contrary, APRA also needs to take more enforcement action that acts as a deterrent. But ASIC should be the primary strategic conduct regulator.

The Commission is mindful that these matters may be subject to consideration by the FSRC. Ultimately, and with the benefit of this report and that of the FSRC, the Government should clarify the precise allocation of roles between APRA and ASIC without delay. At the same time, it should comprehensively examine whether APRA and ASIC need stronger powers and whether penalty provisions should be strengthened, especially in terms of policing misconduct. This could involve, for example, providing ASIC with additional powers under the Superannuation Industry (Supervision) Act, introducing civil penalty provisions for trustee misconduct, and extending ASIC's forthcoming product intervention powers to cover MySuper.

The Commission does not consider that a single regulator would therefore solve regulatory problems in superannuation — most of which stem from a lack of effective accountability by government of the regulators (discussed below). New boundary issues would be created and tensions would remain, albeit located within one body. A regulator focusing exclusively on superannuation would also potentially lack the broader perspectives gained from being exposed to issues elsewhere in the financial services sector.

RECOMMENDATION 23 AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

APRA should focus more on matters relating to licensing and authorisation, ensuring high standards of system and fund performance. It should (in addition to recommendations 4, 16 and 19):

- supervise and enforce the obligations of the licences and authorisations it grants
- require all APRA-regulated superannuation funds to conduct formal due diligence of their outsourcing arrangements, at least every three years, to ensure the arrangements provide value for money. Each fund should provide a copy of the assessment to APRA (including the fees paid and the comparator fees)
- require all APRA-regulated superannuation funds to include a clause in material service contracts with outsourced providers that obliges the provider not to do or take any action that adversely affects members' interests
- report annually to the Council of Financial Regulators on funds' progress with implementing the elevated outcomes tests and on fund merger activity
- undertake a systematic assessment of the costs to funds of the thousands of legacy products in the superannuation system. If the evidence demonstrates that they represent a significant cost in accumulation, APRA should further refine trustees' obligations for member transfers so these products can be rationalised
- embed product-level reporting within its reporting framework as soon as practicable (no later than 18 months) to enhance visibility of actual member outcomes across all APRA-regulated funds and to bring reporting for the choice segment into line with the MySuper segment. APRA should also expedite efforts to address inconsistencies in reporting practices.

The Australian Government should set an explicit 'member outcomes' mandate for APRA in its regulation of superannuation.

RECOMMENDATION 24 AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

ASIC should focus more on the conduct of superannuation trustees and financial advisers, and on the appropriateness of products (including for particular target markets) and disclosure. It should (in addition to recommendations 6 and 8):

- proactively set and enforce standards for the meaningful disclosure of information to members on superannuation products and insurance policies (in addition to product dashboards). Information should be simple, comparable and easy for members to understand
- require all superannuation funds to publicly disclose to current and prospective members the proportion of costs paid to service providers that are associated with related-party outsourcing arrangements
- proactively investigate (questionable) cases where mergers between superannuation funds stalled or did not proceed, and report to the Council of Financial Regulators on its enforcement against trustee directors who breach their duties by not pursuing a merger when it would be in their members' best interests
- undertake recurring thematic reviews on financial advice in superannuation, including advice in relation to choice platform products and SMSFs.

RECOMMENDATION 25 CLARIFY REGULATOR ROLES AND POWERS

The Australian Government — with the benefit of this inquiry report and that of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* — should clarify the roles of APRA and ASIC in relation to superannuation. In doing so, it should consider the suitability of each regulator's powers, the suitability and strength of penalty provisions for misconduct, and whether there are any undesirable constraints on either regulator engaging in strategic conduct regulation.

Greater accountability

The accountability mechanisms for regulators that exist within the Australian (Westminster) system of government — such as ministerial and Parliamentary oversight and inquiries, performance reporting, the Statement of Expectations and Statement of Intent — have been left dormant or at best underutilised by the Government in the case of APRA and ASIC. As a result, ASIC and APRA have been left to make decisions in isolation regarding the 'public interest' — decisions that are properly the preserve of elected ministers.

To enable better accountability, the Australian Government should set clearer expectations of each regulator and monitor their performance against these expectations. While this would mostly involve updating Statements of Expectations for each regulator, it could also require some legislative adjustments.

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- For APRA, the Government should provide a more explicit ‘member outcomes’ mandate to replace its traditional prudential mandate. In defined contribution, the main threats to members are likely to be issues of poor performance, excessive fees or poor handling of conflicts of interest by trustees — not just a matter of accounting for the money. The Government should also clarify that ‘outcomes’ should be synonymous with actual member outcomes, not adherence with processes.
 - For ASIC, the Government should set clearer expectations that ASIC should identify and prioritise enforcement action where there is greatest potential for member harm and where ‘test cases’ are needed to establish and clarify the law by strategically choosing which cases to pursue in the courts (as showcased by the ATO and Australian Competition and Consumer Commission). Regulators should not be so conservative that they never risk losing a case — indeed, an unexpected loss could helpfully prompt legislative change where this is considered desirable by government.
 - For the ATO, the Government should set clear expectations for the provision of a centralised online service, cleaning up lost and unintended accounts, policing unpaid contributions, and regulating SMSFs.

While Statements of Expectation (and Intent) already exist for the regulators, they are deficient in some areas, such as the articulation of risks and accountability processes (chapter 10).

It is essential that the regulators work closely together to share information (including on trustee and adviser conduct), prioritise areas for closer scrutiny (with the elevated outcomes tests playing a frontline role) and coordinate enforcement action. A revamped memorandum of understanding between APRA and ASIC would help in this regard, as would a memorandum of understanding between ASIC and the ATO in relation to SMSFs.

Regulator accountability should also be bolstered by regular reporting to the Government and the public. Each year, both APRA and ASIC should identify their enforcement priorities for the coming year. In addition, APRA should report on the outcomes members are experiencing from the super system and flag areas for improvement.

Better resourcing

Government also has a duty to ensure the regulators have adequate expertise and resources to deliver on the expectations that have been set. While the Government has already initiated a capability review of ASIC, no such review has taken place for APRA, even though the Government had previously agreed to initiate one. Recently announced reviews are no substitute, nor is the recent review of APRA by the International Monetary Fund. A capability review should be initiated immediately. This review should also examine the number and capability of staff dedicated to regulating superannuation, future resourcing needs (including those likely to arise from implementing this inquiry’s recommendations), internal governance structures, data analytics capabilities and the use of APRA’s powers.

RECOMMENDATION 26 APRA CAPABILITY REVIEW

The Australian Government should immediately initiate the independent capability review of APRA, which it had previously agreed to do. This review should also examine how efficiently and effectively APRA operates to achieve its strategic objectives in relation to superannuation, including:

- the capability of APRA to adequately supervise and regulate the superannuation system in line with its current responsibilities and those proposed in draft legislation (as well as future responsibilities arising from the implementation of recommendations in this inquiry), including a focus on capability in enforcement
- identification and analysis of immediate and forward-looking priorities and risks
- the use of legal powers and enforcement tools, including the pursuit of test cases and effective coordination with ASIC and other regulators in this regard
- the skills, capability and culture of the organisation, including the number of staff dedicated to regulating superannuation and their capabilities
- internal governance and accountability mechanisms
- engagement and information sharing with other regulators, especially ASIC
- the use of data collection and analytics
- future resourcing needs.

The review should be completed and published during 2019.

Collect better data

There is also scope for regulators to make greater use of data, both as an input to their duties (as a necessary precursor to strategic conduct regulation) and to inform the broader public. Despite regulator awareness, there are some major gaps and inconsistencies in the datasets held by regulators — such as returns and fees for choice products and by asset class, fund outsourcing arrangements, and details of the insurance members hold through super. Among the most egregious is serial under-reporting and non reporting of indirect investment costs.

Poor-quality disclosure by funds appears to go unchecked and unpunished, and attempts to modernise data collection have been slowed down by industry opposition (largely on the basis of short-term compliance costs) and the lack of a strong member voice to give impetus to change. To say this inquiry has been hampered by data problems is an understatement (chapter 10). The Commission's funds survey was designed to plug some of these gaps, but many responses fell well short of 'best endeavours', even after funds were given a second chance — which of itself proved revealing.

The regulators need to confidently and systematically collect more data that are relevant for assessing member outcomes — and to make these data public. This would help members to compare how their fund is performing, shine a light on the best performers (thereby making competition 'fairer'), help the regulators to perform and prioritise their activities, and

improve public confidence in the system by way of greater regulator accountability. It cannot be overstated how fundamental data analytics are to strategic and effective conduct regulation of the super system. Government needs to hold the regulator accountable, such that ongoing monitoring and decisive action occur.

APRA, as the system's main data custodian, should enhance its data reporting framework to collect more data on actual member outcomes. At a minimum, this should include the data used in this inquiry to benchmark investment performance (including by asset class) and compare fees and costs. Indeed, there is nothing to prevent the regulators from collecting the data needed to replicate — and extend — the analysis undertaken by the Commission in the course of this inquiry. APRA should also address glaring deficiencies in its existing data collection, tackle inconsistencies and misreporting by funds head-on, and collect and publish member and performance data at the investment option and asset-class level (including legacy products).

APRA already has the necessary legislative powers to do this — as well as the power to punish trustees that fail to adequately comply. Indeed, funds should have all of this information if they were acting in members' best interests in a day-to-day operational sense. Those funds that do would only face modest costs of supplying it to APRA. Those that do not will need to lift their game.

Other regulators can play a supporting role. ASIC needs to take leadership on requiring funds to publish a dashboard for all their products (recommendation 6). It should also make use of the data APRA collects to inform its strategic conduct regulation. The ATO is best placed to link data on members across multiple accounts, and to shine more light on the outcomes of SMSF members — indeed, it is currently in the process of ramping up the types of data that it collects on members (such as balances and contributions) from their super fund (O'Halloran 2018). As the custodian of data on taxation and taxpayers, the ATO could also link data on members' superannuation outcomes to other data on their income, wealth and household characteristics — which it has already started doing through its aLife project (ATO 2016b).

To support these improvements to data, a working group should be established, comprised of APRA, ASIC, the ATO, the Australian Bureau of Statistics and the Commonwealth Treasury, as well as the member advocacy body described below. This working group should be tasked with modernising data collection and analysis across the whole super system, with a strong focus on collecting and publishing consistent data. It should also draw on consumer testing and evidence from behavioural economics in deciding how best to present data. Treasury should take the lead on this working group.

RECOMMENDATION 27 SUPERANNUATION DATA WORKING GROUP

The Australian Government should establish a permanent superannuation data working group, comprised of APRA, ASIC, the ATO, the ABS, the Commonwealth Treasury and the new member advocacy body (with Treasury taking the lead). This group should:

- identify ways to improve the consistency and scope of data collection and release across the system, with a focus on member outcomes
- evaluate the costs and benefits of reporting changes, including strategies for implementation
- identify areas where legislative or regulatory change may be necessary to support better data collection
- report annually to the Council of Financial Regulators on its progress, and on the data analytics capabilities of each regulator.

Support a well-funded independent member champion

Member advocacy on superannuation is lacking. The availability of resources on the industry side has meant that much of the discourse on superannuation has been dominated by the interests of funds and their service providers rather than the interests of members. There is a lack of a single, well-resourced body to effectively advocate the views and perspectives of superannuation members in policy and regulatory deliberations — along the lines of what already exists in telecommunications and energy.

A new organisation to understand, promote and give voice to member interests is urgently needed, and the Government should provide ongoing funding for it. This organisation should provide assistance to members (including truly independent information and guidance), undertake and fund research and data analysis, and work with regulators and other bodies to advocate on behalf of members. The Superannuation Consumers Centre — established in 2013 and first funded in 2018 — is a possible contender to do this.

RECOMMENDATION 28 AN INDEPENDENT MEMBER ADVOCACY BODY

The Australian Government should, as a priority, provide adequate ongoing funding to support an independent superannuation members' advocacy and assistance body.

Ongoing review

Ensuring the super system works for all members will require ongoing review of outcomes and policy settings and, where necessary, adjustments. There are some elements that should be reviewed regularly, rather than on an ad hoc basis.

-
- Every two years, APRA and ASIC should jointly produce a *State of Superannuation* report to detail the performance of the system (akin to the Commission’s analysis in this inquiry), including outcomes relating to investment performance, fees, low-balance inactive accounts, merger activity and the elevated MySuper and choice outcomes tests. This report should also detail progress by the industry and regulators to implement government policy changes and address performance and member harm issues identified in this inquiry report.
 - Every five years, the Australian Government should commission an independent review of the effectiveness of the MySuper and choice elevated outcomes tests at meeting their objectives, and whether they are being suitably applied by APRA to remove underperforming funds and options from the super system.
 - Every ten years, the Australian Government should commission an independent public inquiry into the super system, including a review of the criteria used to assess best in show products.

In addition, existing reporting mechanisms should be better deployed by regulators to more clearly report on their progress in implementing policy changes and their enforcement priorities (discussed above). There should also be an independent inquiry into insurance in super within four years (section 13.4).

RECOMMENDATION 29 ONGOING REVIEW OF THE SUPER SYSTEM

The Australian Government should:

- require APRA and ASIC to jointly produce a *State of Superannuation* report every two years on the performance of the superannuation system, including outcomes relating to investment performance, fees, low-balance inactive accounts, merger activity and the elevated MySuper and choice outcomes tests. This report should also detail progress by the industry and regulators to implement Government policy changes and address performance and member harm issues identified in this inquiry report
- commission an independent review, every five years, of the effectiveness of the MySuper and choice elevated outcomes tests at meeting their objectives, and whether they are being suitably applied by APRA to remove underperforming funds and options from the super system
- commission an independent public inquiry, every ten years, of the superannuation system, including a review of the criteria used to assess ‘best in show’ products.

