



SUBMISSION

Productivity Commission Issues Paper: Superannuation Efficiency and Competitiveness

NAB (via the MLC wealth arm), September 2016

Superannuation

Productivity Commission

BY EMAIL: <http://www.pc.gov.au/inquiries/current/superannuation/competitiveness-efficiency>

About us

MLC is National Australia Bank's wealth management arm and provides investment, superannuation, financial advice and insurance¹ to our corporate, institutional and retail customers.

MLC has 1.7 million customers, 5,000 employees and 1,800 in the financial adviser network.

National Australia Bank (NAB) Group is a financial services organisation with over 12,700,000 customers and 42,000 people, operating more than 1,700 stores and business banking centres globally.

¹ Proposed sale of MLC Limited: Last year the NAB Group announced a plan to sell 80% of its insurance business (MLC Limited) to Nippon Life Insurance Company. This is planned to be completed late 2016.

TABLE OF CONTENTS

PRELIMINARY	1
SUMMARY	2
OUTCOMES: systemic VS member OUTCOMES ASSESSMENT	3
Objective of Superannuation	4
CRITERIA - overview	4
EFFICIENCY OBJECTIVE 4.2 Net returns	5
Historical returns	6
Benchmarking	7
Asset class benchmarks	8
Net returns (choice)	8
Comparison – individual attribution (Wrap) versus pooling (master trust)	9
Tax management on Wrap platforms/SMAs	15
EFFICIENCY OBJECTIVE 4.3 – member preferences and needs	18
Underdeveloped retirement system	19
Trustee designed retirement options (including CIPRs)	21
Member Engagement	22
Improving our approach	22
EFFICIENCY OBJECTIVE 4.4 — insurance at least cost	26
TRUSTEE OBLIGATION	27
GROUP INSURANCE - OPT OUT OR OPT IN	27
MySuper group insurance - temporary / income replacement	28
Improving designs	29
The value of insurance – an example	30
COMPETITION OBJECTIVE 4.1	32
Member/demand side drivers	32
Supply side	33
REGULATORY IMPEDIMENTS IN SUPERANNUATION COMPETITION	34
Merger/consolidation impediments	37
Complexity in consolidation	38
Regulatory imposts	44

PRELIMINARY

National Australia Bank (NAB) through MLC welcomes the draft report of the Productivity Commission and appreciates the opportunity to provide comments.

The extensive analysis, draft criteria and metrics developed by the Commission is a significant step towards a framework against which participants and policy makers can measure the overall health of the system and determine whether it is reasonably delivering for consumers.

As an entity that has participated in the superannuation system for many decades NAB, through MLC, has a keen interest in continuing to meet, and to improve, outcomes for a broad range of superannuation customers through efficient designs, delivery and ongoing innovation.

It is our belief and indeed experience that competition within and across the superannuation system exerts pressure upon incumbents to continually adapt, renovate, and innovate to meet ever-changing needs across a wide demography.

Overall, MLC is supportive of the multiple criteria approach taken by the Commission in its draft report noting the layers enable 'testing' of the component outcomes.

This multifaceted approach could provide a more robust view than use of a single criterion, or limited criteria. However, it is an ambitious approach and may benefit from staging depending on intent and repetition. The cost to implement an assessment framework also needs to be considered in the context of the benefit to members.

Refinement of approach, and some of the metrics, is recommended if the assessment is to be applied across the membership spectrum, including choice options. This would permit assessment of member outcomes in a richer environment that caters to a wide dimension of consumer engagement and activity (from none to self-directed).

We would also welcome some clarification of the purpose and longevity of the assessment process. That is, the final report could identify whether the assessment is intended to be once-off or recurring and if so, the timing and through which body. This is particularly pertinent given some of the criteria and metrics being considered will involve potentially significant analysis, compilation and, likely, additional costs (for both funds directly, their service providers, and government bodies/regulators).

One of the core questions we have is whether the intent is to drive a more concentrated, limited choice offer(s) designed by the trustee and catering essentially to disengaged members or, to build on engagement and accommodate additional options which allow individuals to tailor products and services to their needs (which can come at a cost).

Commentary around lifecycle smoothing, behavioural finance and trustee analysis of member situations and tailoring suggests a preferred paternalistic approach.

Recommendation: Clarify assessment target (system and/or member outcomes); longevity of assessment framework and conducting entity.

SUMMARY

- Assessment criteria to determine the efficiency of the superannuation system, and separately efficiency of funds and products, needs to be multifaceted. If the assessment is intended to provide a richer view of member outcomes, rather than an overall systemic view, it is important to segment on a 'like for like' basis to avoid misleading or confusing outcomes.
- The scope of the proposed framework is ambitious. It may be preferable to undertake an assessment of the system comprising the majority of members (as a starting point) – this would be the default [MySuper] segment.
- Choice options including SMSFs and SMSF-like arrangements can provide strong 'uplifts' in outcomes taking into account individuals' circumstances, risk profiles and tax timing for those with higher balances and the ability to absorb related costs.
- Master trust multi-asset portfolios or lifecycle options offered by a trustee (including MySuper) deliver the benefits of scale and pooling to provide well-managed diversification at lower cost than most would afford individually.
- Choice can add to costs in the system. However, while 'default' or pre-designed products are an important feature for those who are disengaged or prefer decision support, capacity to choose from a range of structures and products is important to meet idiosyncratic risks particularly in retirement and particularly with the system operating as a 'pay as you go' model (defined contribution).
- There is reasonably strong competition amongst service providers to trustees.
- There are legislative barriers to entry and exit of funds and withdrawal of products including:
 - An arbitrary restriction to 15 funds in respect of mandatory contributions where an employee does not make their own choice under the modern award framework.
 - Regulatory impediments, including significant complexity, which hinders fund and/or product mergers and consolidation. Improvements could be achieved through a dedicated review and potentially a focused set of laws for this purpose.
- Insurance, particularly through group employer arrangements, provides valuable benefits at lower cost to 'retail' or external products mitigating underinsurance in Australia. However, there are engagement issues which can lead to inadvertent lapses or unintended duplication negatively affecting retirement outcomes.
- The benefit of insurance, financial advice, engagement activity and options for retirement drawdown suggests the assessment should be considered in terms of improved financial wellbeing rather than the end retirement outcome.
- Efficiency in the system is significantly impacted by ongoing policy changes which have been and are extensive and costly.
- The system has a number of governance overlays including a trustee model in addition to extensive laws and prudential regulators. This can add to costs but given mandatory flows and recommendations from a previous review into the superannuation system, the existing model is considered an appropriate governance framework.

OUTCOMES: SYSTEMIC VS MEMBER OUTCOMES ASSESSMENT

As noted in the Preliminary section of our submission, it would be useful if the final report clarified whether the main aim is to assess the overall system outcomes at a general or aggregated level, or to provide a more graduated assessment of member outcomes incorporating both 'default' and choice options, and savings and retirement phase.

The draft report does seem to contemplate a more detailed assessment of member outcomes. In this regard, our initial submission indicated it was important to compare products/segments on a 'like for like' basis to avoid misleading or confusing outcomes. Due to the very different consumer segments serviced by the superannuation system (particularly 'low engaged or trustee-reliant default' members versus 'engaged self-directed choice' members) we believe the report could more clearly enunciate:

- The components and aims of the assessment framework. That is, distinguish systemic assessment (and in some cases metrics) from the member outcomes framework and what each (if that is applicable) is seeking to determine.
- The focus area for member outcomes, in particular whether the 'system' assessment is predominantly intended to determine the health/performance of the 'default' product market given the FSI attention to the effectiveness of MySuper² in encouraging more efficient and competitive outcomes (which should include building and servicing member engagement to assist with optimising retirement outcomes).
- Whether it is intended to capture all members including those selecting choice options. If so, we would recommend the structure of the framework be separated into at least three segments comprising:
 - 'Default' accumulation;
 - Choice accumulation, which differentiates SMSFs and 'SMSF-like Super Wrap' options from 'blended portfolio' choice options; and
 - Retirement.
- The main intended audience for overall assessment and, if applicable, specific assessment(s).

A systemic assessment would combine significant data from multiple sources which would provide only a headline view of the system, and its health. However, this is not conducive to, or appropriate for, comparisons of outcomes for the different segments (even less so for more refined categories for example, based on member cohorts by one or more of age, gender, life-stage, engagement profile).

The findings of the Commission will potentially influence participant behaviour which is why we believe the above segmentation and clarification is important.

Our view is that a diverse range of options including member services (e.g. education, online advice capability) and choices, while they may add to overall costs, and even to some complexity, affords the broadest range of consumers the capacity to optimise their outcomes over a lifetime and also at different times/stages especially as needs vary (sometimes unpredictably).

In this regard, it is acknowledged that improved engagement as well as product suitability frameworks (as contemplated in FSI recommendation 21) will be increasingly important.

Insight/recommendation:

- To the extent the assessment is to consider member outcomes, separate analysis into at least 3 segments: accumulation (default); accumulation choice (separating SMSF and SMSF-like); and retirement.
- Clarify intended audience(s).

² Noting that MySuper may be chosen.

OBJECTIVE OF SUPERANNUATION

MLC acknowledges the Commission is operating in accordance with the Government's announced policy regarding the objective of superannuation which is to substitute for, or supplement, the aged pension.

At an aggregate level the tracking of core system components would identify whether it is broadly meeting this goal. Given recent policy changes particularly capping contributions, it is likely this goal is a manageable target for a majority of participants in a mature system.

Our view remains that superannuation, as the predominant private vehicle for funding retirement³ (including via mandate) would benefit from a broader aspirational objective (and associated policies) which would focus on an adequacy target allowing an individual to reasonably maintain their quality of living in retirement.

In effect the retirement system objective should be framed by lifecycle finance theory (which is not the same as lifecycle/stage investment structures); that is, public policy should support attaining a level of retirement income relative to pre-retirement income.

We recognise and acknowledge the need for limits to the tax concessions afforded superannuation particularly in respect of those who have significant means. We also acknowledge individuals may choose other mechanisms to fund overall retirement needs and indeed expect this to occur if superannuation policy continues to be unstable and unpredictable. This potentially amplifies risks if those savings are diverted to leveraged assets such as property or the local share market (which is highly concentrated) that can amplify losses. That is, the diversification that usually occurs in the fiduciary controlled superannuation environment is undermined.

To the extent that superannuation is to be, and remains, a main source of post retirement income for a large proportion of the population (at maturity) the objective should accommodate a reasonable adequacy target.

CRITERIA - OVERVIEW

We have not addressed all the criteria and options. Our focus is based on discussions with members of the secretariat. Key areas we address are:

- Efficiency
 - Net returns in the context choice options
 - Insurance
 - Member engagement/preferences – recent research and testing outcomes
 - Regulatory costs – excluding confidential data previously supplied
 - Consolidation impediments (previously supplied but reiterated due to constraints).
- Competition
 - Market contestability
 - Barriers to exit.

³ RBA Bulletin, June Quarter 2016, Paul Ryan, Tahlee Stone, Household Wealth in Australia: Evidence from the 2014 HILDA Survey – "Superannuation accounted for around half of the value of non-housing assets in 2014 and was the second largest asset class in Australian households' balance sheets, after housing."

EFFICIENCY OBJECTIVE 4.2 NET RETURNS

The Commission proposes the following objective for the assessing the efficiency of the system:

The superannuation system maximises net returns on member contributions and balances over the long term⁴.

And further notes:

Maximising net returns (after fees and taxes) is the most important way in which the superannuation system contributes to adequate and sustainable retirement incomes. The Commission will focus on assessing system-wide long-term net returns, and compare them to various benchmarks.⁵

At a conceptual level, the objective encourages a focus on what the system should be producing, being adequate and sustainable retirement incomes. The contribution of investment returns, over time, to this outcome is as important as the capital contributed, more so in the increasingly longer retirement phase⁶.

Depending upon the aim, making this the headline feature for measuring the efficiency of the system ahead of all else could lead to flawed conclusions.

If the intent is to measure whether the overall system (in moving to maturity) is on track to provide most members an aged pension through a significant contribution from investment performance relative to contributions, it may be a reasonable approach. However, clarity of audience and caveats will be important because, without other moderating factors, it could drive or change behaviour (of trustees, managers and members) to 'chase' the number (including downwards) at the risk of some other beneficial services and at the risk of insufficiently funded retirements relative to pre-retirement living standards.

If the assessment is intended to deliver more insights and tracking of outcomes across the membership spectrum consider:

- The terms of reference use the term 'optimise'. We would support retention of that descriptor instead of 'maximising' returns. There are a range of member services and features which we believe will, in different circumstances, enhance outcomes but which come at a cost which would reduce headline net returns. For example:
 - Financial advice;
 - Education and engagement (beyond legally required disclosure material);
 - Life insurance (see further below);
 - Strategies to insure against a range of risks including sequence, market and longevity risk – this can mean purchasing 'protection' (for example through a deferred annuity, or dynamic hedging strategy or other insurance), holding larger amounts particularly in retirement to manage health or once-off cost/risks;
 - Membership demographic – while potentially not optimal from a pure investment return viewpoint, funds with more older retirees will generally have a lower risk tolerance driving them to lower performing conservative asset classes but also potentially allowing greater flexibility of access if needed, for e.g., to pay health costs;
 - Engagement and distribution costs for those with MySuper offers that are not listed on awards.