The Australian Government should also commission an independent public inquiry into the role of compulsory superannuation in national savings and the broader retirement incomes system, and including ahead of any increase in the Superannuation Guarantee rate above current levels. This review should examine the net impact of compulsory super on private and public savings, as well as its distributional impacts across the population and over time. It should also holistically examine the role of superannuation in funding retirement

(alongside the Age Pension, private savings, housing and aged care), and its impact on public finances (including tax concessions and Age Pension outlays). Further, the inquiry should examine the economic and distributional impacts of the non-indexed \$450 a month contributions threshold. These public policy issues have not been subject to review since they were (partially) considered by the FitzGerald Report on National Savings in 1993 (FitzGerald 1993).

RECOMMENDATION 30 INDEPENDENT INQUIRY INTO THE RETIREMENT INCOMES SYSTEM

The Australian Government should commission an independent public inquiry into the role of compulsory superannuation in the broader retirement incomes system, including the net impact of compulsory super on private and public savings, distributional impacts across the population and over time, interactions between superannuation and other sources of retirement income, the impact of superannuation on public finances, and the economic and distributional impacts of the non-indexed \$450 a month contributions threshold. This inquiry should be completed in advance of any increase in the Superannuation Guarantee rate.

13.7 How to implement these recommendations

The package of policy improvements in this report is designed to lift the overall performance (efficiency and competitiveness) of Australia's super system. Collectively, the improvements will modernise the super system by harnessing healthy competition and making it better equipped to serve the needs of all Australians into the future.

To achieve these outcomes, the industry and its structure will need to change. Making sure this happens in an orderly manner will require a considered transition and implementation strategy that delivers outcomes that are in members' best interests — and that is manageable for the regulators (especially APRA) to oversee and for industry to digest. The objectives of such a strategy should be to minimise member harm by:

- reducing disruption to members currently in high-performing funds
- avoiding material losses to members who need to be transferred to a new fund
- attaining the benefits of a modern super system as soon as possible.

As change proceeds, system stability should be viewed through the long-term lens of members being shepherded from poor to better performing funds and products, with those members bearing no further erosion of balances by way of poor transition (for example, due to poorly timed asset sales or insufficient fund liquidity arising from moving balances too rapidly). This applies equally to movements of members and assets that are initiated by funds and regulators, as well as to movements initiated by members themselves — especially if switching rates are higher than in the past.

With these objectives in mind, the Commission has designed a transition timetable that allows for a considered implementation of the recommendations in this report (figure 13.3). The transition to a modern super system should be achievable within three years (following the passage of legislation, with the Commission anticipating one year for legislation to be passed). The main components are set out below (with the exception of insurance, covered in section 13.4). The Commission discussed the implementation timetable with APRA and ASIC to ascertain its feasibility and consequential resourcing needs.

Clean up underperformance

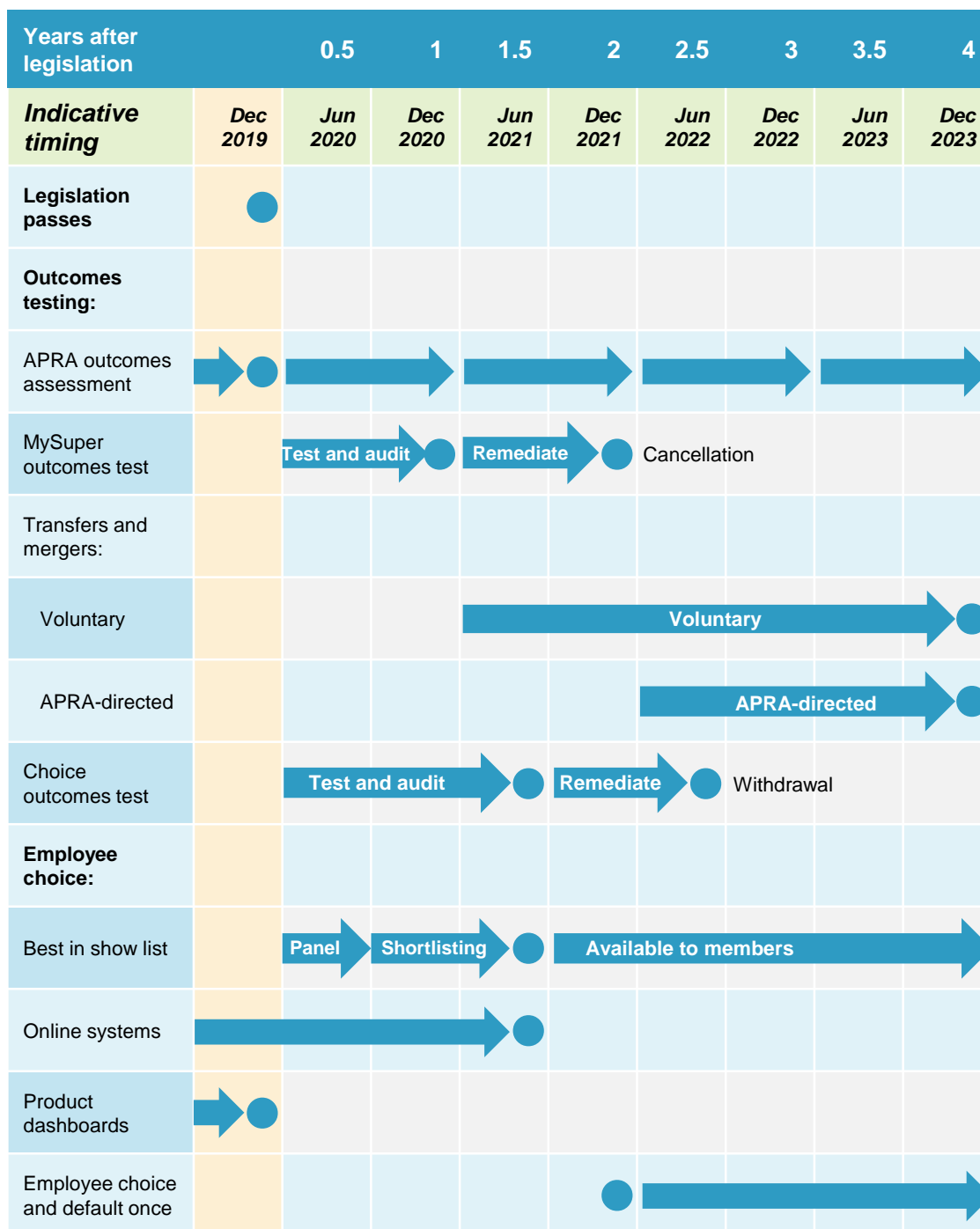
Introducing elevated outcomes testing — for both MySuper and choice — will compel trustees of underperforming funds and options to remedy their underperformance or transfer their members elsewhere. Much of this is expected to occur as trustees take voluntary action ahead of potentially having their MySuper authorisation revoked or being directed by APRA to withdraw choice options (as set out in section 13.2). Some trustees may also decide to wind-up or merge their fund ahead of the best in show process and switch from employer to employee choice (see below).

In all likelihood, there will be an uptick in merger activity across the super system. The Commission expects that a material number of products and funds will be closed during the transitional period — and especially choice legacy products. APRA will need to provide careful and timely oversight of affected funds — and may itself need additional resourcing during this period — to ensure members' interests are protected (box 13.2).

The Commission's transition timetable allows room for an orderly exit of underperformers, a process that may already have started as a result of elevated member switching in light of the FSRC.

- APRA's forthcoming outcomes assessments (in a prudential standard that takes effect from 1 January 2020) will put greater discipline on how funds assess the outcomes they are delivering for their members. Trustees of funds that are unlikely to remain sustainable in the future would be expected to improve the performance of their investment options (such as by reducing fees) or commence (if they have not already) a merger.
- Once legislation requiring outcomes tests is passed, funds would have 12 months to undertake their first elevated MySuper outcomes test, and 18 months for their choice outcomes tests. This includes obtaining independent verification. Not all trustees will require the whole time period, and some are anticipated to choose to complete their outcomes tests earlier.
- Where an investment option 'fails' the elevated outcomes test (as determined by APRA), the fund would have 12 months to remediate its performance or transfer members elsewhere. If this does not occur, APRA would need to oversee a process of transferring the members to another fund, as described in section 13.2.

Figure 13.3 Implementation: a transition road map



In supervising these processes, APRA should prioritise the removal of underperforming MySuper products from the system, with the orderly transfer of members to better performing MySuper products (including, where appropriate, to those on the best in show shortlist). It is also expected that, as these processes unfold, the potential to acquire

additional members will benefit many of the funds on the best in show shortlist, and thus make competition for the initial best in show shortlist more attractive for funds.

Box 13.2 What does implementation mean for system stability?

As the effects of policy change work through the system, stability should rightly be a concern, but should solely be seen through the lens of members. The overriding objective of funds and regulators should be the shepherding of members from poor to better performing funds or products with no further erosion of their balances by way of poor transition. Cooperation between funds and APRA should minimise any risk of harm to members.

Implementation of elevated outcomes tests could see both small and large funds potentially seek to exit the system. But, as APRA noted (sub. DR204, p. 11):

... whilst there will be significant impacts in the medium to long term for individual funds that lose default [MySuper] status, these impacts could, with adequate transition arrangements, be managed at an individual RSE licensee level without causing undue instability or material adverse impacts for members.

The move to the new default allocation mechanism will also have implications for inflows and outflows of members (and their balances) from existing funds. Funds on the best in show shortlist will likely see greater inflows of new members, while those that miss out may see some of their members voluntarily switch funds. This is unlikely to destabilise the system. Commission modelling suggests that even if many members chose to switch to a shortlisted fund, and other funds needed to exit or merge in the first few years, this should be manageable for APRA (chapter 12) — a view confirmed by the regulator (APRA, sub. DR204). This activity would advance (not compromise) members' interests.

Moreover, the default once element of the new mechanism would mean a fall in new members for many funds, but the cashflow impacts of this change would be offset by a reduction in outflows as contributions from current members are retained when they change jobs (and do not choose to switch funds). APRA modelling suggests the impact on funds would not be immediate nor drastic, and funds would have time to react and adjust their operations.

Build the new choice architecture

Several structures need to be in place before switching from employer-chosen defaults to employee choice, so that making a choice is simple and safe for members (section 13.1). The process of cleaning up the 'tail' of underperforming MySuper products will need to have commenced (as described above), so that new members cannot join these products.

Most of the other components will need legislation passed before they can commence, but work on some parts can start now.

- An expert panel to select the best in show shortlist will need to be appointed. This should take no more than 6 months after passage of legislation.
- Developing and publishing the first best in show shortlist can be done over the following 12 months. This includes the panel articulating its precise selection criteria, funds making submissions to the panel, and the panel evaluating those submissions and finalising the shortlist.

-
- The ATO will need to design, test and implement the centralised online service to present the best in show list. There is nothing to prevent this commencing before legislation is passed — and it need not hold up developing the first best in show shortlist.
 - ASIC will need to refine product dashboards and ensure full compliance across the super system. This should be done as soon as possible, and ahead of the other components. ASIC and the ATO will also need to work together to ensure the dashboard metrics are smoothly incorporated into the centralised online service.

With adequate resourcing for the agencies involved, these milestones should all be achievable by 18 months after the passing of legislation. As soon as the new choice architecture is in place, it should be made available to all members via myGov, enabling them to compare, switch and consolidate their super accounts (even before changes to how defaults are allocated). This change should, ideally, induce an uptick in voluntary member switching as members begin switching to better funds — an awakening of healthy competition that should be manageable for high-performing funds and the regulator (box 13.2).

Having the first best in show shortlist available by the 18-month mark would also facilitate both voluntary and APRA-directed transfers of members out of underperforming MySuper products. And once the shortlist is in place, there is no compelling reason to delay a move to default once and removing employer choice of defaults (see below).

This would mean that the initial 6 months (of the total four year duration) of the first best in show list would be a period of merger activity and voluntary member choice. As noted, the potential to gain additional members as underperformance is cleaned up would likely boost the incentives of funds to participate in the best in show process.

Remove employers from selecting defaults

The final step in the transition is to remove employers from selecting defaults. This means switching to sequential allocation from the best in show shortlist to default new workforce entrants that do not make a choice of their own, and implementing systems for existing members to keep their account when they change jobs (unless they choose otherwise) — a world of ‘default once’. It will remove the twin risks of members being defaulted into an underperforming product or accumulating unintended multiple accounts.

Breaking the nexus between job and default fund would immediately shrink the importance of employers and the workplace relations system in selecting default funds. Specific workplace instruments (including modern awards) would need to be amended to permit this, such that employers can legally direct default contributions to a fund specified by the ATO (on the basis of an employee’s existing account or defaulting to the best in show list). This will likely require legislative intervention, should the FWC be unwilling or unable to modify modern awards accordingly.

However, moving to employee choice and default once will also be a major change for those funds currently reliant on default inflows, and most will need time to adjust to this, whether

by adapting their member engagement and marketing strategies, restructuring their products or merging with another fund. Nevertheless, the short-term impact on the cashflows of these funds should be modest in most cases, as the contribution flows of members moving in and out of a fund due to job turnover would roughly offset each other in most cases.

A case could be made for removing employers from selecting defaults two years after the passing of legislation. By this point, the supporting choice architecture would be in place and the risk of default members being stuck in underperforming products removed. Should circumstances permit, however, an earlier move to ‘default once’ would benefit members and should be considered.

How to keep transition on track?

These policy changes are of significant import to future national wellbeing. The transition to a modern super system should be overseen by a Steering Group of senior officials within the Government. Given the policy imperative of timely and effective implementation, this group should comprise the Secretary of the Department of the Prime Minister and Cabinet, Secretary to the Treasury, Chairs of APRA and ASIC, and the Commissioner of Taxation. Their representation on this Steering Group should not be delegated.

Effective implementation will also require that all relevant regulators and agencies have adequate capability and resourcing. APRA will be at the centre of the changes, and should be subject to a capability review as soon as possible (section 13.6). Additional powers for the regulators will also facilitate a smooth transition. Crucially, ongoing vigilance is also required so that the ‘tail’ of underperforming products does not regrow over time. Regulator accountability is indispensable.

Beyond the specific recommendations in this inquiry, further changes in enforcement practices or new regulation in some areas may also prove to be warranted, pending the final findings and recommendations of the FSRC. Any such changes will need to be incorporated into the implementation strategy.