⁴ Productivity Commission Draft Report : How to Assess the Competitiveness and Efficiency of the Superannuation System, August 2016 p68

⁵ Ibid. p7

⁶ RBA Bulletin, *ibid* – "Annual mean growth in super was highest for households over the age of 65 years..." Using Russell Investment Group's rule of thumb (10/30/60) 60% of retirement income is from returns generated in retirement (10% from contributions & 30% from pre-retirement returns). This is predicated on linear, and quite generous, earnings assumptions - person joins super fund at age 25 and contributes \$1,000, with this amount rising 4.75% every year until retirement at age 65. Retirement income rises 3% each year until death at age 90, when account balance is nil. Investment return assumed to be 7.8% p.a.

- Accumulation versus retirement outcomes. See above comments regarding demographic, risk tolerance, flexibility of access. In retirement phase, it may be relevant, all other things being equal, to assess the actual or likely failure rate of a superannuation pension in terms of a target age or death.
- The fundamental differences between default MySuper designs, choice options and between choice options particularly SMSF and SMSF-like options. When assessing net returns, consideration must be given to what fees are excluded particularly in SMSF/SMSF-like arrangements (see below).
- The effect of tax management strategies in choice options for SMSFs and SMSF-like options (see below).

HISTORICAL RETURNS

Average returns in the past are, as noted by the Commission an ex post measure, and are not reliable as a predictor of expected future returns, whether you look at total return or active return over a benchmark.

In fact, it is rare that an investment mandate of an underlying manager used by a trustee runs for much longer than 3 – 5 years and even within that timeframe will be adjusted if conditions dictate.

This is one of the reasons we believe the Commission needs to clarify audience and purpose of the assessment framework. Another is that provision of services, particularly those focused on increased engagement, will impact returns and be seen negatively if considered in isolation to the holistic customer journey.

In a systemic assessment, trend analysis over longer periods would assist and we note reference to periods of 5, 10 and 20 years. However, there are a number of issues with this approach if the assessment is to occur in 2020:

- Availability of data is limited both in terms of investment performance and fees – at least in a consistent way.
- There have been significant and dramatic changes to products and services in the last 10 to 20 years to the point where most modern products are not comparable with past products.
- Legacy or off-market products would need to be excluded to mitigate distortionary effects – consider for example, whole of life, endowment and similar ‘traditional’ products.
- MySuper, upon which the FSI recommendation and Government response is largely focused, commenced only on a mandatory basis from 1 January 2014 with a transition period to 2017.

While some simpler funds may have used a single existing default, many which accommodated: multiple workplaces and bespoke ‘default’ options; and/or merged corporate funds had to design a new single offer (as required by the MySuper provisions) into which other defaults had to be merged.

- Amalgamating MySuper with choice data (including retirement incomes performance), depending upon the audience and desired level of granularity for member outcomes, would produce an unreliable result (see comments below particularly with regard to Wraps where portfolios may be frequently rebalanced).

It may be that a baseline assessment is undertaken in 2020 potentially taking data from the full implementation of MySuper in 2017, along with a number of SuperStream reforms explicitly intended to enhance operational efficiency to be followed up with a subsequent assessment(s) at future dates.

BENCHMARKING

Given the challenges and issues with measuring system-wide performance we would support the principle of using multiple metrics rather than relying on any one metric. No single approach will provide a solution and each has its own issues and flaws.

Where measuring system-wide net returns, we would endorse an approach of using a passive reference portfolio based on industry wide aggregate asset allocation. This would give some representation of the system wide value-add from active management but not much else.

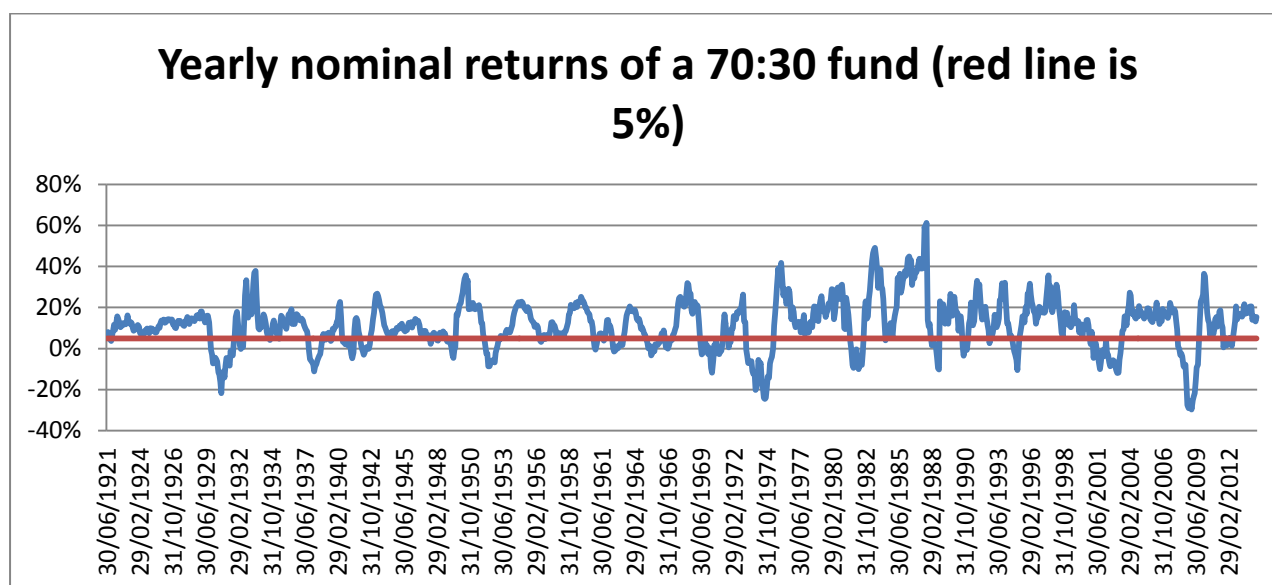
However, in determining the aggregate asset allocation of the industry, data will need to be collected as widely as possible ensuring a comprehensive coverage of all funds including industry funds, retail funds, SMSFs and public sector (non-defined benefit given liability rests with Government and the taxpayer for defined benefits).

Where measuring against a CPI + X% benchmark, measurement will need to be cognisant of the fact that different funds, or sub-plans/segments, have different CPI targets and this could be due to different risk settings for example due to different demographic characteristics.

In determining what level of X% is appropriate to assess the system against, it may be useful to collect data on return targets of funds across the industry and determine an average target for the aggregate industry based on a weighted or simple average (with at least a segmentation of accumulation and retirement phases).

Nevertheless, in doing this, it will need to be recognised that even over a period of 10 years the success of meeting this objective can be **more driven by market conditions rather than “efficiency” of the system.**

The below graph is sourced from: Global Financial Data (purchased series), assumes a diversified balanced (70:30) fund; historical data from 1900; MLC analysis of the data.



There are significant fluctuations in performance and with hindsight some more or less predictable cyclic peaks and troughs but also clear black swan events.

Survival of some in the most recent, the GFC, was fortuitous rather than well-planned particularly given the latitude in valuation timing of (less liquid) assets.

Asset class benchmarks

With regards to asset class benchmarks, the choice of benchmark can lead to very different outcomes. For example, in global equities the use of MSCI World Index will lead to very different return outcomes than the MSCI All Countries World Index (which includes emerging markets).

Depending upon the intended longevity of the framework, it might be useful to collect data on asset class benchmarks used across the industry and use the most represented (i.e. most common) index as the benchmark or take some average of these indices as a benchmark for the system.

In addition, when collecting data on asset class returns from funds, it will be important to ensure that funds submit performance for the actual asset class exposures used in their diversified funds, and not “carve outs” or other smaller components of the asset class that they might have.

There would need to be very clear guidelines on how asset class returns are to be determined and represented.

NET RETURNS (CHOICE)

In the choice environment, members (often with an adviser) design their own portfolio as opposed to the trustee-designed MySuper product.

In many choice options particularly Wrap⁷ and Separately Managed Account (SMA) platforms the portfolios may be re-weighted/re-balanced depending upon the investment strategy.

There are a number of different approaches – it is possible for example to calculate the weight of a member’s portfolio in terms of sector; geographical region; index exposure; type of security, such as bonds or small-cap technology companies; etc.

Depending upon the fund’s exposure to choice members, this could mean considerable variation in the outcome for the fund as a whole, and not particularly indicative of outcomes for the overall choice cohort.

On average, clients on the MLC Wrap superannuation platform hold 8 investment options to make up their own diversified portfolio - this includes multi sector investments, single sector investments, Term Deposits and listed shares. Administration and similar service fees are related to the account, not each option selected.

This is very different to the MySuper product which is offered (and generally taken) as a single option comprising a variety of assets in a ‘constructed portfolio’ singly or by life-stage for a specified investment and administration fee.

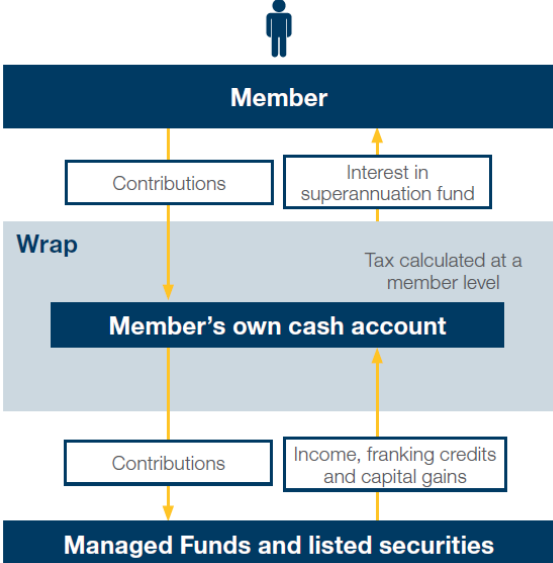
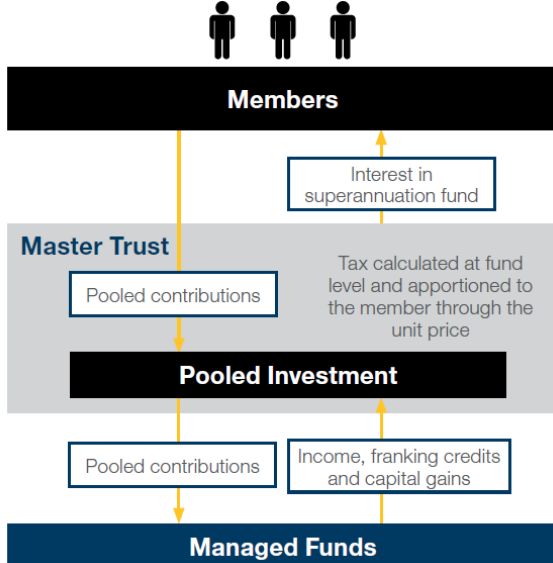
Other constructed portfolios such as Growth, Balanced and Conservative or similar⁸ may, if selected as the sole option, be comparable to MySuper.

⁷ These are really administrative platforms that ‘wrap’ up the options selected by the member with consolidation investment and tax reporting. SMAs or SMA-like platforms are a Wrap but also effectively manage parcels within the platform before conducting market trades which can minimise transaction costs and CGT.

⁸ This nomenclature is another area of contention given the widely varying construction and exposures to different asset classes. It is what led to the development of the ‘Standard Risk Measure’ (which is underwhelming).

Comparison – individual attribution (Wrap) versus pooling (master trust)

The table below summarises key differences between individually attributed asset and tax choice options (Wraps⁹) versus pooled options (can include both choice and MySuper). This illustrates the potential difficulties arising from comparing the efficiency of the superannuation system if Wraps are included in the analysis.

Wrap ¹⁰	MasterTrust (includes MySuper product) ¹⁰
	
<p><u>Investing</u></p> <p>Investments are attributed directly to the individual such that buying and selling of assets occurs directly in response to the transactions initiated by the member.</p> <p>Key point: member is fully invested in chosen asset and receives actual return on asset.</p>	<p>Investments are pooled by the trustee on behalf of all members that invest in that pool. The pool generally consists of investment assets and cash, and transactions only occur at a pool level when an agreed trigger occurs (to buy or sell assets).</p> <p>Key point: all investments are pooled and may not be directly correlated to asset (e.g... includes cash buffer and netting of transactions between members in and out).</p>
<p><u>Value for transactions</u></p> <p>Member receives value for the transactions on settlement of the transaction in the market.</p>	<p>Member receives immediate value for transactions in the pool.</p>
<p><u>Attributing income</u></p> <p>Investment returns for members are calculated net of tax and reflect:</p> <ul style="list-style-type: none"> The actual gain/loss (controlled by activity of the member directly) in value of underlying assets held on behalf of the member, plus 	<p>Investment returns for members are calculated net of tax and reflect:</p> <ul style="list-style-type: none"> Apportioned value of the increase/decrease in value of the pool (inclusive of gain/loss on assets and income received), less

⁹ These are really administrative platforms that 'wrap' up the options selected by the member with consolidation investment and tax reporting. SMAs or SMA-like platforms are a Wrap but also effectively manage parcels within the platform before conducting market trades which can minimise transaction costs and CGT.