RECOMMENDATION 31 A STEERING GROUP TO OVERSEE IMPLEMENTATION

The Australian Government should prioritise the implementation of this inquiry’s recommendations by establishing a Steering Group of Departmental and agency heads to oversee the implementation. This group should comprise the Secretary of the Department of the Prime Minister and Cabinet, Secretary to the Treasury, Chairs of APRA and ASIC, and the Commissioner of Taxation.

A Inquiry conduct and participants

The Commission is undertaking this inquiry under the twin (stage 2 and stage 3) terms of reference. Stage 2 entailed developing alternative models for allocating default members to products (with a draft report in March 2017) (PC 2017d). Stage 3 brings both streams of work together to provide an overall assessment of the efficiency and competitiveness of the superannuation system (including an assessment of default allocation) and recommend policy changes.

The Commission received the terms of reference for stage 3 on 30 June 2017. It subsequently released an issues paper on 7 July 2017 inviting public submissions and highlighting particular matters on which it sought information.

- The Commission received 101 submissions associated with stage 2. These submissions are listed in table A.1 and are available on the inquiry website. As part of stage 2, the Commission met with a wide range of stakeholders including in Chile, New Zealand and the United Kingdom (table A.2). Two days of public hearings were held for this inquiry. Hearing participants are listed in table A.3 and transcripts are available on the inquiry website.
- The Commission received 232 submissions associated with stage 3. These submissions are listed in table A.4 and are available on the inquiry website. As part of stage 3, the Commission held meetings with a wide range of stakeholders (table A.5). The Commission also held four roundtables and the list of participants is contained in table A.6. Three days of public hearings were also held. Hearing participants are listed in table A.7, with the transcripts published on the inquiry website.

Over the course of stages 2 and 3, the Commission received 333 submissions and met with around 100 stakeholders spanning governments, regulatory bodies and peak bodies, as well as superannuation funds, organisations and individuals.

The Commission also had consultancies and contracts with a range of parties. These are listed in table A.8.

The Commission would like to thank all those who contributed to this inquiry, including through participation in its surveys — two of members, two of funds and one of chief executive officers (appendix C).

Table A.1 Submissions^a

Stage 2

<i>Participants</i>	<i>Submission number(s)</i>	
Accommodation Association of Australia (AAA)	16	
Ai Group	21	
AMP	42, DR94	
Association of Financial Advisers Limited (AFA)	DR91	
Association of Superannuation Funds of Australia (ASFA)	24, DR96	
Australian Chamber of Commerce and Industry (ACCI)	27, DR79	
Australian Council of Trade Unions (ACTU)	34, DR71	#
Australian Hotels Association (AHA)	6	
Australian Institute of Superannuation Trustees (AIST)	28, DR90	
Australian Prudential Regulation Authority (APRA)	33, 50, DR101	*
Australian Securities and Investments Commission (ASIC)	41	
AustralianSuper	19, 48, DR60	*
Bell, David	DR83	
BT Financial Group (BTFG), (Westpac)	DR67	
Cbus	DR74	
Centre for International Finance and Regulation (CIFR)	7	
Centre for Market Design	18	
CHOICE	31, DR93	
Club Plus Super	32	*
Colonial First State (CFS), (CBA)	25	
Committee for Sustainable Retirement Incomes (CSRI)	DR75	#
Community Clubs Victoria	9	
Corporate Super Association	35, DR59	
Council of Small Business Australia (COSBOA)	DR86	
Cranford, Alexander	DR54	
Deloitte Touche Tohmatsu (Deloitte)	DR61	
Dixon Advisory	DR76	
Fair Work Commission	51	#
Financial Planning Association of Australia (FPAA)	29, DR98	
Financial Services Council (FSC)	38, 49, DR88	#
Financial Services Institute of Australia (FINSIA)	DR95	
First State Super	26, DR84	
Gateway Network Governance Body (GNGB)	DR72	
Grattan Institute	DR82	
HESTA	37, DR70	*
Independent Fund Administrators and Advisers (IFAA), QIEC Super and Club Super	13, DR65	
Industry Super Australia (ISA)	40, DR78	
Institute of Public Affairs (IPA)	17	
Kinetic Superannuation	45	#

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Table A.1 (continued)

<i>Participants</i>	<i>Submission number(s)</i>
Land, Richard	22
Law Council of Australia	DR80
Limmings, Timothy	DR53
Linacre, Andrew	52
Link Group	DR92
LUCRF Super	30
MacDonald, Michelle	DR77
Mair, Peter	1
Mercer	15, DR73
MetLife Insurance	DR66
Mine Wealth + Wellbeing	46, DR64
Murphy, Sean	DR99
MLC Wealth, (NAB)	DR69
NESS Super	47
Police Federation of Australia (PFA)	14
PricewaterhouseCoopers (PwC)	12, DR85
Queensland Nurses and Midwives' Union (QNMU)	DR57
REST Industry Super	23, DR68
Restaurant and Catering Australia	10
Rice Warner	43, DR87
Simplicity	DR58
SMSF Association (SMSFA)	DR100, DR230
Sunsuper	36, DR89 *
Sweeney, Phillip	2, 3, 5, 8 #
Sy, Wilson	DR63
TAL	44 *
Telford, John	DR55
UniSuper	20, DR62
United Voice	DR97
Vision Super	4
Vanguard	39 *
Whan, Steven	DR56
Workplace Super Specialists Australia (WSSA)	11, DR81

^a An asterisk (*) indicates that the submission contains confidential material NOT available to the public. A hash (#) indicates that the submission includes attachments. DR before a number denotes that the submission was lodged subsequent to the release of the stage 2 draft report.

Table A.2 Consultations**Stage 2**

Participants

Australia

Ai Group

AMP

Association of Superannuation Funds of Australia (ASFA)

Australian Chamber of Commerce and Industry (ACCI)

Australian Communications and Media Authority (ACMA)

Australian Council of Trade Unions (ACTU)

Australian Institute of Superannuation Trustees (AIST)

Australian Prudential Regulation Authority (APRA)

Australian Securities and Investments Commission (ASIC)

Australian Taxation Office (ATO)

AustralianSuper

Chant West

Clark, Gordon (University of Oxford)

ClearView

Department of Employment

Department of Finance

Department of Prime Minister and Cabinet

Fair Work Commission (FWC)

Financial Services Council (FSC)

First State Super and StatePlus

Grattan Institute

Industry Super Australia (ISA)

Mercer Australia

Northern Territory Department of Treasury and Finance

Rice Warner

Superannuation Industry Stewardship Group

The Treasury

UniSuper

Vamos, Pauline

Women in Super

Chile

Bravo, David (Pontificia Universidad Católica de Chile)

Superintendent of Pensions

Villatoro, Felix (Universidad Adolfo Ibáñez)

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Table A.2 (continued)

Participants

New Zealand

ANZ

Booster Investment Management

Commission for Financial Capability

Financial Markets Authority

Financial Services Council

Inland Revenue Department

Kiwibank

Ministry of Business, Innovation and Employment

New Zealand Treasury

Retirement Policy and Research Centre (Auckland University)

Simplicity

United Kingdom

Barr, Nicholas (London School of Economics)

Table A.3 Public Hearings

Stage 2

Participants

Melbourne – 3 May 2017

Australian Council of Trade Unions (ACTU)

HESTA Superannuation fund

Industry Super Australia (ISA)

Minifie, Jim

Simplicity NZ

Council of Small Business of Australia (COSBOA)

Sydney – 8 May 2017

Rice Warner

Financial Services Council (FSC)

CHOICE

Australian Institute of Superannuation Trustees (AIST)

SunSuper

Workplace Super Specialists Australia (WSSA)

Table A.4 Submissions^a
Stage 3

<i>Participants</i>	<i>Submission number(s)</i>	
Actuaries Institute	75	
AIA Australia	76	
Altenburger, Michael	93	
AMP	80	*#
Angelo, Greg	12	
ANZ	73	
Asher, Anthony	DR151	#
Ashurst, Geoff	13	
Association of Financial Advisers (AFA)	DR173	
Association of Superannuation Funds of Australia (ASFA)	47, DR148, DR221	
Australian Council of Trade Unions (ACTU)	50, DR185	
Australian Ethical Investment	DR121	
Australian Industry Group	DR181	
Australian Institute of Company Directors (AICD)	DR164	
Australian Institute of Superannuation Trustees (AIST)	39, 99, DR130, DR198	
Australian Lawyers Alliance (ALA)	65, DR128	
Australian Private Equity and Venture Capital Association Limited (AVCAL)	33, DR187	
Australian Prudential Regulation Authority (APRA)	89, DR204	
Australian Securities and Investments Commission (ASIC)	90, DR206	
Australian Services Union (ASU)	28	
AustralianSuper	43, DR150, DR222	
Ayliffe, Rhett	18	
Barr, Nicholas and Diamond, Peter	74, DR154	
Basu, Anup	DR110	
Bateman, Hazel and Thorp, Susan	DR200	#
Bell, David	DR201	
Berrill and Watson Lawyers	DR176	
Besnant, Colin	DR109	
Bianchi, Robert, Drew, Michael and Walk, Adam	35	
Blythe, Elizabeth	DR226	
Bone, Ron	77	
Boutsiavaras, Ilias	25	
Breast Cancer Network Australia (BCNA)	41	
BT Financial Group (BTFG), (Westpac)	32, DR209, DR149, DR220	*
Cbus	58, DR177	
Centre for Law, Markets and Regulation - UNSW Law	DR141	
Challenger Limited	DR144	
Chant West	DR191, DR224	

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Table A.4 (continued)

<i>Participants</i>	<i>Submission number(s)</i>	
Chartered Accountants ANZ	DR189	
CHOICE	71, DR184	
Clapham, Alan	14	
Class Ltd	DR190,DR216	
ClearView	48, 86	
Cohen, Roger	DR116	#
Colonial First State (CFS), (CBA)	66, DR163	
Consumer Action Law Centre, Berrill & Watson Lawyers, Chronic Illness Alliance	55	
Consumer Policy Research Centre (CPRC)	DR196	#
Consumers' Federation of Australia	DR188	#
Corporate Superannuation Association	DR132	
Council for the National Interest	DR213	#
Council of Small Business Organisations of Australia (COSBOA)	DR203	#
CSF Pty Ltd	DR227	*
Deane, Renuka	7	
Delaney, Chris	DR111	
Deloitte Touche Tohmatsu (Deloitte)	DR172	
Dimensional Fund Advisors	DR135	#
Dixon Advisory	61, DR228	*
Drew.Walk & Co	DR207	
Due Governance	DR160	
Financial Planning Association of Australia (FPAA)	26, DR146	
Financial Services Council (FSC)	69, DR186, DR199, DR218	#
First State Super	37, DR165	
Gandevia, Robin	9	
Gateway Association and Transaction Exchange (GATE)	54	
Gateway Network Governance Body Limited (GNGB)	45	
Gee, Ursula	20	
Geiser, Tom	DR104	
Giannapolous, Perry	81	
Gillard, Ian	DR112, DR211	
Gilligan, Michael	DR122	
Goodwin, Colin	DR115	
Gordon, Neville	DR140	
Governance Institute of Australia	DR152	#
Graham, Alan	10	
Greene, Paul	8	
Gregan, John	84	
Grenfell, Colin	4	#
Grow Super	36	
Hannan, Danny	6	

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Table A.4 (continued)

<i>Participants</i>	<i>Submission number(s)</i>
Hawthorn, Matt	DR101
Hayden Financial Services	DR123
Hemming, David and Delliou, Daphne	38
HESTA Super	70, DR179
Hudson, Paul and Associates Super Fund	1
Hudson, Phillip	DR208 #
Humphreys, Jeff	88 #
iLuvSuper.com.au	DR133
Independent Fund Administrators and Advisers Pty Ltd (IFAA)	DR136
Independent Fund Administrators and Advisers Pty Ltd (IFAA), QIEC Super and Club Super	53
Industry Super Australia (ISA)	5, 59, 87, 96, 100, DR162, DR231, DR232
Investment Analytics Research (IAR)	DR192 #
IOOF Holdings Limited	DR138
Jakovich, Marko	DR102
Johnson, Robert	DR219
Kershaw, Paul	DR105
Kingsley, Randall	22
KPA Advisory Services	DR195
KPMG	DR183
Lifetime Income Pty Ltd	DR142
Lindsay, Louise	DR114
Link Group	DR159
Liu, Kevin	DR139 #
Liu, Kevin and Ooi, Elizabeth	92
Maurice Blackburn	29
McAuley, Ian	DR153 #
Mercer	57, DR175
MetLife Australia	68, DR182
Mine Wealth and Wellbeing Superannuation Fund (Mine Super)	34
Minney, Aaron	DR131
MLC Wealth (NAB)	63, DR174, DR223 #*
MLC Life Insurance	72
Moneytree Financial Technology Pty Ltd	DR166
Morris, Nicholas	DR124
Morse, Russell	11
Munro, Bruce	31
Murphy, Sean	85 #

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Table A.4 (continued)

<i>Participants</i>	<i>Submission number(s)</i>
Name withheld	51, 52, 78, 82, 94, DR 103, DR145, DR180 *
National Foundation for Australian Women (NFAW)	DR127
Nattrass, Geoff	DR106
Nick and Jacques, Virginia	21
Peterson Research Institute	DR161
PricewaterhouseCoopers (PwC)	62, DR129
Prime Super	DR158
Qantas Super	DR137
QIEC Super and Club Super	DR157
QSuper	DR168, DR217 #*
Queensland Nurses and Midwives' Union (QNMU)	DR125
Responsible Investment Association Australasia (RIAA)	DR143
REST Industry Super (REST)	49, DR171
Revenue Review Foundation	64 #
Rice Warner	46, 56, DR202, DR225 #*
Ringrose, Kyle	DR107 #
Rogers, Rod	2
Roll-it Super	DR113
Self-managed Independent Superannuation Funds Association (SISFA)	60, 79
Self-Managed Super Fund Association (SMSFA)	DR194
Sheedy, Elizabeth and Jepsen, Denise	DR108
Slade, Anthony	DR117
Slater and Gordon Lawyers	DR178
Smit, Nicolaas	40
SMSF Association (SMSFA)	67
Sunsuper	DR197
Superannuation Consumers' Centre	DR214 #
SuperChoice	42
SuperRatings	DR167
Sy, Wilson	DR210
Tailored Superannuation Solutions Ltd	16, DR156 #
TAL Life Limited	DR193
Thomson, Angus	23
Town, Robin	27
Twentyman, Daniel	3
UniSuper	DR134
United Voice	24

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Table A.4 (continued)

<i>Participants</i>	<i>Submission number(s)</i>	
Vagg, Matthew	DR212	#*
Valdés-Prieto, Salvador	DR205	
Vanguard Investments Australia Limited	DR155, DR215, DR229	#*
Vann, Peter	DR126	
Victims of Financial Fraud (VOFF)	DR120, DR170	#
Vision Super	30	
Voicce	DR119	
Warren, Geoff	DR118	
Waugh, Madonna	17	
Wilkins, Richard	DR169	
Williams, Trevor	83	
Williamson, Murray	19	
Workplace Super Specialists of Australia (WSSA)	DR147	
Young, Donald	91	

a An asterisk (*) indicates that the submission contains confidential material NOT available to the public. A hash (#) indicates that the submission includes attachments.