¹⁰ The diagrams are sourced from Oasis Funds Management

Wrap¹⁰	MasterTrust (includes MySuper product)¹⁰
<ul style="list-style-type: none"> • The value of income (dividends, distributions or other income) on the assets held on behalf of the member, less • Any fees charged for managing the assets (e.g.. investment manager fees, custody) <p>Key point: Realised gains/losses and income are passed directly to the member for the assets held by the trustee on their behalf and incorporate tax on their investments.</p>	<ul style="list-style-type: none"> • A provisioned for tax (see below) determined by the trustee for gains/losses (realised and unrealised) and income (dividends, distributions or other income), inclusive of an estimate of tax benefits (e.g.. franking credits), less • Any fees charged for managing the assets (e.g.. investment manager fees, custody), less • Asset based administration charges applied by the trustee (not applicable in all cases) <p>Key point: earnings of the pool are apportioned to members and incorporate tax that reflects the effects of all members on the pool.</p>
<p><u>Investment related tax</u></p> <p>Broadly, tax on investments is applied directly to the member based on their transactions and income:</p> <ul style="list-style-type: none"> • Capital gains: tax is applied to realised gains (depending on the platform realised losses may provide a carry forward benefit for the member); • Income: dividend and distribution income (along with the tax advantaged components, e.g... franking credits) flow directly to the member related to the units, shares or attributed value of the investment held on their behalf. <p>Wraps will generally approach realisation of assets in the most effective way for members, or leave it open to selection.</p> <p>[See further section below on tax management]</p> <p>Key point: Tax is generally applied to each member based on their individual tax payable. When assets are realised, the full value of the capital gains tax is applied to members (which also occurs in a master trust but spread in proportion to each member's equitable share).</p>	<p>Members own a share of the assets and are subject to tax based on their share of holdings in the pool.</p> <p>Realisation of assets and the tax effect is considered at a “whole of option” level, so that every member receives an average effect.</p> <p>There is no way to identify whether this gives rise to a better benefit for those leaving the fund or those that remain, given that all members of the option “pay” an average rate rather than one specifically tailored to their transactions or period of membership / investment in the option¹¹.</p> <p>Key point: tax is apportioned to members through their unit price, as the total tax payable by the fund or investment option is apportioned to members irrespective of their individual transactions¹².</p>

¹¹ Larger pooling benefits can be achieved. Given their scale, a pooled entity can generally net trades.

¹² This money is still invested in the market. It is only provisioned for in case the member decides to leave or switch.

Wrap ¹⁰	MasterTrust (includes MySuper product) ¹⁰
<p><u>Transition to pension</u></p> <p>Where investments are carried over to pension phase, capital gains tax is generally avoided when assets are realised after that transition, as there is no tax payable in the pension phase.</p> <p>Key point: No tax is payable on unrealised gains during the accumulation phase if the asset is not realised prior to entering the pension phase.</p> <p>This is arguably allocatively efficient:</p> <ul style="list-style-type: none"> • Tax free transfer from Super to Pension: No fund level accruing of unrealised CGT liability like Master trusts which means if member moves to Pension and maintains asset structure, they do not incur any Capital gains tax • Tax Optimisation: Parcel selection to achieve the best capital gain/loss outcome for clients. Conversely, members do not receive the optimisation benefits of being in a large pooling structure. 	<p>Large super funds generally separate accumulation and pension pools. In effect, new units are bought in pension phase. As a result, in rising markets, members would be subject to capital gains tax on relevant units (reflected in their unit price).</p> <p>Key point: Some funds now provide a “bonus” payment to individual members on transition to pension phase.</p> <p>Pros of applying CGT refund at Group level:</p> <ul style="list-style-type: none"> • Avoids issues regarding applying the refund at an individual level such as: <ul style="list-style-type: none"> – Higher administration costs meaning higher administration fee to members. – It can be difficult to make an accurate assessment of an appropriate amount of CGT to be refunded to any individual member. – Funds offering Individual CGT refunds make several assumptions. It can be done on assessing the benefit that has been achieved from transferring assets into the pension phase. – All members that transition in that year could receive that benefit. e.g. one fund uses the calculation of pension purchase price x 0.30% to determine the refund payable. <p>Cons of applying CGT refund at Group level:</p> <p>Depending upon systems:</p> <ul style="list-style-type: none"> • Benefit not as tangible or transparent to the member due to the refund being embedded in the unit price. Individual payments are made direct into the members cash account as a lump sum payment. • Due to averaging, those withdrawing super in accumulation phase may benefit from a lower effective tax rate than would be the case if the tax had been attributed individually. Members withdrawing super in pension phase effectively subsidise this lower effective tax rate.
<p><u>Range of assets</u></p> <p>Wraps will provide opportunity to invest in a vast range of assets. For example, MLC Wrap allows members to invest in:</p>	<p>Master Trusts will have a constrained range of investments.</p> <p>The investment range for most Master Trusts is typically between 10 to 50 options.</p>

Wrap ¹⁰	MasterTrust (includes MySuper product) ¹⁰
<ul style="list-style-type: none"> • More than 300 managed funds (multi-asset and single-asset class funds) – widely available from professional investment managers across the market. • Up to 500 ASX-listed investments (individually or via professionally managed Separately Managed Accounts) • Term deposits. <p>The trustee sets some boundaries to ensure investment strategies chosen by members achieve diversification, such as maximum proportion of a member’s account balance that may be held in a particular asset or type of asset (particularly for ASX securities and certain single-asset class funds).</p>	<p>These consist of:</p> <ul style="list-style-type: none"> • Multi-asset class investment pools (generally 1 option per risk profile, e.g. cautious through to aggressive) – internally managed, with some allocations to professional external managers. • Single-asset class investment pools (typically in the main asset class types (e.g. Australian shares, Global shares) – typically the same pools that combined to provide the multi-asset class pools. • Some selected single-asset class products run by professional managers. <p>The trustee doesn’t normally establish boundaries as the investment pools do not generally have concentration risk and are well diversified¹³.</p>
<p>Implementation of asset allocation</p> <p>Allows building of detailed portfolios specifically taking into account customer overall positioning (including investments held outside super). Rarely (if ever) will a Wrap portfolio consist of just one asset.</p> <p>It would be odd to focus on just an asset class benchmark and difficult to focus on an overall portfolio given the make-up of one portfolio to the next could be quite different, and established with different client goals.</p> <p>Typically, the member’s adviser will build a portfolio from an approved range of research models. Examples may include:</p> <ul style="list-style-type: none"> • Accumulation models, which provide asset class allocations recommended for specific members’ risk profiles, and recommended allocations to specialist managers across those asset classes, which would be expected to provide correlation benefits (unified and offsetting). Generally these would use managed funds for market access which gives rise to some direct tax benefits, but are still subject to shared tax given the pooled nature of managed. <p>Model portfolios will generally have a number of funds and balance between investments structured for capital gain (some Australian & Global equity) and dividend / distribution income (Australian</p>	<p>Multi-asset class products (“balanced” or “growth”) are most commonly used, as either fixed allocations through membership or as lifestage / lifecycle strategies, where the later strategies “de-risk” over time.</p> <p>Generally, there is less ability to build detailed personal portfolios, with most members holding investments in either a single multi-asset class investment option (such as MySuper), or using these in combination with asset class portfolios to match their risk profile.</p> <p>It is possible for a trustee to offer choice option(s) which may be more illiquid (greater exposure to infrastructure or property etc.) subject to reasonable disclosure and active consent from the member. However, it is not a common practice.</p> <p>Where a fund offers an allocated pension in retirement phase then, depending upon the investment options and systems, there may also be capacity to utilise a form of ‘bucket strategy’ as in Wraps in order to provide a conservative/FI bucket from which income can be drawn for a period of time (e.g. 2 years), a bucket with a proportion in balanced type option(s) for the medium term and a bucket with a proportion in higher growth option(s) for the longer term.</p>

¹³ They are usually professionally managed with a more diverse range of embedded assets (including: Global Private Equity, international).

Wrap ¹⁰	MasterTrust (includes MySuper product) ¹⁰
<p>equity income, hybrid property, fixed income & cash).</p> <ul style="list-style-type: none"> • Accumulation models similar to the above but deconstructed to provide the member with direct attribution (e.g. via Separately Managed Accounts) where the tax benefits flow directly to the member. <p>Some of the accumulation models used in our context are as above, and allow for the inclusion of SMAs in place of some managed funds (e.g. Australian equity), which result in a member holding 14-15 managed funds and a portfolio of 50-80 ASX securities overseen in one or two portfolios by professional managers.</p> <ul style="list-style-type: none"> • Accumulation models as above but adjusted to account for a member's total asset position (including outside super). For e.g. clients may hold a share portfolio, investment property or cash outside super, where it may be appropriate to adjust the risk/return profile of assets inside super to balance total position inclusive of tax benefits of assets inside and outside super. This may include building a specific share portfolio inside super to adjust for an external share portfolio ensuring an appropriate total weighting to a particular share is achieved, or to adjust property or cash weightings. The return outcome inside super may thus be lower or higher to balance overall position. • Accumulation models / portfolio construction can be built to manage the illiquidity premium (limited access for higher return) expectations of short term underperformance for expected longer term outperformance, and other tolerances/expectations of individual members, such that members are not treated as the "collective average"¹⁴. • Retirement models that address liquidity needs, income from assets to provide sufficient return to fund drawdown income, e.g. structuring assets to achieve higher dividend / distribution or income in order to avoid realising assets to facilitate drawdown. These models may or may not be balanced with de-risking assets – it will depend how the customer intends 	

¹⁴ As with the accumulation models, they can be further deconstructed into SMAs or aligned with external holdings.

Wrap¹⁰	MasterTrust (includes MySuper product)¹⁰
<p>to fund short and long term income needs, in light of other assets they may hold (and personal circumstances).</p> <p>In retirement phase, many use the 'bucket approach' - assets are segregated into those required to service various needs, e.g. the income need serviced by highly liquid income producing assets with less risk, the medium term needs with some allocation toward growth assets (targeted at things that a client may have in mind e.g. capital improvements to home) and the longer term bucket).</p> <p>Super assets can't be considered in isolation.</p>	
<p><u>Fees</u></p> <p>Fees are tailored to individuals under a user pays system, discounting for higher balances and often fee aggregation for multiple accounts (including family and non-super accounts).</p> <p>Wrap users pay fees for the services they use or intend to use (e.g. managed funds vs listed investments), and individual transaction costs (e.g. buy/sell spreads on managed funds, brokerage on listed investments).</p>	<p>The MySuper fee requirements lead to very little differentiation in fees between members, unless an administrative scale efficiency discount applies for employees of larger employers. With choice options, the fees will generally depend upon the options chosen, and potentially the size of the member's account balance.</p> <p>Generally, the fees are lower as there are lower levels of transactions and due to pooling effects.</p>
<p><u>Outcomes / efficiency</u></p> <p>Members receive the full benefit of their own strategy.</p>	<p>Members receive an averaged outcome but with benefits of pooling and generally lower fees.</p>

A gross increase (or decrease) in the rates of returns over longer specified time periods (in accumulation and retirement phases respectively and for like 'classes') may be a reasonable approach to assessing system outcomes over time. This may be separately accompanied by the increase/decrease in returns net of investment fees over the same time frames (i.e. **excluding** administration and other 'account/client' based fees).

At a fund level, comparison of 'like' products for assessment purposes seems more apt for a net, or gross, of fees and/or taxes approach. Overall, we would argue that it is very difficult to measure efficiency of the system on the basis of investment outcomes over a fairly limited history and that this would not give a realistic view of outcomes for self-directed members.

At least initially, it might be more effective to focus on an assessment of "inputs" or at least include these with a weighted value in the metrics, for example, assessing the appropriateness of governance structures around investment decision-making, looking at experience and credentials of investment committees, the transparency and timeliness of asset valuations, tax attribution, arbitrage controls and risk management frameworks.

Tax management on Wrap platforms/SMAs

In the SMSF and SMSF-like choice worlds, the capacity to manage tax outcomes more explicitly can be valuable and potentially improve outcomes for the member as their circumstances change. However, it is generally more expensive, only effective for members with higher balances and requires ongoing attention to both the asset selections and relative tax position as well as transition to retirement.

We have limited our comments to Wraps (in comparison to Master Trusts) as this gives an illustration of the differences between an 'individually attributed' choice approach and a 'pooled' or grouped approach (the latter of which applies also to MySuper).

Given the personal choice that is involved in a Wrap platform, each member tracks their own after tax and fee performance based on their portfolio. However, the assets are still owned by the trustee and the tax liability rests with the fund.

Complying funds receive concessional tax treatment and are generally subject to tax at a rate of 15% on taxable contributions and earnings in accumulation phase. The income derived from the segregated pension assets¹⁵ of the super fund is exempt from tax and associated deductions are generally not deductible, but the pool continues to attract the benefit of franking credits.

The trustee of a large fund is generally permitted to deduct amounts from members' accounts for the purpose of funding the progressive payments to the Australian Taxation Office ('ATO') for the annual tax liability of the fund. The amount that may be deducted from each member's account should notionally represent the member's share of progressive payments for the annual tax liability of the fund.