Table A.5 Consultations
Stage 3

Participants

Ambachtsheer, Keith
Association of Superannuation Funds of Australia (ASFA)
Australian Government Actuary
Australian Institute of Superannuation Trustees (AIST)
Australian Prudential Regulation Authority (APRA)
Australian Securities and Investments Commission (ASIC)
Australian Taxation Office (ATO)
AustralianSuper
AUSfund
BT Financial Group (BTFG), (Westpac)
Cameron Research
Cbus
Chant West
Clark, Gordon (University of Oxford)
CEM Benchmarking
CHOICE
Department of Social Services
Donald, Scott (University of NSW)
Financial Services Council
First Super
First State Super
Future Fund
Grattan Institute
Grenfell, Colin
GROW Super
Hartley, David
Industry Super Australia
Insurance in Superannuation Working Group
Jacobi, Liana (University of Melbourne)
Knox, David
KPMG
Mercer Australia
Morris, Nicholas (University of NSW)
PricewaterhouseCoopers
QSuper
Rainmaker Group
REST Industry Super
Rice Warner Actuaries

(continued next page)

Table A.5 (continued)

Participants

Roy Morgan Research
Savage, Jim
SMSF Association
Spaceship Super
Sunsuper
Superannuation Consumers' Centre
Superannuation Industry Stewardship Group
SuperRatings
SuperTrace
TAL Australia
The Treasury
Thorp, Susan (University of Sydney)
UniSuper
Vanguard Australia
Warren, Geoff (Australian National University)
Williams, Raewyn

Table A.6 Roundtables**Stage 3**

Organisation

Economies of scale in the superannuation system – 22 September 2017

Grattan Institute

Hartley, David

Rice Warner

Sy, Wilson

Warren, Geoff (Australian National University)

Worthington, Andrew (Griffith University)

Funds survey – 9 October 2017

Association of Superannuation Funds of Australia

Australian Catholic Superannuation

Australian Institute of Superannuation Trustees

Australian Prudential Regulation Authority

Financial Services Council

Industry Super Australia

Products and advice needs of retirees – 20 August 2018

Australian Government Actuary

Bateman, Hazel (University of NSW)

Challenger

Grattan Institute

King&Wood Malleon

KPMG

Milliman

QSuper

Rice Warner

StatePlus

Thorp, Susan (University of Sydney)

Economies of scale in Australia's superannuation system – 25 October 2018

Chant West

Griffiths, Bill (University of Melbourne)

Jacobi, Liana (University of Melbourne)

Minifie, Jim

PricewaterhouseCoopers

Reserve Bank of Australia

Rice Warner

Savage, Jim

Sy, Wilson

Warren, Geoff (Australian National University)

Table A.7 Public Hearings**Stage 3**

Participants

Sydney – 20 June 2018

CHOICE

Challenger

KPMG

Rice Warner

Berrill and Watson Lawyers

Thorp, Susan and Bateman, Hazel

Warren, Geoff

Donald, Scott

Hanrahan, Pamela

Liu, Kevin

Australian Chamber of Commerce and Industry

AustralianSuper

Trustee Tailored Super

SMSF Association

Melbourne – 21 June 2018

PricewaterhouseCoopers

Industry Super Australia

Australian Institute of Superannuation Trustees

Cbus

Grattan Institute

Consumers Federation Australia

Australian Council of Trade Unions

Corporate Superannuation Association

Responsible Investment Association Australasia

Roll-it Super

Brisbane – 22 June 2018

Financial Services Council

SunSuper

QSuper

BT Financial Group (BTFG), (Westpac)

Council of Small Business Organisations Australia

Drew, Michael

Table A.8 Consultancies and contracts

Stages 2 and 3

<i>Consultant</i>	<i>Purpose</i>
CEM Benchmarking	Procurement of international investment management data and associated advice.
Insight Analytics	Design and conduct of the members choice survey.
Jim Savage (WeWork Co Lendable)	Econometric advice on microeconomic analysis of economies of scale.
KPA Advisory Services	Advice and international data association with the governance survey.
Liana Jacobi (University of Melbourne)	Referee report on Bayesian microeconomic analysis of economies of scale.
PricewaterhouseCoopers (PwC)	Advice on inquiry implementation issues.
Rainmaker	Access to superannuation data.
Rice Warner	Access to superannuation data.
Roy Morgan Research	Design and conduct of the members and funds surveys.
SuperRatings	Access to superannuation data.
Susan Bell Research	Referee comments on the design and interpretation of the members survey.

B Data sources

The Commission made use of existing data wherever possible for this inquiry, including by purchasing and requesting access to existing data where necessary. Where data required to undertake this inquiry could not otherwise be accessed, the Commission undertook five surveys — two of members, two of funds and one of chief executive officers (these are reported in appendix C).

B.1 Data from government agencies

The Commission drew on publicly available datasets as far as possible, including the:

- Australian Bureau of Statistics (ABS) superannuation data
- Australian Prudential Regulation Authority's (APRA) Annual Superannuation Bulletin, MySuper Statistics, Fund-level Superannuation Statistics and Superannuation Performance statistics
- Australian Taxation Office's (ATO) self-managed superannuation fund (SMSF) statistics.

The Commission also obtained unpublished data from regulators as follows:

- additional data on SMSFs, and counts of individuals with multiple accounts and accounts with insurance, from the ATO
- aggregate and fund level data, and data on life insurance from APRA
- member experience data from the Australian Securities and Investments Commission (ASIC), including from ASIC's Effective Disclosure Project and some preliminary data from ASIC's Employers and Super project and its Insurance in Super project.

The Commission has only used sensitive data provided in confidence in aggregated formats and has cleared its publication of aggregated data with relevant agencies.

B.2 Data from research firms

The Commission made use of data from several research firms.

Rainmaker

Rainmaker collects option level data reported by some APRA-regulated and exempt public sector funds.

The Rainmaker data purchased by the Commission for the purposes of this inquiry include background information about funds, their products and product options; the value of assets at the fund level; member demographics at the product level; product features; returns and fees at an option and product level; and asset allocation at an option level.

The Commission purchased the full historical dataset beginning in 1997, but mainly relied on data for the years 2005 to 2017 because of better coverage in those later years. Coverage of the APRA-regulated system was over 50 per cent of assets and member accounts in 2014-15 (table B.1). Rainmaker data covered 100 per cent of industry funds in 2014-15 and 59 per cent of retail funds.

Table B.1 Coverage of APRA-regulated system by research firms
Per cent

	<i>2004-05</i>	<i>2009-10</i>	<i>2014-15</i>
Number of funds			
SuperRatings	16	43	56
Rainmaker	9	22	33
Assets (funds under management)			
SuperRatings	61	81	90
Rainmaker	30	42	52
Member accounts			
SuperRatings	64	83	91
Rainmaker	42	50	55

SuperRatings

SuperRatings collects option level data from a number of APRA-regulated and exempt public sector funds. Data are self-reported by funds. The data are collated by SuperRatings from public information, such as product disclosure statements, and by surveying funds.

The SuperRatings data purchased by the Commission for the purposes of this inquiry include: background information about individual funds and their products; disaggregated fees by product; insurance cover offered by product; membership and asset data at the product level; product features; and asset allocation, returns and investment fees at an option level.

SuperRatings data are for the years 2002 to 2017. Coverage of APRA-regulated funds has been over 80 per cent of assets and member accounts at least since 2009-10 (table B.1).

SuperRatings coverage of APRA-regulated funds was 100 per cent for industry funds in 2014-15 and was almost 50 per cent for retail and corporate funds in 2014-15.

Rice Warner

Rice Warner supplies a range of self-reported superannuation data.

For this inquiry, the Commission subscribed to Rice Warner's Super Insights database, purchased Rice Warner's Superannuation fees analysis 2017 data and purchased superannuation insurance data. The Rice Warner Super Insights member dataset is for the period 2013 to 2017. It includes member demographics, member balance and investment details and member movements between funds, all of which were utilised by the Commission. The Commission used Rice Warner's Superannuation fees analysis 2017 data to estimate APRA-wide total fees for the years 2006 to 2016. The insurance data analysed by the Commission include member take up rates, levels of cover and premiums by insurance type and fund type for the years 2013 to 2016.

Rice Warner data cover around 50 per cent of APRA-regulated funds.

CEM Benchmarking

CEM Benchmarking collect data for pension funds across six regions of the world. For this inquiry, the Commission purchased CEM's 2016 data covering the number of funds, the value of assets and investment management costs (net of all fees and taxes), and also ten-year investment return data for 2007 to 2016 to compare the performance of the Australian superannuation system with that of major economies and regions of the world.

The CEM Benchmarking dataset has a high representation of funds in the United States, Canada, Netherlands and the United Kingdom.

CHOICE survey report

The consumer group CHOICE surveyed 2498 CHOICE members' about their experience and perceptions of the superannuation system. Among other things, the survey obtained member responses about their level of engagement with their superannuation.

CHOICE provided the Commission with confidential access to the survey results for the purposes of this inquiry. The Commission used the results to help assess the superannuation system from the perspective of a sample of superannuation members.

Investment returns index data

The Commission acquired investment returns index data from a number of sources to inform its analysis of investment performance. Index data include that of S&P, Bloomberg, MSCI and FTSE Russell. For further details refer to technical supplement 4.

Class Limited

The Commission was provided with some additional data on SMSFs from Class Limited. These data included: rate of return (ROR) estimates (based on publicly available data) that adjust for the time period in the denominator, as well as the effect of contributions tax and insurance flows; and on the asset allocation of SMSFs on more of a ‘look-through’ basis — that is, assigning the assets within various trusts and managed funds to specific asset classes.

B.3 Quality assurance

The Commission has relied on a number of external experts to review its data work for this inquiry. This includes consulting with several technical experts and industry practitioners in using data for the construction of portfolio benchmarks.

External reviewers for the surveys undertaken by the Commission are reported in appendixes A and C.

The Commission asked APRA to review its approach to modelling the potential transition impacts of alternative default models and APRA confirmed that the methodology and underlying assumptions were reasonable and consistent with APRA’s understanding of the industry. However, the views and conclusions in the report based on the modelling undertaken are solely those of the Productivity Commission.

C Surveys: an overview

This appendix details the conduct of the five surveys undertaken by the Commission as part of this inquiry (which addresses the terms of reference for both stage 2 and stage 3) (figure C.1). These include the:

1. **stage 2 members choice survey** — a survey of how members might behave when choosing a superannuation product when assisted by a shortlist of good products (section C.1)
2. **members survey** — a survey of superannuation fund members, to better understand their experiences with the system (section C.2)
3. **‘initial’ funds survey** — a survey of institutional superannuation funds regulated by the Australian Prudential Regulation Authority (APRA), to gather data on fund inputs, operations and behaviour (section C.3). This survey was conducted prior to the release of the draft inquiry report
4. **‘supplementary’ funds survey** — this gave funds another chance (following the draft report) to provide a subset of key data specifically on net returns and fees by asset class, as well as on the share of expenses to associated and non-associated parties.
5. **governance survey** — a survey of chief executive officers (CEOs) of all APRA-regulated superannuation funds, on fund governance (section C.5).

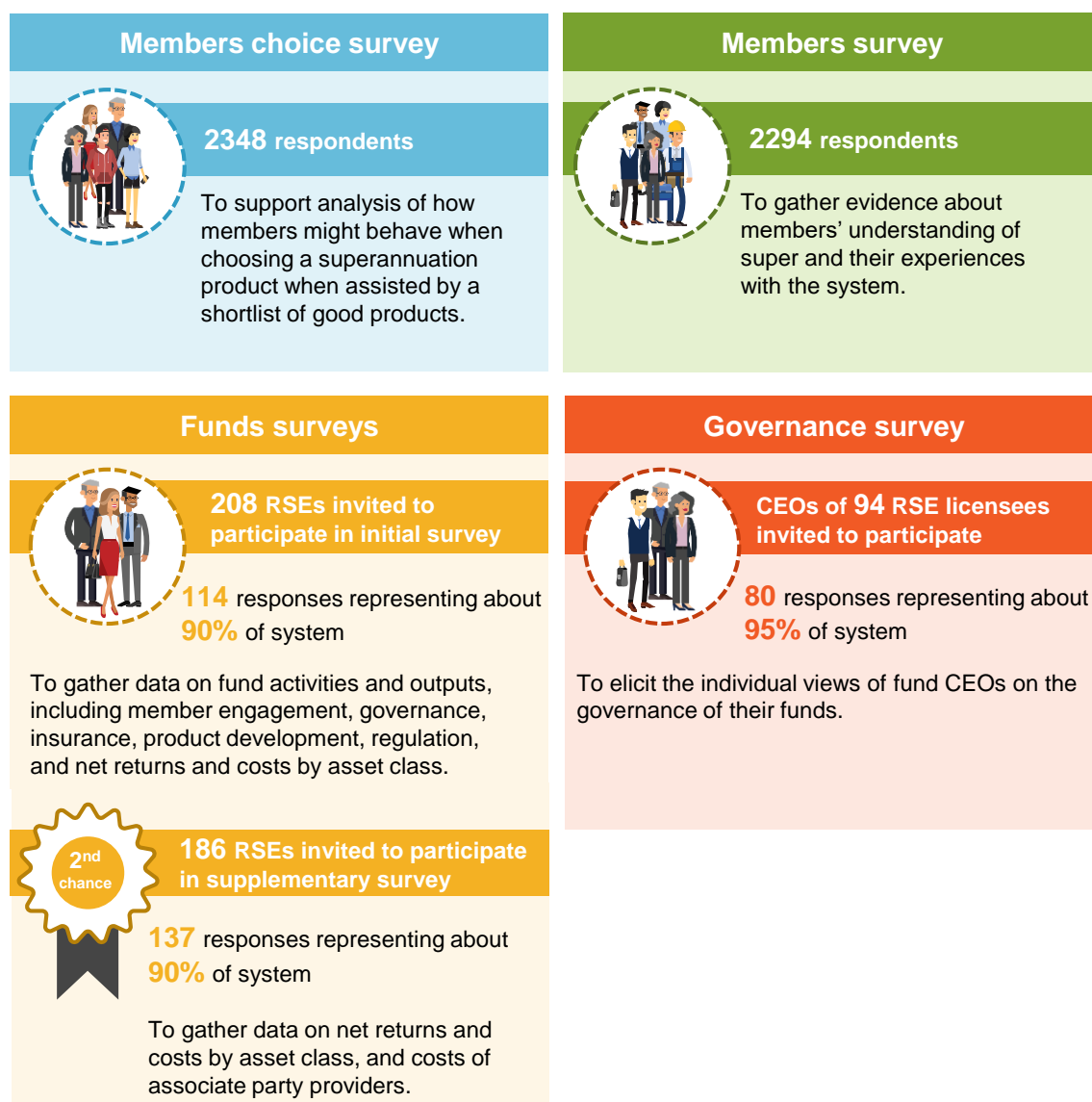
The stage 2 members choice survey results were published as a supplement to the stage 2 inquiry draft report (PC 2017d). Technical supplements 1, 2 and 3 present key supporting results for each of the members, funds (including the supplementary survey) and governance surveys.

All five surveys focused on filling the relevant evidence gaps faced by the inquiry, and were designed to minimise the compliance burden on superannuation funds. The evidence gaps were identified by the Commission as part of its stage 1 study (PC 2016a), which included consultation with a range of participants at that time. The Commission’s surveys were identified as the primary means of gathering particular pieces of evidence that were not available from other sources.

The Commission’s survey results presented throughout the inquiry report have been de-identified to protect the confidentiality of respondents.

The Commission thanks participants in all five surveys for their input. A list of survey recipients and respondents for the funds and governance surveys are in tables C.9 and C.10, respectively.

Figure C.1 The five surveys



C.1 Stage 2 members choice survey

As part of its work on alternative default allocation models, the Commission undertook a survey of member behaviour. Respondents were surveyed on their past and present experiences and attitudes towards super, and also asked to complete some experimental tasks to enable the Commission to better understand how members make their decisions.

The survey was primarily designed to gather evidence relevant to understanding how people would likely behave if they had to choose a superannuation fund without any assistance (unassisted choice), as well as in the presence of a shortlist of superannuation products

(assisted choice). The survey was also intended to address gaps in the evidence already available from other surveys and behavioural research.

Given the specialised nature of the research, the Commission sought external expertise, particularly in behavioural finance and randomised control trials (RCTs) to design and conduct the survey. Insight Analytics was engaged to design the survey on the Commission's behalf. Insight Analytics also conducted the survey, in conjunction with a third-party panel provider.

Survey design

The survey contained two types of questions:

- general questions — to gather information on demographic characteristics of respondents, their past experiences and financial literacy
- experimental questions — to elicit information about respondents' decision making and behaviour by assigning different respondents to different 'treatments'. Treatment design varied across groups of respondents to test the impact of specific presentation elements.

Choice experiment

For this experiment, the 2348 respondents were randomly assigned to one of two main treatments: 17 per cent to unassisted active choice (the 'control group'), and the remaining 83 per cent to assisted employee choice (the 'treatment group'). Respondents were not told that they had been randomly assigned to different treatments. More respondents were assigned to the treatment group due to the number of variations being tested within that group. Respondents were requested to imagine they were starting a new job and had to choose their own superannuation fund; they were asked 'what super fund would you go with?'.

Respondents in the control group faced a nomination decision without any assistance. Respondents in the treatment group were provided a shortlist of funds to assist in their nomination. The shortlist included four metrics for each fund, covering the risk level, past returns, return target and fees associated with it. Within the group, respondents were assigned to one of ten specific treatment categories (figure C.2). Specifically, each respondent was presented with either four, five, six, seven or eight options, and with the fee and return metrics presented either in terms of the percentage of account balance or in dollar figures (based on a nominal \$50 000 balance). Respondents also had the option to select 'something else' and nominate a different fund in a free-text entry box.

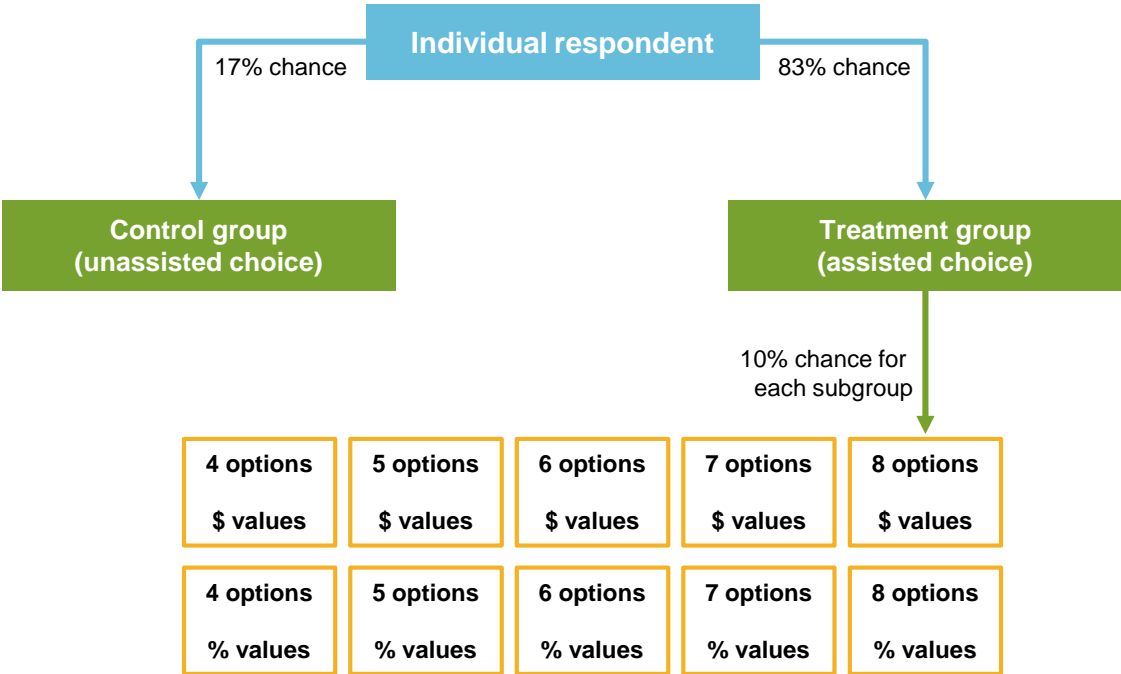
The hypothetical products used for this exercise were loosely based on a selection of real MySuper products available in the market. In each instance, respondents were presented with a set of actual fund logos combined with a block of the four metrics (returns, fees, risk, and target return). The eight funds used in the experiment were chosen based on their actual size

(total membership and assets under management), with the blocks of metrics based on real performance figures for these funds' MySuper products. The set comprised both industry and retail funds.

Within each of the ten treatment categories, there was further random assignment of the:

- order in which funds were listed
- specific fund name and corresponding logo
- block of metrics shown for each fund.

Figure C.2 **Choice experiment: control and treatment groups**



Source: PC (2017b).

These elements were randomised to allow for subsequent testing of (or control for) the effects of ordering, presentation and brand sentiment on decision making.

In addition to nominating a product on the shortlist, respondents were also able to nominate a fund of their choosing or not nominate at all. Once respondents had completed the experiment, they were asked why they chose the particular fund, in a free text field. They were also asked to explain how difficult they found the exercise, and to score this on a scale of one to five (where five was the most difficult).

List experiment

A ‘list experiment’ is a technique that is commonly used by psychologists and political scientists to gauge attitudes where respondents may not feel comfortable providing honest answers to questions asked directly. To overcome potential biases that can arise from social desirability, non-response and other effects, the questions of interest are asked indirectly by combining them with a set of other, less sensitive questions.

This list experiment was designed to elicit information on behaviours, decision making and attitudes related to the last time that respondents had to choose a superannuation fund (those who had never had a fund were excluded from the task). Respondents were randomly assigned to one of 12 ‘branches’. In each branch, four lists were shown with the treatment branches containing the sensitive statement. The order of statements in each list was randomised for each respondent.

Fieldwork

Insight Analytics conducted the survey online from 22 February to 2 March 2017, via a third-party panel provider (Quality Online Research).

The survey was estimated to have taken most respondents about 10 to 15 minutes to complete.

The full sample included 2348 respondents, with approximately 2000 completing all major components of the survey. The survey was successful in achieving the Census quotas, resulting in a full sample broadly representative of the working-age Australian population.

Data

The final survey data and documentation were delivered to the Commission on 16 March 2017, following some cleaning and checking of the data by Insight Analytics.

Further details about the survey design (including the choice and list experiments) and the results were published online as a supplement to the stage 2 inquiry — *About the survey and the results* (PC 2017b). That publication along with the survey questionnaire, data and associated documentation can be downloaded on the Commission’s website at: <http://www.pc.gov.au/inquiries/completed/superannuation/alternative-default-models/draft>.

C.2 Members survey

The members survey was commissioned to better understand members’ experiences with the superannuation system, with a particular focus on evidence gaps identified in the Commission’s stage 1 study (PC 2016a).

Following a competitive request for proposal process, Roy Morgan Research was engaged to design and conduct a survey of superannuation members on behalf of the Commission.

Survey design

A targeted sample size of 2000 members was set to achieve adequate samples of different types of members, of both institutional and self-managed superannuation funds.

Sample frame

The primary sample source was the Roy Morgan Research consumer panel, supplemented by an external panel provider (Survey Sampling International) for hard-to-reach young respondents (males aged 15–34 years and females aged 15–24 years). People aged 15 years or more who were members of superannuation funds and/or owned retirement income products qualified for the survey.

While consumer panels facilitate ready access to a specified sample size of individuals, they can be marked by unobserved bias. The size and significance of any bias is, however, difficult to measure.

To enable the final data set to have an adequate sample size of members across the full range of fund types, members with corporate and self-managed funds were over-sampled relative to their distribution in the population. To do this, quotas were set for superannuation funds and retirement income products (table C.1). In addition, age and gender quotas were set within each superannuation fund type, but not for retirement income products. Roy Morgan Research also applied quotas based on the balances of respondents' superannuation funds to ensure a representative sample by size of balance. In the final stages of field work, age and gender quotas within each superannuation fund type were relaxed so that more responses could be achieved from hard-to-reach individuals.

Table C.1 Members sampling quotas

<i>Quota groups</i>	<i>Quota size</i>
Superannuation fund type	
Industry	817
Retail	505
Public sector	278
Corporate	100
Self-managed	200
Retirement income products	100
Total	2 000

Questionnaire design and pilot testing

The Commission's initial questionnaire design focused on gathering information on 18 of the total 89 unique indicators developed in the Commission's stage 1 study (PC 2016a). Further questions about the retirement phase and a 'choice experiment' (discussed below) were also added to the questionnaire.

Broad areas covered in the online questionnaire comprised: superannuation and insurance literacy; retirement; satisfaction, member services and information on funds; use of advisers, account monitoring, intra-fund advice, beneficiary nominations; change in insurance options, claims; switching and rolling over; financial literacy; choice experiment; and demographics.

The Commission's questionnaire design also benefited from the input of four external reviewers — Susan Bell Research, CHOICE, Australian Securities and Investments Commission (ASIC) and APRA — and advice from Roy Morgan Research.

A pilot test was conducted on 28 September 2017 prior to the start of the fieldwork. The pilot tested the programmed questionnaire with 50 respondents. No changes to the questionnaire or its operational functioning occurred as a result of pilot testing. The 50 pilot tested responses are included in the final data set.

A copy of the members survey questionnaire is available on the Commission's website at: <http://www.pc.gov.au/inquiries/completed/superannuation/assessment/surveys>.

The choice experiment

The Commission's choice experiment in stage 3 builds on the previous choice experiment undertaken as part of the stage 2 members choice survey (section C.1).

The choice experiment in stage 3 explores the relative value attached to member services in the accumulation phase. The experiment follows a standard design from a well-established literature which includes work by Hensher et al. (2005) and Revelt and Train (1998).

Respondents were asked to choose between two superannuation products which differ only on the features, insurance offerings and yearly fees charged, with a total of 2880 possible combinations of product features.

The characteristics which define a product are listed in table C.2. The specific 'level' of each characteristic for each product was randomly chosen from the available levels with the exception of fees. Further information on implementation is in box C.1.

The Commission received 6585 observations from the experiment. This sample size is larger than Hensher's et al. (2005) choice experiment, based on 1266 observations and 1440 possible combinations of product features.