A comprehensive calculation of the notional tax liability of each member (which has arisen as a consequence of taxable contributions, income distributions and capital gains which the trustee has received on their behalf) must be performed each year as part of the annual tax process (or at the time of exiting the fund or transferring their benefit to another account in the fund), which in aggregation, and subject to certain modifications, represents the annual tax liability of the fund.

Both the fund level tax calculation and member notional tax calculation includes consideration of certain tax benefits referable to income derived, including franking credits and tax deferred amounts.

The member calculation also includes benefits relating to excess franking credits, revenue losses, capital losses and foreign income tax offsets referable to member investments. Generally net capital losses can only be offset against current and future capital gains.

Notional Tax processes - overview of notional tax in pooled options

Taxation law does not outline how super funds should treat tax at a member account level. Funds attribute tax to each member account by determining on an ongoing basis the notional tax position (based on the information available at the time), considering the transaction activity occurring on their account.

¹⁵ In some funds, an actuarial certificate is used to calculate the portion on exempt pension income (this is generally expressed as a percentage of the funds income is exempt from tax).

This notional tax position takes into account assessable income, which includes:

- Tax on investment earnings (including dividends, interest, traditional securities gains/losses, and distributions)
- Tax on financial arrangements;
- Tax on assessable contributions;
- Tax on net realised capital gains;
- Tax benefit for net realised capital losses;
- Tax on assessable compensation;
- Tax deductions on deductible expenses, and
- Tax credits.

A pooled superannuation product allows members to choose an investment option that is professionally managed that matches their level of risk and financial objectives. Unless the member's circumstances change, from the member's perspective a pooled super product is often a 'set and forget' product.

Given all of the assets are held by the trustee in a pool, the taxation outcomes are fairly and reasonably allocated to each of the members based on the percentage of the member's holding in the pool. Pooled superannuation generally has the following benefits:

- Professionally managed investments;
- Scale;
- Liquidity;
- Taxation optimisation/pooling benefits; and
- Cheaper particularly for members with lower balances.

Members will get access to assets and markets that are available to the trustee based on aggregated capital. Many individuals, particularly with lower balances, would be unable to access many of the options and markets at the price a trustee of a pool can negotiate.

Most APRA regulated funds with pooled assets utilise a unit based system, although some still use a crediting rate, to allocate members a proportion of the assets of the fund in a fair and equitable manner.¹⁶

Unitisation is the process of breaking down the assets into portions of ownership (units). In the funds we administer unit-pricing is used due to:

- Provide more current and transparent information on the member's equitable share of the fund. Earnings are reflected in the unit price continually (rather than being allocated periodically through a crediting rate) and adjusted for estimated tax liability based on market valuation of assets should they leave the fund or switch investment options.
- Facilitate mobility of funds – unit pricing allows members to buy into or exit from an option or the fund readily. The inclusion of a range of choice options means unit pricing is preferred.
- The timing of asset valuations particularly exchange listed assets.

The unit pricing process is conceptually easy. It involves the calculation of the net assets (assets less liabilities) of the super fund divided by the units on issue.

¹⁶ The APRA & ASIC Unit Pricing Guide to Good Practice provides a good summary of fiduciary requirements.

The process for unit pricing is designed to enable interests to be transacted at prices that reflect the following;

- The value of all assets and liabilities;
- The number of units held;
- Allowance for tax where applicable;
- Allowance for transaction costs; and
- Rounding adjustments.

Although it is conceptually a very simple process, the calculation process is more complex. For example, the calculation of the estimated tax liability in the formula can be difficult.

The taxation estimate is generally calculated via an “effective tax rate” methodology. This method involves calculating an estimated rate of tax per investment portfolio (which is generally estimated based on historic tax rates to minimise or smooth differences over time and for the existing and new members).

The rate generally takes into account the following items:

- Capital gains tax discount (1/3 discount for assets held for greater than 12 month);
- Franking credits;
- Foreign tax credits; and
- Deductible expenses.

Given that unit pricing is not an exact science (relying on historical data and in some cases valuations) regular true-up processes are performed to actualise the tax liability in the price when the actual data is made available.

Large life companies and superannuation funds generally use more sophisticated estimation processes than highlighted above. Given the size of these entities, they have invested in unit pricing systems that will accrue tax at different rates depending on the ordinary or statutory income tax that is included in the daily line feed from the custodian.

In most of these entities, unit prices are updated daily based on daily asset valuations of the ‘common investment pool’ assets and the most recent valuations for the ‘external collective investment’ assets.

Risk management policies are in place to minimise the risk of arbitrage.

Insights/recommendations:

- MySuper will not be fully implemented until 2017. Similarly, SuperStream initiatives are still in development. This will not provide long, comparable histories. Absence of other longitudinal data including fees, inclusion of legacy and off-market options will distort results.
- Choice options can allow greater control of consequences based on personal circumstances with associated uplifts in overall retirement outcomes but require appropriate and timely attention to settings.
- Pooled arrangements can harness scale benefits, and subject to systems of tax management, can trend toward more sophisticated individual tax outcomes approaching those achieved in Wraps (albeit still with averaging returns which can deliver upside as well)
- Consider balancing the net return objective with a governance assessment taking into account transparency and timeliness of asset valuations, tax attribution, arbitrage controls and risk management.

EFFICIENCY OBJECTIVE 4.3 – MEMBER PREFERENCES AND NEEDS

The superannuation system meets member preferences and needs, in relation to information, products and risk management, over the member's lifetime.

*Life-cycle consumption smoothing in superannuation is driven by member decisions about the size and timing of superannuation savings and withdrawals ... The superannuation system should offer the tools and products that allow members to manage these risks, and **should also collect sufficient information about preferences to help members make the necessary decisions.***

Related questions posed by the Commission include:

Are member preferences and needs being met by the system providing products and information to help members optimally consume their retirement incomes?

Are members' balances being allocated in line with their risk preferences and needs?

There are two (arguably three) very distinct phases in superannuation. The first is the savings phase where mandated contribution rules force deferred consumption through superannuation savings. There is limited capacity (due to legislated preservation rules) to consume those savings until the next phase, retirement, which, in general terms, allows access to either or both a lump sum or pension upon ceasing work after reaching a minimum age. The exception is transition to retirement pensions (which may largely become a legacy offering with proposed law changes).

So, consumption smoothing in savings phase is largely legislatively-driven. In terms of building retirement benefits, pooled arrangements generally, and particularly for MySuper, accommodate a 'set and forget' approach. The portfolios, whether a single diversified approach or lifecycle, are constructed on a diversified basis and a managed asset allocation – basically management of risk and averaging of outcomes including tax (refer to the section [Net returns in choice options](#)).

Life-stage or life-cycle strategies can be effective at managing sequence and market risks. They can, depending upon the age-based rules, transition settings, and dynamic response to markets, also involve added risk which may not optimise retirement outcomes.

We are still in a period of 'new normal' with increasing correlation between equities and bonds. While this is a statistical measure it does mean more focus is needed to balance and diversify portfolios.

"Imperfect correlation of asset returns is a fundamental assumption used in portfolio theory and is the basis for construction of diversified investment portfolios (Markowitz 1952; Sharpe 1964). However, correlations of returns on various risky and risk-free assets do change over time and have at times switched signs. For instance, the correlation between US equities and long-term US Treasury yields was negative over much of the 20th century but has been strongly positive in the 2000s to date."¹⁷

The reality is that the future is always uncertain. The risk management process is critical. It explicitly considers what could go wrong and what the implications of this are for investment outcomes.

¹⁷ Ewan Rankin and Muhummed Shah Idil, A Century of Stock-Bond Correlations, RBA Bulletin | September Quarter 2014

The portfolio construction process considers the nature and sources of portfolio risks, and adjusts the investment strategy to ensure the consistency of risk exposures with investment objectives. The approach should be to, as far as possible, manage risk first and then seek returns to the extent that this is consistent with the required risk control and in the context of the membership.

There are pros and cons to both single diversified and lifecycle approaches that must be assessed to determine what is likely to be best for the overall membership and potential membership.

Ongoing exposure to 'growth assets' on transition into, and in early retirement, is critical due to increasing longevity. Based on the 10/30/60 rule of thumb⁶ the bulk of retirement income is generated in retirement.

A single diversified strategy, expertly managed, which contains a reasonable exposure to such assets through savings phase and into early retirement, can avoid the pitfalls of too early conversion to conservative asset classes. It is for this reason that many funds now build or ensure pension products provide the same investment options as savings phase to reduce costs or risks of transition (buy/sell spreads, market timing risks, in some cases tax liability e.g. CGT).

Once in retirement or pension phase, the member controls the level of income (or indeed lump sum) they consume (subject to legislated requirements). It has become more evident that as balances grow and can sustain income payments for longer periods, the 'retirement phase' needs further development to accommodate risks.

It is not possible in a fund such as the main master trust administered by MLC to set 'ideal/best' asset allocations for individual members in accumulation or retirement phases, as insufficient information is available.

Data analytics may help to improve offers, or indeed in future, help design a number of 'cameos' based on a set of common but differentiated characteristics but again, this can have pros and cons - no individual will ever exactly 'fit' a given cameo.

Engagement, along with appropriate, timely and accessible advice will generally deliver the most effective outcomes.

UNDERDEVELOPED RETIREMENT SYSTEM

Australia created an accumulation system that does a good job of collecting many small contributions over a long period of time and then providing a lump sum which may be converted to an income stream – but usually only an account-based income stream. We didn't create a well-rounded retirement system in the early stages (largely because the focus was on building a PAYG savings system and it would take time to mature).

In the shift away from providing reliable pensions via defined benefits we also transferred risks from institutions / employers to those individuals who were superannuated previously (predominantly the public sector, larger corporates and professional firms). These are predominantly investment risk (the risk that future long term returns are less than assumed) and population mortality risk (the risk that longevity improvements for an entire population are greater than assumed).

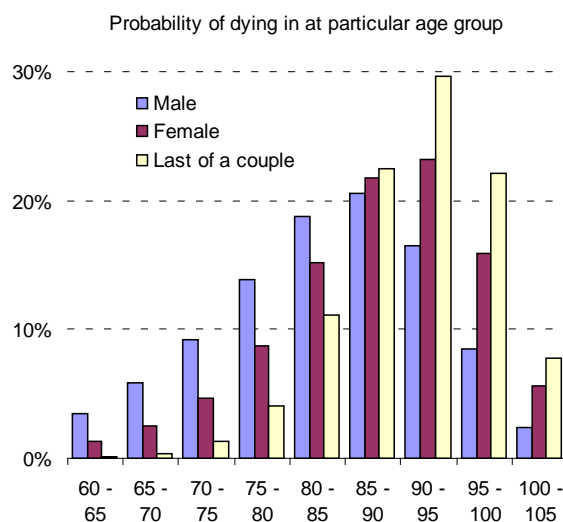
Less obvious is that new risks were created. That is, where there were defined benefits pool lives and assets, this effectively eliminates idiosyncratic risks for long term participants. The assignment of responsibility to individuals created idiosyncratic longevity and sequence of returns risks.

Products such as lifetime annuities can act similarly but capital access restrictions, costs of acquisition (depending upon markets and rates), ceding control to a provider and provider risks have contributed to the 'annuity puzzle' and limited take up - even on a partial annuitisation basis.

While the use of averages is an affordable simplification for accumulation planning, it is inappropriate in a pre- and post-retirement context because risks are amplified in retirement and there is little capacity to rectify (through return to work or reduced consumption which could compromise living standards).

Individual idiosyncratic risk is the real issue

In Australia, since 1970, life expectancy has increased from 16 to 21 years from retirement age. For every 60 minutes we've been alive, life expectancy has increased by 8 minutes.



While population mortality affects retirement planning, this is at the margin. A more significant challenge is idiosyncratic risk. Using life expectancy as a planning objective is hazardous. Only 5% actually die in the year of life expectancy. There isn't even a tight clustering around life expectancy. For males, for example, 20% die before 76 and 20% die after 93. That is, there is a 17 year gap between two equally realistic outcomes.

For a couple's life expectancy (the last of a couple to survive) the dispersion is smaller but the longevity is higher. 20% will die before 86, but 20% will live beyond 98.

From an individual's perspective, while their life expectancy might increase 3 years for every 20 they're alive, this isn't their key issue; the key issue is managing their assets to 98. Idiosyncratic risk is far riskier than systemic risk.

There are generally four main objectives that individuals seek to meet in retirement. Not all can be maximised simultaneously.

1. Growth assets 10/30/60 rule (at or in earlier retirement)
 - 60% of the income in retirement derived from market returns during retirement (10% contributions, 30% market returns during accumulation)
 - Need continued exposure to growth assets (which is why some target/life stage approaches can be problematic)
 - Investing more conservatively can deplete pension 25% earlier.
2. Flexibility
 - No flexibility implies no access to capital.
 - Members want flexibility for unforeseeable events (particularly health but also housing/repairs/upgrades), and have behavioural biases ("annuity puzzle").