Table C.2 Product characteristics in the choice experiment

<i>Product characteristic</i>	<i>How was it introduced?</i>	<i>Levels available</i>
Member services — engagement channels	Ways you can engage with your superannuation product provider (to ask questions/raise concerns/make insurance claim/change insurance options/change investment options, etc. ...)	<ul style="list-style-type: none"> • Over the phone, email • Over the phone, email, online website • Over the phone, email, online website including real time online support • Over the phone, email, online website, smartphone app • Over the phone, email, online website including real time online support, smartphone app
Member services — engagement content	Ways a superannuation product provider engages with you	<ul style="list-style-type: none"> • Low: Only statements of account balances and obligated engagements • Medium: Everything in low, newsletters and surveys to better understand members such as yourself • High: Everything in low and medium, education seminars and webinars
Member services — promotions	Discounts on products and services unrelated to superannuation, for example on travel and clothing	<ul style="list-style-type: none"> • Yes • No
Member services — convenience of multiple services	The ability to purchase other financial products from the superannuation product provider such as home loans, banking accounts and insurance	<ul style="list-style-type: none"> • Yes • No
Control of assets	The level of control you have over investments	<ul style="list-style-type: none"> • No control (You can assume that the product will deliver a high level of returns) • Choice of investment strategy (is it a growth, balanced or conservative investment strategy?) • Choice over underlying assets (this would allow you to choose specific investments, such as in high-tech companies and ethical investments)
Level of life and total and permanent disability (TPD) insurance cover	Level of Life and TPD insurance cover	<ul style="list-style-type: none"> • None • A low level of cover — \$90,000 for both life and TPD insurance • A medium level of cover — \$200,000 for both life and TPD insurance • A high level of cover — \$500,000 for both life and TPD insurance
Level of income protection insurance cover	Level of income protection insurance cover	<ul style="list-style-type: none"> • None • A low level of cover – Coverage of up to the equivalent of a \$40,000 after tax salary in monthly payments • A medium level of cover – Coverage of up to the equivalent of a \$60,000 after tax salary in monthly payments • A high level of cover – Coverage of up to the equivalent of a \$100,000 after tax salary in monthly payments
Total administration fees	Total fee for the year. (These fees are comprehensive so that there are no additional fees to consider.)	<ul style="list-style-type: none"> • Fees were drawn with a specific algorithm as described in box C.1.

Box C.1 How the choice experiment was conducted

Overview of the method

Each respondent saw three sets of choice experiments. Each one compared two superannuation products which differed in their features, insurance and yearly fees. For the features and the type of insurance cover, the level presented — for example whether the fund allowed members to engage with them via phone or website — was randomly selected by an algorithm.

However, having a similar random selection process for fees would have resulted in too many choices (including some unrealistic products).

To reduce complexity fees were created to be specific to each type and level of insurance (table below). For example, if the algorithm had randomly selected a medium level of Life and TPD cover for a respondent, the algorithm was instructed to choose from fee levels that had been set for this level of insurance, i.e. from \$0 to \$4000.

Fee levels associated with each type of insurance and level of cover

<i>Level of cover</i>	<i>Fee (\$)</i>
No cover	25, 50, 75, 100, 125, 150, 175, 200
Life and TPD	
Low — \$90,000	0, 25, 50, 75, 100, 150, 200, 300, 400, 500, 750, 1 000
Medium — \$200,00	0, 25, 50, 100, 150, 200, 250, 300, 400, 500, 700, 900, 1 200, 1 500, 2 000, 2 500, 3 000, 4 000
High — \$500,000	0, 50, 100, 150, 200, 300, 400, 500, 750, 1 000, 1 250, 1 500, 2 000, 2 500, 3 000, 3 500, 4 000, 5 000, 7 500, 10 000
Income protection (IP)	
Low — up to \$40,000 after tax	0, 30, 60, 90, 120, 180, 240, 300, 375, 450, 525, 600
Medium — up to \$60,000 after tax	0, 50, 100, 150, 200, 300, 400, 500, 625, 750, 875, 1 000
High — up to \$100,000 after tax	0, 80, 160, 240, 320, 480, 640, 800, 1 000, 1 200, 1 400, 1 600

The fees were calculated using data from APRA MySuper (2016 fourth quarter) data.

When the pairs of products are identical

It is possible that the algorithm could create two identical products. When this happened, the product pair was rejected by the system and replaced.

(continued next page)

Box C.1 (continued)

When one of the pair of products is clearly superior

An adjustment was also made to ensure that a different type of unrealistic product offering was excluded, specifically a superior product being offered at an unrealistic price. For example, take two products, A and B:

- A has at least one characteristic that is better than B
- the fee for A is the same as B, or lower than B
- for all the other features, A and B are the same, or A is better than B.

To exclude these cases, the algorithm rejected:

- any pair where the fees for Product A were lower than fees for B if B had no features that were superior to A. Superior is defined as lower on the list in each cell of column 3, table C.2
- any pair where product A fees and product B fees were the same
- any pair where if the fees of product A were greater than the fees of product B, then at least one characteristic of A must be better than for B.

Finally quotas were used to ensure that all levels of each characteristic are adequately represented in products presented to participants.

Results of the experiment are presented in technical supplement 1.

Fieldwork

The members survey was conducted online between 28 September and 20 October 2017.

On average, superannuation members took around 21 minutes to complete the questionnaire. However, as those with retirement income products had fewer questions directed to them, they took less time to complete the questionnaire, with an average online interview length of around 13 minutes.

Responses achieved

A total of 2294 online responses were collected, comprising 2195 superannuation members and 99 retirement income product owners (with no superannuation). Of the 2195 respondents who were superannuation fund members, 204 held both a retirement income product and were members of a superannuation fund. Table C.3 provides an overview of the number of interviews achieved by fund and product type, and by age and gender.

Table C.3 Interviews achieved by type of superannuation fund and retirement income product by age and gender

Gender and age	Superannuation fund						Total	Retirement income product	Total
	Industry	Retail	Public sector	Corporate	Self-managed	Fund not specified			
<i>Male</i>									
15–24	37	16	8	13	2	7	83	0	83
25–34	99	41	30	38	6	13	227	1	228
35–49	152	85	41	23	25	19	345	0	345
50–64	112	91	41	16	54	13	327	16	343
65+	21	32	15	4	36	10	118	41	159
<i>Female</i>									
15–24	83	12	4	5	2	7	113	0	113
25–34	126	34	22	13	4	9	208	0	208
35–49	163	77	55	19	20	24	358	1	359
50–64	121	60	49	15	45	25	315	11	326
65+	24	23	18	3	22	11	101	29	130
Total	938	471	283	149	216	138	2 195	99	2 294

Source: Members survey.

Table C.4 provides an overview of the distribution of accumulation members by balance of main superannuation fund.

Table C.4 Superannuation balances in main fund by type of fund^a
Per cent

	Industry	Retail	Public sector	Corporate	Self-managed
Less than \$100,000	77.9	65.1	55.7	53.6	25.1
Between \$100,000 and \$249,999	12.7	21.8	25.5	23.0	23.4
\$250,000 or more	9.5	13.2	18.8	23.5	51.5

^a Based on members in the accumulation phase. Results weighted by Commission weights. Those without accumulation products and those who respond to question S8a with 'Can't say/Don't remember' or 'Prefer not to say' are omitted.

Source: Members survey.

Data

On completion of the fieldwork, Roy Morgan Research coded responses for 'other — please specify' questions. The final data was provided to Commission in spreadsheet format.

Weighting

Weighting enables population totals to be inferred from survey responses, reflecting the fact that some subsets of the population are likely to be over- or under-represented in the sample.

The Commission constructed population weights for the members survey data using a technique called minimum cross entropy; an approach taken from information theory (Preckel 2001). This approach constructs a set of weights to enable population-weighted aggregations of the survey data to hit a set of targets (for example, population aggregates from additional data sources, or additional judgments). It does this by minimising the cross-entropy — a measure of the difference between the initial data (which assumes that all observations have equal weight) and the set of weights that would hit all the targets (imposed as constraints on the system). The advantages of this approach is that it involves less manual data manipulation, and can be used when there are a large number of complicated targets.

The Commission's population weights were constructed using a number of external data sources, specifically the Australian Bureau of Statistics' (ABS) *Survey of Income and Housing* (SIH) (ABS 2015) and 2016 Census (ABS 2017a), unpublished APRA superannuation data (provided to the Commission for the purpose of the inquiry), and data from the Australian Taxation Office (ATO).

Specifically, the constraints were:

- 88 equality constraints based on APRA unpublished data: fund type (4 categories), gender (2 categories) and age ranges (11 categories).
 - Another (single category) constraint based on ATO data was used to identify the proportion of self-managed super funds
- 85 equality constraints based on ABS' SIH and Census data: the proportion of people in age ranges (5 categories) that are receiving a pension or annuity
- 2294 inequality constraints placing an upper bound on each observation's weight of five times the mean weight.

The approach used by the Commission was reviewed by Susan Bell Research.

Results

Key results from the members survey data are presented in relevant chapters and technical supplements to this inquiry report. A set of summary statistics and supporting results from the members survey are provided in technical supplement 1.

In adherence to the Commission's transparency principles (PC nd), a copy of the members survey data set (in de-identified form) and associated documentation will be made available on the Commission's website following the conclusion of the inquiry.

C.3 Initial funds survey

Following a competitive request for proposal process, Roy Morgan Research was engaged to design and conduct a survey of institutional superannuation funds on behalf of the Commission. In response to this survey a number of funds submitted poor quality data on expenses, assets, net returns and fees, requiring a second, ‘supplementary’ survey. This supplementary funds survey is outlined in section C.4.

Survey design

Sample frame

As the focus of the funds survey was on large superannuation funds (that is, those with more than four members) regulated by APRA (APRA-regulated funds), APRA’s list of registrable superannuation entities (RSEs) was used as the sample frame. In an attempt to seek universal participation, all RSEs were invited to participate.

APRA provided the Commission with a list of contact details of these funds’ CEOs. In turn, these details were provided to Roy Morgan Research for the purposes of this inquiry.

Initial questionnaire design

The Commission’s questionnaire design focused on gathering information on 30 of the 89 unique indicators developed in the Commission’s stage 1 study (PC 2016a).

The Commission’s questionnaire design phase included extensive consultation with the ABS’ Statistical Clearing House, APRA, and two former senior executives of large RSEs: Howard Rosario, a former CEO, and David Hartley, a former chief investment officer. This consultation process sought to ensure that the survey was fit-for-purpose and minimised the compliance burden on participants. The covering note to the funds survey also outlined the context for the survey, basic instructions and assurances about data confidentiality and protection arrangements.

Broad areas covered in the online questionnaire comprised: general information about the fund; member engagement; governance; insurance; market contestability; fund activity and product development; regulation; and net returns and fees by asset class.

Once the questionnaire was designed, Roy Morgan Research constructed an online version. Prior to entering the field, the online functionality of the questionnaire was tested by Roy Morgan Research reviewers and Commission staff.

Strategies to ensure an adequate response rate and a representative sample

At the outset of this inquiry, the issues paper signposted the Commission's aim to achieve universal participation in the funds survey and its intention to publish a list of funds survey recipients and survey respondents. Prior to the commencement of fieldwork, on 22 August 2017 the Commission wrote to all survey recipients alerting them to the funds survey, requesting their cooperation in completing the questionnaire and providing assurances about data confidentiality.

Participants were also provided with the option to deliver the survey online or in hard copy.

Fieldwork

On 18 September 2017, Roy Morgan Research emailed the questionnaire to the CEO (or designated officer) of all APRA-regulated funds. Survey responses were sought by 10 October 2017.

Following the launch of the survey, the Commission and Roy Morgan Research received a large volume of questions and comments reflecting participant concerns about the content of the survey, its functionality, timelines for completion and data protection and confidentiality arrangements.

Consequently, the survey was paused on 2 October 2017 to provide time to resolve those concerns. During this time, the Commission hosted a roundtable on 9 October 2017 with selected groups and organisations (appendix A). Further discussions surrounding questionnaire design with interested parties occurred following the roundtable. The Commission concurrently worked with Roy Morgan Research to implement the changes in the questionnaire design and survey functionality.

The Commission also strengthened existing confidentiality and data security protections through: establishing a stronger confidentiality clause in the Commission's contract with Roy Morgan Research; and creating non-disclosure agreements with specified personnel at Roy Morgan Research. Further, Roy Morgan Research gave an undertaking to:

- survey recipients to: treat their responses and the identity of respondents as confidential information; and that it would have correspondingly robust data storage arrangements
- the Commission to: destroy all funds' survey data on interim storage locations as soon as it was transferred to Roy Morgan Research servers; destroy the funds' survey data held on its servers at the conclusion of the inquiry; and notify the Commission once these steps have occurred.

The above confidentiality protections were broadly outlined to CEOs (or designated officers) in a letter from the Commission advising of the resumption of the survey and the extended deadline. In addition, the covering note to the survey was extended to explain the changes to

the questionnaire and its functionality following the Commission’s consultations, the extended deadline and the revised confidentiality and data protection arrangements.

Following online testing of the questionnaire by the Commission, Roy Morgan Research and APRA, the survey resumed on 8 November, with a 5 week deadline for responses of 13 December 2017. As previously, emails were sent to the representatives of 208 APRA-regulated funds inviting them to take part in the survey. A reminder email was sent on 20 November. Subsequently, several participants requested an extension and were granted an extension to 20 December 2017. To facilitate the extensions, the survey remained open for all respondents until 22 December 2017.

A copy of the funds survey questionnaire is available on the Commission’s website at: <http://www.pc.gov.au/inquiries/completed/superannuation/assessment/surveys>.

Responses achieved

A total of 114 funds responded to the online survey, representing 55 per cent of all 208 funds invited to participate. Funds that did not respond tended to be smaller in size, meaning responding funds accounted for about 90 per cent of total assets, and 88 per cent of all member accounts (table C.5).

However, a response does not indicate that the survey was completed in full, with a number of responses missing information in different parts of the survey. For example, at an aggregate level, 18 per cent of all data items were missing from the general fund-level section that requested information about numbers of members, accounts and total assets for different years. The quality of information provided about assets, net returns and investment management costs for different asset classes was highly variable, with nearly 23 per cent of responding funds providing no 2016-17 data at all for these questions (figure C.3).