3. Capital certainty

- A 25% correction at retirement is equal in value to losing all contributions made
- Sequence of returns: drawing income following correction makes loss permanent
- Risk aversion: retirees 10:1 instead of 2:1

4. Longevity (idiosyncratic) and mortality

- Not a tight cluster of mortality around the average — volatility of mortality same as volatility of market.
- Impossible to plan consumption rate: 20% of 65 year olds die by 76, 20% live past 93.
- Members' long retirement: 25% of one of a couple will live past 100 (improved annuitant mortality).

Decisions about the type of income product and the mix of products are increasingly important in the trade-offs that occur.

While there are some products on the market such as 'variable annuities' (MLC's protected capital and protected income products) as well as guaranteed life and fixed term annuities (but limited providers) there are also impediments under the regulatory settings which have stifled innovation in this arena. This includes differences in tax treatment for some products with longevity/market risk protection (variable annuities and deferred lifetime annuities).

These impediments are part of a current review into legislative changes that could provide more latitude in the development of options and arguably must precede the offer or development of laws accommodating 'comprehensive income products in retirement' (CIPRs) as recommended by the FSI. In this regard, regulatory settings could also operate to encourage individuals into products (at least with a portion of their benefits) which include risk mitigating features. This may include some form of social security concession.

Trustee designed retirement options (including CIPRs)

Generating an adequate replacement income is critical to maintaining living standards. This will not merely encompass a CIPR or superannuation income stream. It is important to encourage individuals to consider a range of factors including home equity, external assets, and ongoing work participation.

We are yet to see consultation on actual CIPRs but we do not see CIPRs as a single or best single solution to retirement income needs given idiosyncratic risks. A trustee does not have, and is not likely to have, sufficiently detailed information to optimise an approach for any given person – health status, debts, family/dependants, external assets, even work status.

We do see CIPRs as an important feature as they can:

- Encourage an income drawdown culture;
- Mitigate decision inertia for those overwhelmed by options; and,
- Promote product designs that include features that mitigate risks in income reliability, including longevity.

However, it is important that the designs allow provider and product changes without significant capital costs, at least for an initial 'decision/experience period'. Members' needs are highly variable and, in retirement, 'one size fits all' approaches can undermine outcomes as they do not address idiosyncratic risk.

In this regard, engagement which assists members to plan earlier, taking into account their circumstances in order to best optimise their retirement outcomes, is an identified need particularly in the absence of an adviser.

We think it is important to avoid thinking of a CIPR as a single option, both from a member and trustee perspective.

Key insights/recommendations:

- Our retirement products and services are immature.
- It is not possible to simultaneously maximise the 4 main objectives most people desire in retirement.
- Trustees cannot design the optimal asset allocation or retirement solutions for members. Idiosyncratic risks mean better outcomes will be driven by the members taking into account holistic needs.
- Trustees can and should arrange offers and services (including educational material) which help members to understand meet their needs (this may be through advice or transfer).
- Regulatory settings have a powerful influence on the offers created and indeed the acquisition of such. Tax and social security levers are significant drivers of behaviour.

MEMBER ENGAGEMENT

Questions posed by the Commission included:

Are member preferences and needs being met by funds collecting relevant information to ensure product offerings are suitable for their diverse member bases?

Are member preferences and needs being met by the system providing high-quality information and financial advice to members to help them make decisions?

For a long time, many superannuation funds' focus was geared toward compliance with legal obligations often at the expense of clear and appropriately stepped information for members.

Partly this was attributable to: lack of understanding/limited research; cost effective communication tools/capability; intermediated relationships; and legislative requirements (for example requirement for 'written' consents, requirements to 'give' documents which precluded, and still do in some cases, electronic communication/publication).

Research findings (internal, industry, academic and regulator) have highlighted the gaps in what is provided and what is desired / needed by members.

Digital tools and data analytics capability are helping to improve the ways in which members can be engaged at more affordable, and in the member context, time-preferred, ways. This is still an area under development particularly in the advice realm for advice practices funds and service providers.

Improving our approach

As a large and diverse institution, we have identified a need to improve our engagement with our superannuation customers.

The Future of Financial Advice reforms were a major trigger for reviewing the approach to the advice needs of a range of consumers both from an institutional and also an advice practice perspective.

In 2014, research conducted for MLC identified that financial advice in the traditional face to face (F2F) form was inaccessible by 75-80% of Australians with a plethora of education materials and simple calculators which were not integrated and largely ineffective.

The legislative drive to create transparency in the provision of financial advice has led to clearer guidelines for the provision of quality advice, particularly in the definition of requirements around advice of limited scope.

Customers seek personalisation, simplicity and flexibility. New technology in mobile, social and other digital channels has enabled customers to shift the way they can seek help and guidance.

Websites and digital tools have:

- Limited control over accuracy of information supplied by the customer and therefore relies on the customer to ensure the information is accurate; and
- Limited time and real estate to adequately explain difficult concepts.

This makes placement of information, simplicity of messaging, and warnings¹⁸ critical to the delivery of effective personal advice. The user experience should be supported with a variety of communication mediums such as images, text and video yet these must supplement, not impede the user experience.

Importantly, robust 'triage funnels' are required to direct the customer to an accessible alternative (including F2F) where they fall outside the scope of the digital tool.

Even in F2F advice, sophistication of technology (rules engines and product comparison tools) has helped to reduce the cost of advice provision by eliminating manual processes and streamlining business operations.

The introduction of digital platforms (using social media and mobile) which aggregate customer data is creating a behavioural shift in the way people engage with their money.

This multi-channel, variable and flexible framework is finding its way into superannuation provider and member relationships.

Research and outcomes in superannuation

MLC has partnered with an external expert firm to undertake research to identify paths to better engagement and enablement tools. Much of this is new and outcomes are still being tested and assessed for refinement (or replacement if appropriate).

Ethnographic research into needs and perceptions of super and advice for a wide range of Australians has been and is being undertaken.

While much of the detailed research has been completed, ongoing customer testing has been and continues to be performed on some recent and upcoming initiatives which aim to respond to the input. Part of this process identified that immersive research, particularly via interviews and workshops, was more valuable than surveys for this purpose.

Individuals showed that they thought they didn't know much about super going into the interviews, but the way it was shown to them was a key factor in how they understood it.

¹⁸ Within reason. Currently PDS disclosures tend to presume PDF documents. Where relevant to counter the problem of unwieldy PDF documents, PDSs should be able to take the form of a series of website pages or a microsite. That would then allow a consumer to more effectively and quickly access the information they need on a particular topic rather than being forced to scroll through 50 pages of information.

Many realised it wasn't as hard as they thought; it's just that it had always been shown to them in an overwhelming way.

Key points:

- At a very high level, we can build engagement by boosting **confidence** and **literacy**. Simple explanations, personalised experience and a way to make it less “scary”.
- Customer insights include:
 - In financial services generally: 70% are using mobile devices and 30% desktop services. Most check apps daily or weekly. Age isn't a barrier – with everyone from 18 to 80 involved. Online is preferable to having to go to physical location (generally). Relative to banks, superannuation funds' footprint in the online world is underdeveloped.
 - When it comes to understanding the concepts which underpin how people's super is invested or just being able to read and understand statements and gauge the performance of their fund, opaque language negatively effects people's beliefs, attitudes and behaviour and can promote poor comprehension, and disengagement
 - Many people perceive independent advice as preferable but often inaccessible. Focussed education, targeted timely information and increased accessibility to advice (click to chat/ digital tools and educational support) are important to engagement.
 - First and foremost, people want instant, easy access to their super balance, fees paid and to be able to see and understand the growth (or otherwise) of their balance (and not be swamped with other information).
 - For many, especially younger people, the implications of their super balance for their future lifestyle is intangible and the less immediate concern re financial wellbeing in retirement drives less engagement than those nearing retirement.

Insights are being used to build, test and roll out (or not) services/options which seek to meet the above identified customer preferences. These include:

- Developing deeper more accessible online presence including social media and website tools which are interactive and more personalised will work.
- Testing and roll out of campaigns or programs utilising more personal approaches and web interactive tools indicates a much better engagement rate and action.
- Examples of changed approaches include:
 - Live Chat - this is a new platform for MLC, and we have seen significant improvement in results in terms engagement and action by customers.
 - Marketing and engagement tools that allow us to avoid irrelevant content and offers by more appropriately identifying and personalising material and proposals.
 - Call centre outreach and improved digital options on our websites.
 - Blogger Outreach.
 - Below are some of the outcomes indicating improved connection and activity.
 - The volume of logins on to MLC has increased steadily since FY11 with an estimated 28% increase in logins since FY15.
 - Specific interactive initiatives (which typically have very poor responses) used to test improvements included:
 - * Smart email capture – 49,000 customers set a username alias since launched 4 June 2016.
 - * Certificate of Currency Downloads: 12,599 downloads since going live. This was all done via phone interaction and mail confirmations previously.
 - * Updating beneficiary nominations online: 7,697 updates made since Jan-16. Again a manual process.

SuperGap campaign

- Instead of paper based forms we developed an automated multi-channel journey and material unique to member circumstances to help provide information on improving super through consolidation in an engaging manner including using infographics and videos.
- This has resulted in improved response rates compared to traditional paper based approaches.

Member statement campaign

- 106,700 superannuation customers were contacted online (including both initial and reminder emails). 13.6% (14,536) were opened (normally we are lucky to get 3-5% open rate). **27.7%** (4,032 customers) then proceeded to log into mlc.com.au which equates to 11% of total logins for the month of June (from 36,469 customers)

Call centre email address campaign

- Over a thousand customer calls were initiated to validate or capture an email address.
- 84% of the customers that spoke to our consultants either validated or provided their email address. This was an unprecedented response relative to mail campaigns.

Blogger outreach – examples in Quarter 3

- Getting Financial Advice – Elliott's eWeb
- Understanding the advantages of Superannuation Funds – Inside Small Business
- Are you a boomer or a zoomer? – You and your money
- What mums need to know to maximise their super – Frugal and Thriving
It's Good to Talk – The Life Master

In conjunction with improved search engine optimisation there has been a significant spike in 'organic traffic' by 36% in June year on year.

- Simpler tools that aim to make super more accessible e.g. Supersizer: <http://supersizer.nab.com.au>. This is a 'health check' tool but may lead to more engagement. This tool has been launched recently. There is currently insufficient data to demonstrate engagement impacts at this time.

The following concepts are in development to focus on deepening engagement via digital tools and services:

SuperSaver — mobile solution (app) that allows members to understand their retirement adequacy gap and close the gap by contributing in one of three ways including, but not limited to, setting up recurring contributions or lump sum contributions.

Financial Wellness Series — A changed approach to seminars. This is an education series which is brand agnostic conducted across the country on various topics through the year focused on the financial wellness of our customers. The aim is to provide holistic education and engaging experiences for our customers that go beyond superannuation.

We engage our customers by presenting them with opportunities to learn about different topics, speak with each other and advisers, explore the many benefits that may be available to them as fund members. This event saw a registration uplift of 20% and an attendance uplift of 33% from the similar event run in 2015.

Insights/recommendations:

- Immersive research, using interviews and workshops, is more effective than surveys in the development of relevant 'offers/services'.
- Members will engage more if we communicate in different and interactive ways and avoid opaque language, untimely or irrelevant disclosure.
- Members (and advisers) can influence product and service designs provided our approach facilitates it.

EFFICIENCY OBJECTIVE 4.4 — INSURANCE AT LEAST COST

The commission proposed the following objective:

“The superannuation system provides insurance that meets members’ needs at least cost”.

In contemplation of this feature of the system, the Commission noted that insurance detracted from retirement incomes, but it was constrained by the policy (laws) and so limited to *“assess[ing] whether trustees are offering the most appropriate insurance for their members, and whether the costs of insurance are minimised for the type and level of cover provided”.*

Insurance is a valuable feature in the superannuation environment. Particularly for those not in defined benefits arrangements, it is a mechanism where the impacts of unexpected premature death (in respect of dependants’ economically relying on the member) or pre-retirement disablement can be ameliorated in the short and potentially longer term. That is, insurance proceeds have an important role in financial wellness, and make up for unanticipated lost income and/or retirement savings.

This was a large driver behind the framing of the prudential laws dealing with the purpose of super and the specific inclusion of death and disablement cover as ancillary benefits.

A major advantage is the capability of the system to provide broad coverage to a large component of the **working** population through default ‘group’ insurance. Unlike private health cover which utilises a ‘carrot and stick’ to promote self-provision¹⁹, there is no legal requirement for individuals to take out life and/or disability insurance which could otherwise come at a significant cost to the taxpaying public through increased pressure on the social security system.

Unless someone has had a close experience, or knows their risks, their contemplation of the necessity or desirability of life / disability insurance, with no immediate or tangible benefit, just does not occur. This is why it generally involves advice (retail acquisition of preferred insurance which is subject to health underwriting) or, is delivered through ‘default’ group insurance for employees. It is particularly valuable for younger workers and workers with young families because they have had little time to build assets.

The trustee makes the purchasing decision on behalf of the members although, in group arrangements, the design for employees of different employers can vary within the overall offer. The trustee oversees the framework insurance offer in the discharge of its duties which are codified in the SIS Act. This may include allowable options that can be chosen by the member (retail) or, default group super arrangements.

Comparisons of default with choice may lead to distortions in outcomes and efficiency assessment.

¹⁹ The Medicare Levy Surcharge is imposed in addition to the 2% Medicare Levy for those above a certain income who don't have private hospital cover and provides a rebate for those under the threshold.

TRUSTEE OBLIGATION

In the discharge of its duties the trustee has 3 broad responsibilities;

1. It must act in the best interests of all members (Trust Law and SIS duty)
2. It must satisfy the requirements of SIS section 52(7).

Insurance covenants

(7) *The covenants referred to in subsection (1) include the following covenants by each trustee of the entity:*

(a) to formulate, review regularly and give effect to an insurance strategy for the benefit of beneficiaries of the entity that includes provisions addressing each of the following matters:

(i) the kinds of insurance that are to be offered to, or acquired for the benefit of, beneficiaries;

(ii) the level, or levels, of insurance cover to be offered to, or acquired for the benefit of, beneficiaries;

(iii) the basis for the decision to offer or acquire insurance of those kinds, with cover at that level or levels, having regard to the demographic composition of the beneficiaries of the entity;

(iv) the method by which the insurer is, or the insurers are, to be determined;

(b) to consider the cost to all beneficiaries of offering or acquiring insurance of a particular kind, or at a particular level;

(c) to only offer or acquire insurance of a particular kind, or at a particular level, if the cost of the insurance does not inappropriately erode the retirement income of beneficiaries;

(d) to do everything that is reasonable to pursue an insurance claim for the benefit of a beneficiary, if the claim has a reasonable prospect of success.

3. It must satisfy the Insurance Prudential Standard SPS 250, which broadly represents S52 of SIS.
4. It must not provide insurance benefits which are inconsistent with the SIS conditions of release in relation to preserved benefits

GROUP INSURANCE - OPT OUT OR OPT IN

Group insurance is provided automatically (with limited eligibility requirements), without underwriting (in contrast to retail). The provision of automatic cover means group insurance takes on the risks (good and bad) without full insight.

In general, trustees offering MySuper products **must** provide minimum death and permanent incapacity (disability) benefits which can be on an **opt-out** basis. The trustee **may** also allow temporary disablement or income replacement benefits.

A fundamental premise behind low cost, easily accessible group insurance cover for employees is that everyone in the group (generally subject only to an 'at work' test) is insured thereby eliminating the need for individual underwriting.

The default approach minimises anti-selection risks thus reducing the likelihood that only those with a high probability of claiming will retain insurance which in turn increases premium rates and makes cover less affordable, or unaffordable. However, it is also recognised that for various reasons, for example having cover elsewhere, members should be able to opt out.

Group insurance through super provides a positive benefit through the effect of wholesale or group buying power which is afforded by an opt out arrangement.

The main issue with group insurance is that it is not needed until it is needed (see below customer commentary). And, indeed, in the majority of cases it is not needed. But, this is why it can be provided as a premium-based product which is, relative to fully funding the benefits that are paid, inexpensive. Because of the pooling of all participating members, the risks are spread and this allows benefits to be paid that can be significant in value relative to premiums.

In this context, the 'health' of the pool is critical²⁰.

An "Opt in" approach without underwriting has a number of risks. Frequently, only those who think they might claim will take up the cover and more often members, particularly those in a default fund, don't exercise that right and therefore are uninsured despite having a potential need.

In effect the "Opt in" approach introduces significant selection risk, dramatically increasing the need for insurers to require member health information before agreeing to provide cover. This is likely to result in higher premium costs and a lower take-up of insurance cover and contribute to underinsurance problems particularly in the young adult to middle aged groups where debt, dependants and lower assets/savings can be serviced in the event of premature death or major disability.

MySuper group insurance - temporary / income replacement

The inclusion of more expensive income protection disablement insurance (IP) in super and particularly group MySuper has both opponents and proponents. It will reduce amounts funding retirement benefits and impact net returns. But, as with death and permanent disablement, IP cover is part of the underinsurance risk for many working Australians.

Tax considerations:

Premiums for non-superannuation IP cover are tax deductible whether they are paid by the employer or the employee. Where provided through superannuation, the premium is deductible to the employer but is not deductible to the employee unless they are self-employed, earn less than 10% of their total income from employment, or can arrange to pay the contribution via salary sacrifice²¹.

In a significant number of cases, insurance costs in superannuation are met from deductible employer premiums, deductible superannuation contributions for those who are eligible to claim, or those who can salary sacrifice.

In both super and non-super arrangements the income stream payable is generally tax assessable to the recipient.

Even for those where IP insurance through superannuation is less tax effective than outside, this is often outweighed by the fact that, without the option of funding the cost of insurance from superannuation, which in group schemes can be at a lower cost, they will not actively take it up.

²⁰ This is why in retail offers the duty of disclosure is important and in the group insurance environment the use of an 'at work' requirement which is intended to mitigate selection risks which affect all participants in the pool.

²¹ If the Government's proposed policy change allowing universal deductions for personal contributions up to the relevant cap is legislated then this restriction is removed. In effect, a member making personal contributions which are used for insurance cover in super could effectively get a deduction (at the super fund tax rate which may be higher or lower than personal rate depending upon income).

Workers compensation

Depending upon the circumstances, income replacement on disablement will not be provided to the extent of any workers compensation paid.

This has been a criticism of the provision in super.

Insurers indicate that this has been a common feature of the Group Life Insurer's IP products for decades. As such, the historical IP claims experience/liabilities incurred by life insurers, which they utilise as a key means to determine their IP base rating factors, already allow for the 'offset' of claims liabilities from workers compensation insurance.

In effect, the offset is allowed for when experience investigations are undertaken i.e. the claims versus premiums analysis is done on the claims basis being net of those other payments already so that it can be taken into account when setting premiums/pricing. Furthermore, where group arrangements are in place, premium rates are often discounted due to scale.

Trustees also have the capacity to offset premiums with the value of deductions so, for many (including those on low marginal rates, who may also qualify for a co-contribution for personal non-deductible contributions) the provision of IP insurance through super can be both socially important (reducing reliance on the Disability Support Pension or Sickness Allowance) and more cost effective.

IMPROVING DESIGNS

In the past decade, Insurers have had to respond to greater demands for flexibility in the design of insurances.

Tender processes and trustee comparative analysis has led to greater competition within the sector.

In the past, it was generally only possible to obtain the same level of death and permanent disability cover which would reduce over time (almost a proxy for the more traditional defined benefit or endowment/whole of life approach).

There have been movements to make insurance designs more contemporary and more responsive in the 'group' environment. This includes product innovations which consider lifestyles.²²

MLC Lifestage insurance is a combination of Death and Total and Permanent Disablement (TPD) insurance that's been designed to cater to different life stages.

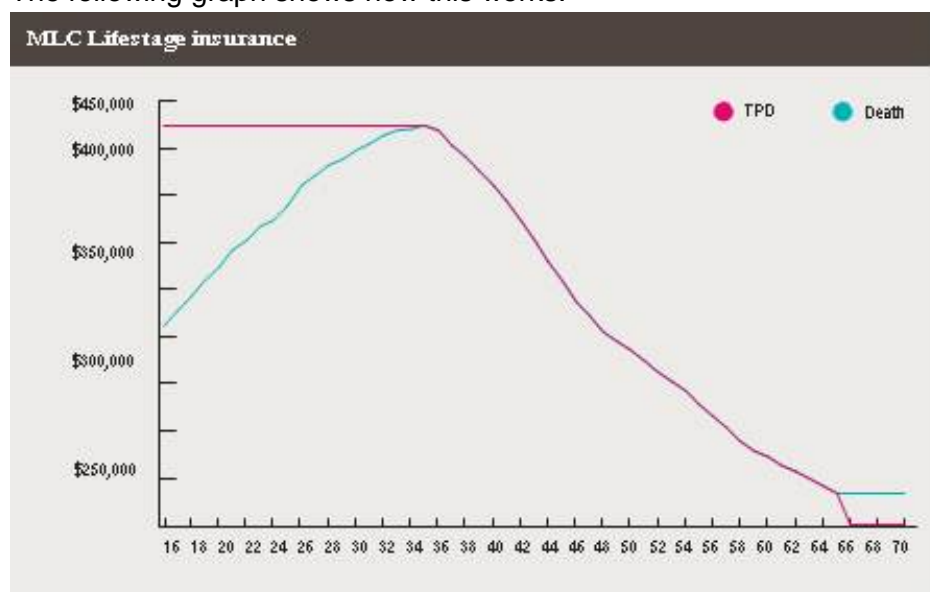
Death insurance will increase when at ages where members are likely to have a higher mortgage or children at home.

TPD insurance will be higher for younger members to help cover costs in the event of total and permanent incapacity at an early age.

Death insurance continues until age 70 and TPD insurance to age 65. Insurance is adjusted each year on each member's birthday.

²² In this regard, REST was one of the industry leaders having a younger demographic.

The following graph shows how this works:



The evolution in product designs is being accompanied by a new focus on servicing and claims management processes.

Improvements are needed in engagement and building understanding. While some members are cognisant of the value of insurance in super and actively elect to maintain accounts in different funds for the cover, others in the group environment let existing super accounts lapse often with their insurance continuing until balances run low or out losing the compensatory contingent benefit, and/or end up paying for more than is needed which unnecessarily erodes their retirement benefits.

This can be particularly evident with IP disablement cover. In some funds the IP cover will cease once contributions cease (even though the person may still be working and possibly be in another fund without IP cover). In others, the IP may continue even though the person has left the relevant sponsoring employer and contributions have ceased. The amount of IP cover would be based on the salary level of their "old" role at time of ceasing employment.

For those who move to another job that pays more, the amount of cover in effect becomes fixed cover. But, for those who leave the workforce, they are in effect paying for cover they can't receive (although they would usually get an entitlement for IP cover without underwriting when back in the workforce).

The value of insurance – an example²³

The below is an example of the benefits that insurance through superannuation can provide particularly when employers are active agents in the establishment and oversight of their employee's default superannuation. The last sentence is a most apt summary.

This material is completely separate from all other material in the submission and does not reflect any agreement or otherwise by the contributor (MinterEllison) with the views of MLC as expressed in the submission.

It is provided as an illustration of the effect group super cover can provide.

²³ Affected member's names changed for privacy purposes.

ILLUSTRATION OF VALUE OF INSURANCE IN SUPER

“MinterEllison takes a keen interest in the welfare of its staff.

This includes our Staff Superannuation Plan (Plan). A key part of our Plan is a reasonable level of insurance cover for members, which is the reason we have opted for a benefit design of Death & TPD cover set at five times a member’s base salary.

In times past, the Plan had a default cover of three time base salary, which our Policy Committee²⁴ felt was too low, given (i) the higher levels of debt that are carried these days, particularly by those with a mortgage and (ii) many people carry debt into the latter years of their working life and even into retirement. Also, very few people hold life insurance outside superannuation.

While there have been comments in the media in recent times to the effect that life insurance through superannuation is a waste of money and premiums erode member balances. My response to such an allegation is that, yes, the premiums do erode a members balance and yes, the vast majority of members will consider it to have been a waste of money. These are the members who have had the good fortune never to have suffered a health condition that triggers a claim on their life insurer.

In my 15 years at MinterEllison I have had the saddening experience of dealing with a number of staff who have suffered serious illness and in some cases these conditions have been fatal. I can say without reservation that one of the first things seriously ill staff members make enquiry about is their level of insurance cover and secondly whether this cover can be increased. The health event suddenly focuses their mind and their concern on the financial impact their death or permanent disablement will have on their family.

A couple of examples where life insurance provided through our Plan have made a real difference.

Melbourne employee *Sam Chong* developed a brain tumour 2009 at the age of 38. He was operated on twice by a renowned neurosurgeon. The operations bought him several years of time, but left him quite disabled. The TPD benefit paid by our fund enabled *Sam* to clear his mortgage and provide a nest egg to help his wife and three children after he died. Although *Sam* knew he would die a young man, he was so grateful that he had insurance held through his super (he had no other) that would result in him being able to leave his family in reasonable financial shape.

Another Melbourne employee, *Jane Brogal*, was diagnosed with cervical cancer in middle age. Despite surgery, chemo therapy and radio therapy her condition worsened and she died at the age within a couple of years of diagnosis. The fund (and its insurer) gave remarkable assistance in facilitating a terminal illness death benefit payment to *Jane* in her final days of life. ...*Jane* took great comfort in knowing that her brother and sister, nieces and nephews would benefit significantly from her superannuation, which included the insurance she had held on her account.

Fortunately for most of us life insurance is a waste of money, but when you need it, you really, really need it.

²⁴ Policy committees in larger employer groups provide Trustees with insights relevant to that particular workplace. Trustees will consider views and information from these Committees when discharging their duties.

Insights/recommendations:

- Group insurance including death, TPD and IP is valuable. The contribution of insurance through superannuation to meeting claims should be valued in terms of: mitigating underinsurance (given consequent potential savings to taxpayer funded revenue); relative costs outside superannuation; and efficiency from a group purchase / assessment basis (cost savings from individual health underwriting); flexibility in options (default and capacity to increase or decrease cover)
- Better processes and engagement are needed to mitigate lapses or erosion that effectively negates the cover (all else being equal). Measures may include quality of service (claims management processes e.g. phone/electronic capability; educational material – online, delivered).
- Consider whether funds are more effective (allocatively efficient) if IP ceases on cessation of contributions or is better placed outside [group] superannuation but with a lens of underinsurance generally.