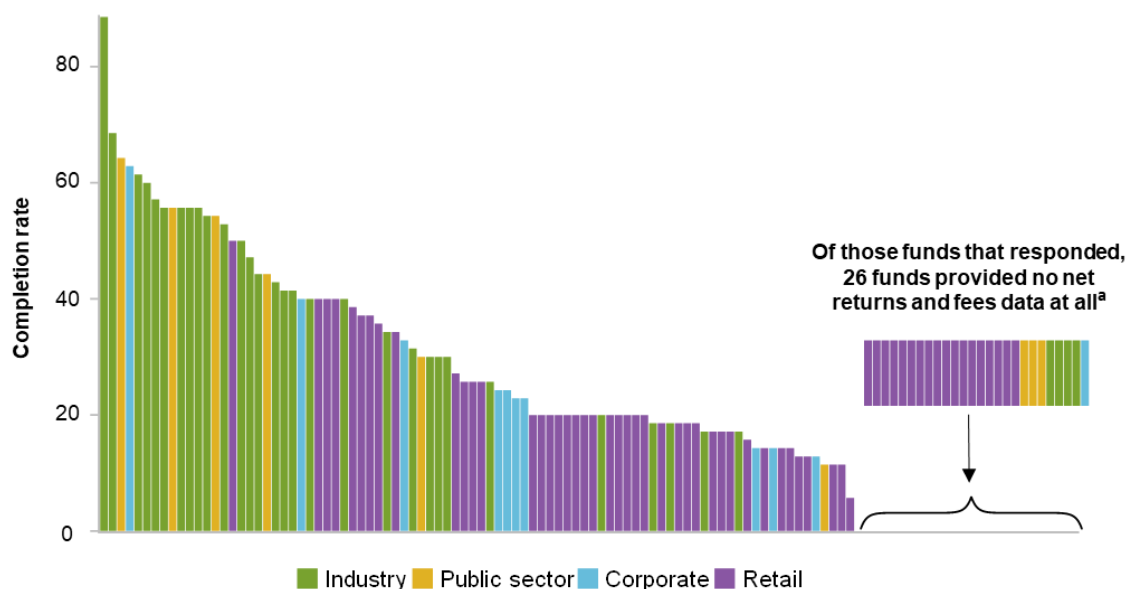
Table C.5 Initial funds survey response statistics

<i>Superannuation fund type</i>	<i>Responses received (number)</i>	<i>As a share of total funds invited to participate (%)</i>	<i>As a share of total assets (%)</i>	<i>As a share of total number of accounts (%)</i>
Retail	57	48	89	91
Industry	34	83	97	94
Corporate	11	48	90	92
Public sector	9	50	78	71
Eligible rollover funds	3	38	60	74
Total	114	55	90	88

^a Total assets and total number of accounts data are from APRA Annual Fund-level Superannuation Statistics.

Figure C.3 **Completion rates by fund type**

Net returns and fees data, 2016-17



^a Of the funds asked to participate in the survey and were not screened out, 73 did not respond. This means that no net returns and fees data was received from 99 of the 208 funds included in the survey.

Source: Initial funds survey.

A list of funds survey recipients and respondents is in annex 1 (table C.9).

Data

On completion of the fieldwork, Roy Morgan Research undertook basic data cleaning and coded responses for ‘other — please specify’ questions. The final dataset was provided to the Commission as an excel file.

Coding of hard copy responses

Fifteen funds submitted surveys in paper format. These were then entered by Roy Morgan Research into the online survey format.

Funds who submitted their surveys on paper were able to modify/amend the survey questions in Word or provide answers/comments that were blocked in the online version due to programmed survey format and logic. For example, some questions required a single answer online but received multiple answers on paper. In other cases questions were answered on paper that should have been skipped due to the survey question sequence logic built into the online version. These occurrences required Roy Morgan Research to establish ‘data cleaning’ rules to fit the paper survey submissions into the online format. The rules avoided the need to

guess the respondent's intention while also trying to utilise as much of the contributed responses as possible. The 15 cleaned data sets were then merged into the final data set.

Results

Key results from the funds survey data are presented in relevant chapters and appendixes to this inquiry report. A set of summary statistics and supporting results from the funds survey are provided in technical supplement 2.

Analysis of the funds survey data has aggregated the data to ensure that individual funds are not identifiable. As agreed with participating funds, the Commission will not publish raw survey data.

C.4 Supplementary funds survey

The Commission surveyed APRA-regulated superannuation funds a second time, to fill gaps in the evidence base that remained following the poor quality responses to the Commission's initial survey. This supplementary survey focused on areas where a lack of information precluded detailed analysis in the draft inquiry report:

- fund assets and returns by asset class, for the financial years 2007-08 to 2016-17. This information allows a comparison of net returns by asset class with international benchmarks and indices
- investment management costs by asset class, for the financial years 2007-08 to 2016-17. This information strengthens the comparison of investment management costs by asset class with international benchmarks
- fund expenses by expense category and by source (for example, outsourced non-associate providers, outsourced associate providers and in-house services). This information was requested for the financial years 2011-12 and 2016-17, and allows a comparison of expenses between funds that do and do not use related parties.

Sample

As with the initial survey, APRA's list of RSEs was used as the sample frame. Invitations to participate in the supplementary survey were sent out to 186 of the 208 funds that were invited to complete the initial survey, with 22 funds 'screened out'. Funds were screened out because they had either commenced or completed a successor funds transfer, had ceased to exist or offered purely defined benefit products.

Fieldwork

The Commission conducted the survey in-house. Fund CEOs were emailed on 29 May 2018 to inform them that a supplementary survey would be conducted in the following week (5 June 2018), and that they would have 15 business days in which to complete it (by 27 June 2018). Survey responses were received and stored securely within the Commission's IT environment, and were accessible only by Commission staff working on the inquiry. A commitment was made to de-identify responding funds in published data.

The survey was administered using an excel spreadsheet form, which included separate sheets for preliminary information, fund expenses, total asset by assets class, net returns by asset class and investment management fees and costs by asset class. Funds were also given the opportunity to provide additional information or feedback. The form included a 'cross check' of total assets data provided with APRA data for individual funds, for the years 2012-13 to 2016-17. Where asset totals were substantially different from available APRA data, funds were asked to briefly explain the reasons for the differences.

Survey responses

A second (second) chance

A number of large retail funds indicated that they were unable to complete the supplementary survey as the required data were not typically collected or reported in the format requested by the Commission. In order to ensure that the survey data were broadly representative of the super system as a whole, the Commission met with a number of large retail funds that were unable to provide data. The Commission agreed that, for 13 retail funds where fund-level data were not available, those funds could provide product- or option-level data that were broadly representative of within-asset-class performance at the fund level. Funds that submitted approximated supplementary survey data after these subsequent requests from the Commission are indicated in annex 1.

Final response rates

Inclusive of the retail funds that provided broadly representative data after the survey closure date, the Commission received supplementary survey responses from 137 of a possible 186 funds. The overall response rate represented over 90 per cent of accounts and assets in APRA-regulated funds, and the response rate was similar for retail and not-for-profit funds. The composition of the not-for-profit funds (that is, the split between industry, public sector and corporate funds) that responded to the survey is similar to the population of not-for-profit funds as a whole. Industry funds make up 54 per cent of responding not-for-profit funds, and account for around 80 per cent of not-for-profit accounts and 55 per cent of assets.

Table C.6 Supplementary funds survey response statistics

<i>Superannuation fund type</i>	<i>Responses received (number)</i>	<i>As a share of total funds invited to participate (%)</i>	<i>As a share of total assets (%)</i>	<i>As a share of total number of accounts (%)</i>
Retail	70	68	91	94
Industry	33	87	97	97
Corporate	13	65	95	96
Public sector	15	88	90	93
Eligible rollover funds	6	75	97	98
Total	137	74	93	96

^a Total assets and total number of accounts data are from APRA Annual Fund-level Superannuation Statistics.

Data quality was still variable

Key results from the supplementary funds survey are presented in the relevant chapters and appendixes to this inquiry report. A set of summary statistics and supporting results from the funds survey are provided in technical supplement 2, and analysis of the investment returns, fees and costs and related party expenses data is included in the supplementary paper on investment performance.

Responses to specific questions varied in quality — for example, 13 of the 136 funds provided no information about expenses at all. While coverage is better than for the initial survey, all data reported from the supplementary funds survey should be interpreted with caution because:

- some funds have made simplifying assumptions to provide data in the form requested by the Commission (for example, some funds indicated that for years prior to 2013-14 they did not have data on assets or returns that exactly matched to APRA’s asset-class classification)
- there are relatively few observations for some questions, particularly for earlier years and related party expenses
- some funds may have interpreted the survey questions differently.

C.5 Governance survey

The Commission utilised an online survey tool, LimeSurvey, to develop and publish its own survey which was hosted on an internal server.

Survey design

Sample frame

As with the funds survey, the focus of the governance survey was on large (that is, those with more than four members) superannuation funds regulated by APRA (APRA-regulated funds). APRA's list of large RSEs was used as the sample frame. The initial list of 208 APRA-regulated funds (which formed the basis of the funds survey) was consolidated as a number of CEOs (or their equivalents) were responsible for multiple RSEs, and a further 7 RSEs were removed on the basis that they accounted for a small number of assets and accounts managed.¹¹⁰ The consolidation resulted in a final list of 94 RSE licensees.

Table C.7 provides an overview of the population of CEOs of large RSEs that were invited to participate in the survey by the type of fund for which they are responsible.

Questionnaire design and pilot testing

The survey was designed to elicit the personal views of CEOs on governance by RSE licensees of funds for which they are responsible.

Table C.7 Population of large RSE CEOs by fund type

<i>Superannuation fund type</i>	<i>Number of CEOs</i>
Corporate	15
Industry	40
Public sector	13
Retail (incl. Retail – ERF)	26
Total	94

The survey was based on a longstanding international survey on fund governance — as designed and conducted by Keith Ambachtsheer of the University of Toronto with a number of collaborators. Details are presented in Ambachtsheer et al. (2008). To date, that survey has been conducted in 1997, 2005 and 2014, and involved funds from Australia, New Zealand, the United States, Canada and Europe. About 80 CEOs or their equivalents have participated in each year, including three and eight Australian fund CEOs in 2005 and 2014, respectively.

The Commission added a number of questions to the international survey to further address the evidence needs of the inquiry. Broad areas covered in the online survey comprised: general information about the respondent and the structure of the trustee board as well as subjective questions concerning governance quality and challenges faced by the board.

¹¹⁰ Henceforth, references to CEOs in connection with the governance survey refer to CEOs or their equivalents.

The survey design phase included consultation with (and an external review by) Keith Ambachtsheer, APRA and four expert academics and other consultants. Prior to entering the field, the survey was pilot tested by four fund CEOs, as nominated by ISA, the Association of Superannuation Funds of Australia, AIST and the Financial Services Council. The online functionality of the survey was tested by Commission staff.

The Commission was able to implement this survey itself given its nature and form. As the survey was hosted on an internal server, the Commission engaged a third party to undertake penetration testing to evaluate the Commission's IT infrastructure security, with all vulnerabilities and risks identified and patched prior to the commencement of the survey on 4 December 2017.

A copy of the governance survey questionnaire is available on the Commission's website: <http://www.pc.gov.au/inquiries/completed/superannuation/assessment/surveys>.

Strategies to ensure an adequate response rate and representative sample

At the outset of this inquiry, the issues paper signposted the Commission's aim to achieve universal participation in the CEO survey by its intention to publish a list of fund CEO recipients and survey respondents. Prior to the commencement of fieldwork, on 22 August 2017 the Commission wrote to all fund survey recipients alerting them to the CEO survey covering governance. The Commission then wrote to all survey recipients on 4 December 2017 requesting their cooperation in completing the survey.

The introduction to the online governance survey provided recipients with assurances about data confidentiality and protection arrangements. Specifically, this included assurance that survey responses would be received and stored securely within the Commission's IT environment, and would only be accessible to Commission staff working on the inquiry. The Commission also assured recipients that responses would be de-identified in published data to protect the identity of funds (and CEOs or their equivalents). Furthermore, the Commission undertook to only use the survey data for the sole purpose of the inquiry, and sought CEOs' permission at the end of the survey for their de-identified responses to be included in a dataset that other researchers (including other government agencies) will be able to apply to the Commission to access following completion of the inquiry.

The majority of participants undertook the survey online. Four responses were received in hard copy, and entered into the dataset by Commission staff.

Fieldwork

On 4 December 2017, the Commission emailed the survey to recipients, with a deadline for responses of 22 December 2017. Subsequently, several participants requested an extension and were granted an extension to 15 January 2018. To facilitate the extensions, the survey remained open for all respondents until 15 January 2018.

Responses achieved

A total of 80 CEOs provided responses to the survey questions, representing a response rate of 85 per cent. However, non-responding CEOs tended to be associated with small RSE licensees, meaning that the CEOs who provided responses accounted for about 95 per cent of member accounts and 94 per cent of assets held by the population of 94 RSE licensees at 30 June 2016.

Table C.8 provides details of the number of responses received by type of fund.

A list of governance survey recipients and respondents is in annex 2 (table C.10).

Table C.8 Governance survey response statistics

<i>Superannuation fund type</i>	<i>Responses received (number)</i>	<i>As a share of RSE licensees invited to participate (%)</i>	<i>As a share of total assets (%)</i>	<i>As a share of total number of accounts (%)</i>
Corporate	13	87	96	96
Industry	34	85	96	96
Public sector	12	92	83	75
Retail (incl. Retail – ERFs)	21	81	98	98
Total	80	85	94	95

Data

On completion of the fieldwork, the Commission coded responses for free text questions and exported the data from the survey tool as an excel file.

Results

Key results from the governance survey are presented in relevant chapters to the inquiry report. A set of summary statistics and supporting results from the governance survey are provided in technical supplement 3.

Annex 1 — Fund survey recipients and respondents

The table below lists the funds that were asked to respond to the Commission’s initial and supplementary funds surveys. The table indicates which funds provided a response to the Commission.