COMPETITION OBJECTIVE 4.1

Competition in the superannuation system that drives efficient outcomes for members through:

- *a market structure and other supply and demand-side conditions that facilitate rivalry and contestability*
- *suppliers competing on aspects of value to members across the accumulation, transition and retirement phases.*

The following includes prior commentary as it remains relevant contextually.

MEMBER/DEMAND SIDE DRIVERS

In terms of demand-side drivers, there remains a significant pool of members who continue in the 'default' segment in savings phase, noting for several of these members this may be a deliberate choice. However, there is strong evidence of increasing choice through SMSF growth and in the retail and industry fund master trusts. Further, 1.1 million members have elected to take their benefits in pension form which is a choice.

Our estimates indicate that around one quarter of the 14.8 million members with an account do make a choice. The level of engagement however tends to be at older ages where balances are higher and retirement planning (after family, education, mortgage stresses reduce) is more to the fore.

The material in the section on [Member Engagement](#) is relevant in this regard.

In the retail sector (and some of the larger industry funds) it is common / usual to have the default MySuper and at least a range of other choice portfolios and in some cases, a Wrap on the same platform. Members of these multi-offer funds can readily make new or additional choices more easily and cost-effectively than changing funds.

While simplicity may lead to a lower cost product, this may be detrimental to customers interests where that product does not include a sufficiently broad offer to satisfy engaged members or the changing needs of members over time, which may effectively mean they can be "forced" to incur the cost of transfer or remain in an option which is unsuitable.

There are many tiers and components to the competition framework within the regulated and concessionally-taxed superannuation industry. The main ones comprise:

- A ticket to entry imposed via the regulatory environment licensing requirements to be a Registrable Superannuation Entity (RSE) or RSE Licensee (trustee).
- The various 'outsourced providers' used by trustees to provide relevant services/products (including within vertically and horizontally integrated structures) — administrators, professional services (including tax professionals, actuaries, auditors, investment advisers), insurers, investment managers, financial advisers.
- The different industry sectors — retail RSEs, SMSFs, public sector funds, corporate RSEs and industry fund RSEs (the latter three may combine at times under a designation of 'not for profit' or 'profit for members')²⁵. Not all segments compete in all markets/products.
- Products - bifurcated as 'Default' (MySuper)²⁶ and 'choice' products which may or may not be offered by all sectors and may also vary in the scope of offers particularly 'choice' products.
- The use of tender consultants, independent advisers and intermediaries to assist (medium-larger) employers select default super.

Contestability amongst 'outsourced providers' is reasonably unfettered with trustees having the power to appoint or dismiss agents based on contractual terms and service agreements (subject to meeting their regulatory obligations — which are significant).

In most cases there are no specific licensing requirements for outsourced providers for superannuation purposes although operators of managed investment trusts (or collective investment vehicles) and life insurers are subject to separate regulatory regimes (from a tax and prudential perspective).

As with any industry, incumbency can bear an advantage although the digital environment has been and will challenge traditional models – in this regard, service providers and consultants are more likely to introduce change. In our experience, rarely, if ever, would we participate in a 'bid' without intermediaries pitting us against our competitors. This is an element that pushes incumbents to remain vital and relevant.

The in-house or fund-shared traditional administration service-providers in mutual companies, bank-related funds and industry funds are changing.

The incursion of professional managers of registry systems and international technology providers indicate a growing awareness of the need for up-to-date and substantive systems which can provide robust reporting, pricing, record retention and tax-capable software. These providers are increasingly managing 'back office' capability.

The investment management market is also highly contested with both local and international funds management firms providing services and competing for superannuation dollars. In this context, size can matter, both in terms of access to private equity markets and capacity to negotiate discounts for scale.

²⁵ All funds make profits for members. Any fund which outsources is usually paying fees that generate a profit for the outsourced provider (and its owners)

²⁶ Default' superannuation for this purpose refers to arrangements supported by the Fair Work laws related to modern awards which direct where mandatory contributions may be paid for any relevant employees covered by the award who have not chosen their own superannuation fund.

Significant consolidation activity occurred through the 1990s as standalone corporate funds moved into APRA-regulated master trusts (retail and industry funds) and in the last decade some consolidation of APRA entities has also occurred as illustrated in the table below²⁷:

Market segment	10 years ago 30 June 2005	Today 30 June 2015*
Not-for-Profit Funds		
Corporate Funds	962	68
Industry Funds	90	49
Public Sector Funds	43	35
Subtotal	1,095	152
Commercial Funds		
Commercial Funds	212	109
Subtotal	212	109

*Sourced from APRA *'Insights Celebrating 10 years of Superannuation Data Collection Issue 2 2007'*.

* Includes 'small APRA' funds (with fewer than five members).

However, there are barriers to building scale through consolidation of funds and/or rationalisation of products, particularly post the implementation of MySuper, some of which are addressed below in ['Merger/consolidation impediments'](#).

Competition in the 'choice' product market is currently strong across all retail providers, some industry funds and also SMSFs. However, regulatory imposts, particularly those with the aim of comparing individual options on choice platforms with standard MySuper products could artificially increase costs without any corresponding uplift in consumer understanding or outcomes.

The development of MySuper in the default segment with legislative protocols that limit variability and encourage comparison are likely to create an environment where peers will adapt and innovate to compete or, be identified as serial underperformers. Trustees acting in the best interests of their members should assess their position and take action to rectify, which may include merger or transfer (see below issues). Similarly, the regulator has powers to revoke MySuper authorisation.

Barriers to entry are in place in the 'default' MySuper product market due to legislative restrictions which are not unambiguously for prudential safety or efficiency (see ['Default superannuation allocation'](#) below).

REGULATORY IMPEDIMENTS IN SUPERANNUATION COMPETITION

Below is a broad discussion of issues related to the current regulatory provisions which can impede competition through barriers to entry (default superannuation allocation), barriers to exit/consolidation and product rationalisation.

Default superannuation allocation

NAB has been on record as promoting open competition for default superannuation as a means of retaining and enhancing competition which we believe improves member outcomes.

²⁷ Rice Warner, Superannuation Market Projections Report, 2015, p17

Currently, employers must make mandatory Superannuation Guarantee (SG) contributions to a fund with a legislatively defined and authorised MySuper product if the employee does not choose their own fund (default super).

In conjunction with this regime are provisions under Fair Work laws which generally limits funds named under awards with MySuper offers to between 2 and 15.

Issues with current Fair Work provisions allowing up to 15 funds to be named

- The process is generally only undertaken under the 4-yearly cycle that applies to the review of modern awards under the Fair Work Act which immediately acts as a barrier to new entrants or existing funds providing new (or potentially revised) MySuper products.
- There are currently 116 MySuper products. Of these 67 are offered to the public (public offer). There's 36 non-public offer (NPO) and 13 "large employer" MySuper products that are classed as public offer but generally focused on employees and relatives or ex-employees of the employer. That is, there are between 67 to 80 funds with MySuper products that would likely apply for many, if not all, awards.
- The limit to a maximum of 15 funds means that up to 65 are disenfranchised potentially for no reason other than that an arbitrary limit of 15 funds has been established in law. Once named, costs to engage and distribute the offer of default MySuper products are reduced. This improves net return outcomes relative to other disenfranchised providers.
- It is accepted that members should be able to transfer between products to access propositions they deem more appropriate; however, product comparisons should not be structured so that a provider of a simple product with limited other options (low cost by virtue of simplicity) obtains an apparent advantage in a competitive review over a fund or arrangement that also provides choice (which will typically come at a higher cost), as customers can ultimately be disadvantaged by the need to transition when a member looks for choice. This is particularly relevant if the fund has no retirement income option.
- In a report prepared for the FSC²⁸ the potential negative impacts of this process include:
 - More than 1 million employees having to be redirected to alternate superannuation arrangements;
 - A potential cost to these impacted employees of over \$150 million;
 - Potential losses to these members of tens of millions from asset buy/sell spreads and crystallisation of tax losses;
 - Several tens of thousands of employers required to redirect superannuation contributions on behalf of some or all of their employees; ... at a potential cost ...in the region of \$30 million"

The framework has significant cost and market implications, which creates systemic risk. These need to be addressed.

Alternate models

The final FSI report issued in December 2014 recommended an alternative process to that of the Fair Work system to help employers select a default superannuation fund.

The longer term recommendation (subject to MySuper proving ineffective at improving competition and efficiency in the superannuation system) was for an auction process for the allocation of default contributions in the longer term²⁹.

²⁸ Rafe Consulting, Impact of Changes to the Fair Work Act on the Australian Superannuation Sector, Employers and their Employees: 16 June 2014

The FSI found that allowing employers to select any MySuper option would only be effective if there were an alternative quality filter. The Productivity Commission's (PC's) inquiry into default funds in awards (2012) found that a 'quality filter' is needed, stating:

*"The Stronger Super reforms serve largely to standardise features and promote disclosure to improve comparability between MySuper products, rather than filter out any products which may not represent the best interests of employees"*³⁰.

The PC made a number of recommendations to improve the effectiveness of this filter, which the FSI supported (see below).

The FSI concluded the *"any MySuper' option could increase employers' compliance costs, particularly new employers, by requiring them to select a fund from a large number of MySuper products that are not easily comparable"*³¹.

In its report, the PC quoted various submitters as declaring, *"To allow all MySuper products to be listed as default funds for a modern award would result in overwhelming choice making it difficult for [employers] to differentiate and make an informed choice in much the same way as if no funds were listed"*.

Interestingly, these submissions did not identify what would constitute 'overwhelming' in terms of numbers of options, whether an employer had a right to protection provided they chose any appropriately regulated fund with a MySuper option.

More importantly, so far as we can ascertain, these submissions to the PC and the FSI did not point out that the Fair Work approach or, any limited approach without grandfathering, would have adverse implications, many the same as those outlined above (including for existing employers who would have to choose another default product for their employees, and add to the proliferation of individuals with multiple accounts).

The FSI Report did not point out that the PC Report explicitly recommended 'all MySuper products that meet the factors' should be listed, noting it may be a "long list", hence a small subset be determined that would best meet the needs of the relevant employees for **new employers**.

This overall approach would have mitigated risks and costs of transfers for marginal gain in existing arrangements in a proposal that did not explicitly pursue grandfathering³². Any formal process that dictates how 'default superannuation' should be allocated needs to address:

- Costs and benefits to existing employers and employee-members of forced change to direction of contributions;
- Potential for creation of multiple accounts for individuals. Although improvements in matching accounts have occurred, it will still create additional costs in the reporting, notification, and amalgamation of accounts which also erodes retirement outcomes.
- Triggering of tax consequences for moving existing balances at the member level and more broadly the systemic issues of realising assets at particular times related to a regulatory review/application process that could lead to market signalling.
- Capacity for new entrants — it should be possible for new entrants to apply for consideration at least annually and to meet 'graduated' requirements if necessary (such as scale). We would note that capacity for scale can be achieved through 'wholesale' arrangements/networks.

²⁹ Financial System Inquiry — Final report (FSI), November 2014, p111

³⁰ Productivity Commission, Default Superannuation In Modern Awards, 2012 p10

³¹ FSI, op. cit. p112

³² Productivity Commission, op cit, pp 2, 15, 217

Merger/consolidation impediments

A core objective of the Stronger Super reforms³³ was to create an environment that encouraged scale. The reforms specifically imposed obligations and duties on Trustees to consider scale in a number of areas, fostered further consolidation through a licensing regime which included scale tests and introduced a number of other measures and policy settings focused on generating scale and efficiency for members.

Scale can be achieved in a number of ways and, as with performance, focusing on scale as a single metric is not an effective tool for measuring efficiency or potential outcomes over time.

However, to the extent that the laws create unnecessary impediments or costs in consolidation of funds (or the transfer of members across funds) where this is determined as appropriate for members by the trustee(s) or regulator, there is an embedded inefficiency.

Research by Rice Warner indicates that:

“Operating expenses reduce significantly with scale. However, as funds get larger, many of these scale benefits are used to provide members with higher levels of service rather than being passed on as lower fees.

Funds with fewer than 25,000 members are sub-optimal with significantly higher expenses than larger funds.

Funds with more than \$10 billion in assets have lower investment expenses than smaller funds. These conclusions suggest that fund mergers should benefit members and the industry”.

While significant change in the shape of the APRA-regulated industry has occurred through consolidation over the past two decades, there are impediments to the efficient operation of the market (and indeed prudential drivers) in facilitating the exit of lagging funds/products.

The operation of successor fund transfer (SFT) provisions, while a vital aspect of the system, need review along with a range of other legislative provisions that trustees must consider when funds are to be merged (or products retired and members ‘upgraded’/transferred).

SFTs require two specific tests to be met:

- That ‘equivalent rights’ are provided to the members in the receiving fund after the transfer; and
- That the transfer is in the best interests of members.

To satisfy the requirement for equivalent rights, the general view has been that members’ positions and rights in the new fund have had to be effectively the same as those in the original fund.

Traditionally, trustees have satisfied these tests and protected themselves through the replication of product complexities for transferring members and the mapping of investment holdings to like investment options in the target fund. In addition, indemnities are usually required to be provided by the transferring trustees for periods of 5-7 years (with appropriate insurance).