Table C.9 List of funds survey recipients and respondents

<i>Name</i>	<i>Initial survey</i>	<i>Supplementary survey</i>
Advance Retirement Suite	✓	
Alcoa of Australia Retirement Plan		✓
AMG Super		
AMP Eligible Rollover Fund		✓
AMP Retirement Trust	✓	✓
AMP Superannuation Savings Trust ^a	✓	✓
ANZ Australian Staff Superannuation Scheme	✓	✓
Aon Eligible Rollover Fund		
AON Master Trust		
ASGARD Independence Plan Division Two ^a	✓	✓
Australia Post Superannuation Scheme	✓	✓
Australian Catholic Superannuation and Retirement Fund	✓	✓
Australian Defence Force Superannuation Scheme		✓
Australian Eligible Rollover Fund	✓	✓
Australian Ethical Retail Superannuation Fund ^a	✓	✓
Australian Meat Industry Superannuation Trust	✓	✓
AustralianSuper	✓	✓
Australia’s Unclaimed Super Fund ^a	✓	✓
Austsafe Superannuation Fund	✓	
Avanteos Superannuation Trust	✓	✓
AvSuper Fund	✓	✓
AvWrap Retirement Service	✓	✓
Boc Gases Superannuation Fund		
BT Classic Lifetime	✓	
BT Lifetime Super	✓	
Building Unions Superannuation Scheme (Queensland)	✓	✓
Care Super	✓	✓
CBH Superannuation Fund	✓	✓
Challenger Retirement Fund	✓	
Christian Super	✓	✓

^a These funds submitted supplementary survey data after subsequent requests from the Commission.

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Table C.9 (continued)

<i>Name</i>	<i>Initial survey</i>	<i>Supplementary survey</i>
Citibank Australia Staff Superannuation Fund	✓	
ClearView Retirement Plan	✓	✓
Club Plus Superannuation Scheme	✓	✓
Club Super	✓	
Colonial First State FirstChoice Superannuation Trust	✓	✓
Colonial First State Rollover & Superannuation Fund	✓	✓
Colonial Super Retirement Fund	✓	✓
Combined Super Fund	✓	✓
CommInsure Corporate Insurance Superannuation Trust		✓
Commonwealth Bank Approved Deposit Fund	✓	
Commonwealth Bank Group Super	✓	✓
Commonwealth Essential Super	✓	✓
Construction & Building Unions Superannuation	✓	✓
Crescent Wealth Superannuation Fund		✓
CSS Fund		✓
CUBS Superannuation Fund	✓	✓
Definitive Superannuation Plan ^a	✓	✓
Deseret Benefit Plan for Australia		
DIY Master Plan		✓
Dow Australia Superannuation Fund		
DPM Retirement Service	✓	✓
DuluxGroup Employees Superannuation Fund		
EmPlus Superannuation Fund	✓	✓
Encircle Superannuation Fund	✓	✓
Energy Industries Superannuation Scheme-Pool A	✓	✓
Energy Industries Superannuation Scheme-Pool B		✓
Energy Super	✓	✓
Enterprise Super		
Equipsuper	✓	✓
Factory Mutual Insurance Company Superannuation Fund	✓	✓
Fairbrother Employees Retirement Fund		✓
Federation Alliance Superannuation Fund		✓
Fiducian Superannuation Fund	✓	✓
Fire and Emergency Services Superannuation Fund		
First State Superannuation Scheme	✓	✓
First Super		✓
Gillette Australia Superannuation Fund		
Goldman Sachs & JBWere Superannuation Fund	✓	✓
Grosvenor Pirie Master Superannuation Fund Series 2		✓
Guild Retirement Fund	✓	✓

^a These funds submitted supplementary survey data after subsequent requests from the Commission.

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Table C.9 (continued)

<i>Name</i>	<i>Initial survey</i>	<i>Supplementary survey</i>
Health Employees Superannuation Trust Australia	✓	✓
Heidelberg Australia Superannuation Fund		
Holden Employees Superannuation Fund		
HOSTPLUS Superannuation Fund	✓	✓
HUB24 Super Fund		✓
IAG & NRMA Superannuation Plan	✓	✓
Incitec Pivot Employees Superannuation Fund		
ING Direct Superannuation Fund		✓
Intrust Super Fund		✓
IOOF Portfolio Service Superannuation Fund	✓	✓
ISARF Superannuation Fund		✓
Itochu Australia Superannuation Plan	✓	✓
Jamestrong Packaging Australia Superannuation Fund		
L&H Group Superannuation Fund	✓	
Labour Union Co-Operative Retirement Fund	✓	✓
legalsuper	✓	✓
LESF Super		✓
Lifefocus Superannuation Fund		✓
Linfox Staff Superannuation Fund		
Local Authorities Superannuation Fund	✓	✓
Local Government Super		✓
Local Government Superannuation Scheme	✓	✓
Lutheran Super	✓	✓
Macquarie ADF Superannuation Fund	✓	✓
Macquarie Superannuation Plan ^a	✓	✓
Macquarie University Professorial Superannuation Scheme		✓
Manildra Flour Mills Retirement Fund		
Map Superannuation Plan		✓
Maritime Super	✓	✓
Max Super Fund		
Meat Industry Employees Superannuation Fund		✓
Media Super	✓	✓
Mercer Portfolio Service Superannuation Plan	✓	✓
Mercer Super Trust ^a	✓	✓
Mercy Super	✓	✓
Military Superannuation & Benefits Fund No 1		
Mine Wealth and Wellbeing Superannuation Fund	✓	✓
MLC Super Fund ^a	✓	✓
MLC Superannuation Fund	✓	✓
MTAA Superannuation Fund	✓	✓

^a These funds submitted supplementary survey data after subsequent requests from the Commission.

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Table C.9 (continued)

<i>Name</i>	<i>Initial survey</i>	<i>Supplementary survey</i>
Munich Holdings of Australasia Pty Ltd Superannuation Scheme		
MyLifeMyMoney Superannuation Fund	✓	✓
National Mutual Pro-Super Fund		
National Mutual Retirement Fund a		
Nationwide Superannuation Fund	✓	✓
NESS Super	✓	
Netwealth Superannuation Master Fund	✓	✓
NGS Super		
Nissan Superannuation Plan		
Oasis Superannuation Master Trust	✓	✓
OnePath Masterfund ^a	✓	✓
Oracle Superannuation Plan		
Perpetual Super Wrap	✓	✓
Perpetual WealthFocus Superannuation Fund	✓	✓
Perpetual's Select Superannuation Fund	✓	✓
Personal Choice Private Fund		✓
Pitcher Retirement Plan		✓
Port of Melbourne Superannuation Fund		✓
Powerwrap Master Plan		✓
Praemium SMA Superannuation Fund		✓
Premiumchoice Retirement Service	✓	✓
Prime Super	✓	✓
Public Sector Superannuation Accumulation Plan		✓
Public Sector Superannuation Scheme		✓
Qantas Superannuation Plan	✓	✓
QSuper	✓	✓
Queensland Independent Education & Care Superannuation Trust	✓	✓
Rei Super	✓	✓
Retail Employees Superannuation Trust	✓	✓
Retirement Portfolio Service	✓	✓
Retirement Wrap ^a	✓	✓
Rexel Australia Superannuation Plan		✓
Russell Investments Master Trust	✓	✓
Smartsave 'Member's Choice' Superannuation Master Plan		✓
SMF Eligible Rollover Fund		
Star Portfolio Superannuation Fund	✓	✓
StatePlus Fixed Term Pension Plan	✓	✓
StatePlus Retirement Fund	✓	✓
Statewide Superannuation Trust	✓	✓
Stone Superannuation Fund		
Suncorp Master Trust	✓	✓
Sunsuper Superannuation Fund	✓	✓

^a These funds submitted supplementary survey data after subsequent requests from the Commission.

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Table C.9 (continued)

<i>Name</i>	<i>Initial survey</i>	<i>Supplementary survey</i>
Super Directions Fund a	✓	✓
Super Safeguard Fund		✓
SuperTrace Eligible Rollover Fund	✓	✓
Symetry Personal Retirement Fund	✓	✓
Tasplan Superannuation Fund	✓	✓
Telstra Superannuation Scheme	✓	✓
The ARA Retirement Fund		
The Bendigo Superannuation Plan ^a		✓
The Executive Superannuation Fund	✓	✓
The James Superannuation Fund	✓	✓
The Paragon Superannuation Fund		
The PPS Corporate Superannuation Fund		
The Retirement Plan		
The State Bank Supersafe Approved Deposit Fund	✓	
The Super Money Eligible Rollover Fund (SMERF)		✓
The Towers Watson Superannuation Fund		
The University of Adelaide Superannuation Scheme A 1985		
The University of New England Professorial Superannuation Fund	✓	✓
The University of New South Wales Professorial Superannuation Fund	✓	✓
The University of Sydney Professorial Superannuation System		✓
The University of Wollongong Professorial Superannuation Scheme		✓
The Victorian Independent Schools Superannuation Fund	✓	✓
Tidswell Master Superannuation Plan		
Toyota Super		
TWU Superannuation Fund	✓	
Ultimate Superannuation Fund	✓	✓
Unisuper	✓	✓
United Technologies Corporation Retirement Plan		
Victorian Superannuation Fund	✓	✓
WA Local Government Superannuation Plan	✓	✓
Wealth Personal Superannuation and Pension Fund		
Westpac Mastertrust - Superannuation Division ^a	✓	✓
Westpac Personal Superannuation Fund	✓	
Zurich Master Superannuation Fund	✓	✓

^a These funds submitted supplementary survey data after subsequent requests from the Commission.

Annex 2 — Governance survey recipients and respondents

The table below lists the RSE licensees that were asked to respond to the Commission’s governance survey. The table indicates which funds provided a response to the Commission.

Table C.10 List of governance survey recipients and respondents

<i>RSE licensee</i>	<i>Response submitted</i>
Alcoa of Australia Retirement Plan Pty Ltd	✓
AMP Superannuation Limited	✓
ANZ Staff Superannuation (Australia) Pty. Limited	✓
AUSCOAL Superannuation Pty Ltd	✓
Australian Ethical Superannuation Pty Ltd	✓
Australian Meat Industry Superannuation Pty Ltd	✓
AustralianSuper Pty Ltd	✓
Austsafe Pty Ltd	✓
AvSuper Pty Ltd	✓
BEST Superannuation Pty Ltd	✓
BOC Superannuation Pty Ltd	✓
BT Funds Management Limited	✓
BUSS (Queensland) Pty Ltd	✓
C.B.H. Superannuation Holdings Pty Ltd	✓
CARE Super Pty Ltd	✓
Challenger Retirement and Investment Services Limited	✓
Christian Super Pty Limited	✓
Citibank Australia Staff Superannuation Pty Limited	✓
ClearView Life Nominees Pty Limited	✓
Club Plus QLD Pty Ltd	✓
Club Plus Superannuation Pty Ltd	✓
Colonial First State Investments Limited	✓
Combined Fund Pty Ltd	✓
Commonwealth Bank Officers Superannuation Corporation Pty Limited	✓
Commonwealth Superannuation Corporation	
Concept One Pty Ltd	✓
CSF Pty Limited	
Diversa Trustees Limited	✓
Electricity Supply Industry Superannuation (QLD) Ltd	✓
Energy Industries Superannuation Scheme Pty Ltd	✓
Equisuper Pty Ltd	✓
Equity Trustees Superannuation Limited	
Fiducian Portfolio Services Limited	✓
Fire and Emergency Services Superannuation Board	✓
First Super Pty Limited	
FSS Trustee Corporation	✓
Guild Trustee Services Pty. Limited	
H.E.S.T. Australia Ltd.	✓

(continued next page)

Table C.10 (continued)

<i>RSE licensee</i>	<i>Response submitted</i>
Holden Employees Superannuation Fund Pty Ltd	
Host-Plus Pty. Limited	✓
I.O.O.F. Investment Management Limited	✓
IAG & NRMA Superannuation Pty Ltd	✓
Industry Funds Investments Ltd	✓
IS INDUSTRY FUND PTY LTD	
Kinetic Superannuation Ltd	✓
L.U.C.R.F. Pty. Ltd.	✓
LCA NOMINEES PTY. LTD.	✓
Legal Super Pty Ltd	✓
LGIAsuper Trustee	✓
LGSS Pty Limited	✓
Macquarie Investment Management Ltd	✓
MAP Funds Management Ltd	✓
Maritime Super Pty Limited	✓
Meat Industry Employees Superannuation Fund Pty. Ltd.	
Media Super Limited	✓
Mercer Superannuation (Australia) Limited	✓
Mercy Super Pty Ltd	✓
Motor Trades Association of Australia Superannuation Fund Pty. Limited	✓
NESS Super Pty Ltd	✓
Netwealth Investments Limited	
NGS Super Pty Limited	✓
NSF Nominees Pty. Limited	✓
NSW Fire Brigades Superannuation Pty Limited	✓
Nulis Nominees (Australia) Limited	✓
OnePath Custodians Pty Limited	✓
Perpetual Superannuation Limited	✓
Pitcher Retirement Plan Pty Ltd	✓
PostSuper Pty Ltd	✓
Prime Super Pty Ltd	✓
Qantas Superannuation Limited	✓
QIEC Super Pty Ltd	✓
QSuper Board	✓
Rei Superannuation Fund Pty Limited	✓
Retail Employees Superannuation Pty. Limited	✓
Sandhurst Trustees Limited	
SCS Super Pty. Limited	✓
State Super Financial Services Australia Limited	✓
Statewide Superannuation Pty Ltd	✓
Suncorp Portfolio Services Limited	✓
Sunsuper Pty. Ltd.	✓
T W U Nominees Pty Ltd	✓
Tasplan Pty Ltd	
Telstra Super Pty Ltd	✓
Tidswell Financial Services Ltd	✓

(continued next page)

Table C.10 (continued)

<i>RSE licensee</i>	<i>Response submitted</i>
Total Risk Management Pty Limited	✓
Towers Watson Superannuation Pty Ltd	✓
Toyota Super Pty Ltd	
Unisuper Ltd	✓
United Super Pty Ltd	✓
V.I.S. Nominees Pty. Limited	
Vicsuper Pty Ltd	✓
Vision Super Pty Ltd	✓
WA Local Government Superannuation Plan Pty Ltd	✓
Zurich Australian Superannuation Pty Ltd	✓

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