³³ Stronger Super is the 2007-2013 Labor government’s response to reforms arising from the Review into the governance, efficiency, structure and operation of Australia’s superannuation system (the Cooper-chaired Super System Review). It included the changes to default super through the introduction of a legislated ‘simple product’ MySuper as well as a range of initiatives to improve back office efficiency and electronic transactions known as Super Stream.

This is clearly not always efficient and may not be possible in a MySuper environment where the same options, benefits and facilities must be available to all members and only a single investment option applied to all MySuper members³⁴.

In this regard, the Super System Review chaired by Jeremy Cooper noted:

“In the Panel’s view, further efficiencies can be achieved by facilitating rationalisation of legacy products in superannuation and, to that end, suggests that the equivalence test for successor fund transfers be changed to a test of ‘no overall disadvantage’ with the intention of allowing more transfers to proceed. There is also benefit in giving the Federal Court the jurisdiction to determine superannuation product rationalisation where the successor fund transfer test cannot be met. CGT relief in these instances should be expanded and made permanent”³⁵.

The explicit recommendations that have not been enacted and should be include:

“Recommendation 10.9

- *The SIS Act should be amended so that the successor fund transfer test is one of ‘no overall disadvantage’ rather than ‘equivalence’.*

Recommendation 10.10

- *The Federal Court should be given new jurisdiction to determine and facilitate product rationalisation in the superannuation industry where the successor fund transfer regime (as amended by the recommendation made in this Review) still does not fulfil legacy product rationalisation objectives.*

Recommendation 10.11

- *CGT rollover relief should be given to superannuation funds in the terms previously afforded by the Tax Laws Amendment (2005 Measures No.2) Act 2005 and should be permanently available to the industry.”³⁶ [See our prior submission for comments on other legislative aspects affecting SFTs]*

There are other potential impediments, including legislative provisions related to the transfer of ‘choice’ members and their choice directions³⁷ as well as possible constraints in ‘matching’ the MySuper offer in a new fund (particularly if a lifecycle option is involved in a transferring fund moving to a diversified option in the receiving fund).

Complexity in consolidation

The table below is a composite of a range of issues that need to be considered particularly in the context of super fund mergers or transfers where the investments are held via life company life policies. We have used some material compiled by the ATO with industry experts (called the Involuntary Superannuation Account (ISAT) protocol). For more detail refer to this link: <http://softwaredevelopers.ato.gov.au/ISAT>

The table is simply for illustrative purposes. However, a number of the requirements evidence a need for facilitative tax and superannuation laws that expressly deal to the mergers of funds and/or transfers of members and related assets at the discretion/direction of the trustee or as a result of a revocation of license by the regulator. It would also be reasonable to test whether the MySuper provisions are creating a drag rather than facilitating mergers.

³⁴ This excludes consideration of creating more than one MySuper product under the auspices of SISA s29TA and s29TB which were developed for specific circumstances to respectively, protect brand/goodwill or accommodate ‘larger employer’ workplaces with specific designs.

³⁵ Cooper Review: *Super System Review Final Report Part One Overview and Recommendations* (30 June 2010) p 17

³⁶ Ibid

³⁷ Regulations were to be made clarifying that receiving trustees could ‘assume’ the directions given to the transferring trustee but have never been made due to changing administrations (post 2013 election).

The uplift and replacement of beneficial entitlements from one fund (or product) to another without adverse tax or other legislative consequences, should be possible. Specific consideration should be given to death and disability benefits (and in-progress claims); family law splits in progress, retention of income stream classifications as well as too prescriptive and costly replication of disclosure etc.

Reporting procedures	Action
Lost members.	<p>Transfer balances to new fund along with lost member details and status (either uncontactable (L) or inactive (I)) to new fund.</p> <p>Provide last activity date to new fund for inactive and un-contactable members (i.e. do not update this date to the date of the SFT).</p> <p>Closing fund to remove all members from its lost members register.</p> <p>Closing fund lodges its final lost member statement.</p> <p>Previously reported lost members that are still lost need to be reported as transferred and previously lost members that have been found by the time of the SFT need to be reported as found.</p> <p>New fund, for its lost member report, will need to include transferred uncontactable and inactive members that are a lost member in that fund.</p>
Unclaimed super money (USM) statement.	<p>Transferring fund to lodge before lost member statement. [So that lost members register doesn't duplicate amounts.]</p> <p>New fund uses last date of contact provided by closing fund (i.e. do not update this date to the date of the SFT).</p>
SuperMatch - consolidation of accounts.	<p>New trustee should not use existing member search and consolidation consents.</p> <p>New trustee needs fresh member consents to use TFNs for SuperMatch and to then consolidate accounts.</p>
Temporary Resident Notifications issued to closing fund.	<p>Closing fund pays the entitlement to the ATO by the due date, and also includes it in the unclaimed money statement.</p> <p>Alternatively, if the entitlement has already been transferred to the new fund, the closing fund reports it as transferred (T) and the ATO will issue a fresh notification to the new fund.</p>
Member Contribution Statement (MCS) reporting.	<p>Closing fund reports all contributions it receives during the year prior to the SFT and that the member accounts are closed. It may lodge the MCS early.</p> <p>If the administrator remains the same, it can later amend MCS reporting for pre-SFT periods to correct errors (provided member and account identifier numbers remain unchanged).</p> <p>While the transferring trustee still exists and still has an ABN, it can also amend MCS reporting for pre-SFT periods to correct errors.</p> <p>Otherwise the new trustee can give the member a letter with information to give to the ATO to ask for a contribution adjustment.</p> <p>The new fund in its MCS reports the member accounts as opened.</p>
SuperStream rollover data standards.	<p>A SuperStream compliant rollover transaction message does not need to be given from the closing fund to the new fund if both funds use the same administrator and software or a common registry. No efficiency advantage is gained from messaging in that scenario.</p> <p>If a message is still given, note that the tax free component reported is permitted to exceed the amount transferred.</p>

Reporting procedures	Action
	<p>Mandatory information to pass to the new fund is:</p> <ul style="list-style-type: none"> - unique superannuation identifier - member client identifier - service period start date - tax-free component - KiwiSaver tax-free component - taxable component Element tax in the fund - taxable component Element untaxed in the fund (should not arise for taxable funds) - preserved amount - KiwiSaver preserved amount - Restricted non-preserved amount - Unrestricted non-preserved amount
Notice and authority issues	Action
<p>Notice from the ATO to remove incorrect TFN from member account (s.299TB of SIS)</p>	<p>Notices that the closing fund receives before the SFT should be actioned. 'No-TFN' contributions tax applies on taxable contributions for that year if the corrected TFN is not provided by 30 June.</p> <p>Closing funds that receive a notice after the SFT should contact the ATO. (The closing fund should not receive any further notices after the new fund lodges its first MCS.)</p>
<p>'No-TFN' contribution tax offset</p>	<p>TFNs provided to the new fund trustee cannot be used by the new fund trustee to claim a tax offset for No-TFN contributions tax paid by the closing fund trustee. Therefore warn members in advance of the SFT to provide their correct TFN if they have not already done so.</p> <p>Consider retaining the incorporation of the trustee of the transferring so that it still exists to claim any No-TFN tax offsets if former members instead provide their TFNs to it. [No-TFN tax offsets are refundable tax offsets.]</p>
<p>Notices of deduction [Notices by predominantly non-employed members are required for the tax deductibility of personal contributions. Note recent 2016 Budget announcement could remove complexity in this respect.]</p>	<p>Original notices can be given to the new fund for contributions made to the closing fund. [The new fund pays the resulting contributions tax.]</p> <p>Similarly, variation notices can be given to the new fund where the contribution and original notice of deduction were given to the closing fund. [In that case the closing fund would have paid the contributions tax. Any tax refund would therefore presumably be paid to the closing fund trustee, and would then need to be transferred to the new fund. It could be slightly more complicated if the closing fund had transferred the tax on its contributions to a PST or life company.]</p> <p>If the member gives an original notice to the closing fund shortly prior to the SFT but it was not acknowledged (i.e. not actioned), the member can give a fresh notice to the new fund. The new fund should advise the member of their ability to do that.</p> <p>Closing fund should provide details of personal contributions and prior notices to the new fund to enable it to determine whether subsequent notices it receives are valid.</p>

Notice and authority issues	Action
Spouse contribution splitting	Any splitting application must be given to the closing fund before the SFT (and for splitting of deductible personal contributions, the notice of deduction must first have been given). Warn members in advance.
Bankruptcy orders	An account freezing notice may prevent transfer of an account to the new fund. Obtain legal advice to confirm.
Binding death benefit nominations (BDBNs)	BDBNs may no longer apply. Fresh BDBN may need to be given to the new fund. Obtain legal advice to confirm.
Power of Attorney (PoA) etc.	PoAs and authorities for adviser access to information given to the closing fund expire. Warn members in advance.
Outstanding family law agreements and orders to split super etc.	Closing fund should advise new fund of uncompleted agreements or orders, and any un-actioned applications for information about member superannuation accounts. Obtain legal advice to confirm.
Release Authorities	<p>The obligation to act on a release authority passes from the closing fund to the new fund and the obligation should be included in the drafting of the SFT Deed.</p> <p>Ensure any release authorities for excess contributions tax are actioned.</p> <p>If the closing fund returns a release authority to the ATO un-actioned, the ATO can issue a fresh release authority to the new fund.</p> <p>[The ISAT protocol analysis seems to proceed on the basis that the work of the release authority is done as soon as it is given to the closing fund, but that the new fund picks up the closing fund's obligation to pay.]</p> <p>[Seek further guidance from ATO or pay all presented release authorities before the SFT.]</p>

Liability issues	Action
Fund wind up notification	<p>Closing fund trustee to advise:</p> <ul style="list-style-type: none"> - APRA when the resolution to wind up the fund has been made (SIS Reg 11.07(6) and (7)); and - the ATO of the date from which it will no longer accept ATO files and payments e.g. superannuation files and Government co-contributions.
SuperTICK for new fund	New fund should advise ATO quickly following the SFT that it has become the destination for Government payments for transferred members.
Government payments to closing fund	<p>Closing fund to ensure Government payments are either credited to member accounts or returned to the ATO using a payment variation advice (9.2).</p> <p>Government payment types include: Government Co-contributions; Low Income Super Contributions (LISC); Superannuation Guarantee Charge; FHSA, USM and special account credits.</p>
Unprocessed terminal illness, death and disability benefit	Ask member to remove terminal illness certification if payment will not be made before the SFT.

Liability issues	Action
payments	<p>Ensure pending disablement / death benefits are paid before the SFT Failure to do so can result in excess contributions tax assessments. The member/beneficiary may need help in asking the ATO to waive these. However, there may still be added tax on the withdrawal of the subsequent benefit that cannot be waived.</p> <p>[Death benefits are not 'member' benefits so cannot be rolled over. Any transfer would amount to a new contribution on behalf of (probably) the relevant death benefits beneficiaries. Terminal illness and disability benefits are 'member' benefits however, and should not be put into the same category.]</p>

Pension issues	Action
SIS minimum draw down	<p>Ensure SIS minimum payment conditions are independently met for:</p> <ul style="list-style-type: none"> - the pension paid from the closing fund up to the SFT; and - the new pension paid from the new fund from the SFT. <p>Failure to meet SIS minimum pension draw down requirements in respect of both funds independently causes exempt current pension income tax exemption to be lost for that fund for the year.</p> <p>[Note that the minimum draw down for the new fund phase will be set (i.e. reset) by reference to other account value at the date of the SFT.]</p>

Lump sum issues	Action
Disability tax free component modification	<p>Closing fund to advise new fund of eligible service date to enable it to make the modification calculations if/where required.</p> <p>[The date may also be relevant for death benefit tax modifications.]</p>

Fund-level impact	Action
Closing fund tax return	<p>Consider who should bear responsibility for preparing it. [Also consider who should have control over Div 310 elections.]</p>
Fund merger costs	<p>"The issue of which entity is entitled to claim merger costs as a deduction and various agreements entered into by merging funds is under review by the ATO."</p> <p>"Contributions are to be included in the fund's assessable income for the purposes of determining deductions, so that the entities can deduct amounts incurred in obtaining the contributions."</p> <p>[Merger implementation costs incurred by the new fund may be tax deductible costs of obtaining the rollover contributions. These cases are deemed to be incurred for an assessable purpose.]</p>
Foreign income tax offsets (FITOs)	<p>FITOs available to the closing fund that it does not use are lost. The new fund cannot use them.</p>
Tax attributes of assets transferred	<p>New fund should satisfy itself that adequate due diligence is undertaken about tax attributes of assets it acquires from the closing fund, and whether tax losses transferred to it are real.</p>

Fund-level impact	Action
45 day holding period for franking credits starts afresh	Consider impact of 45 day period being restarted.[Note: (1) 45 day rule can be satisfied before or after dividend payments; (2) consider alignment with dividend record dates and payment.]
Ongoing record keeping	Records of the closing fund should to be retained to meet record retention laws, e.g. generally 5 – 7 years for tax records.

General issues

Significant event member notification required by *Corporations Act 2001*.

Standard choice of fund forms following a SFT.

Members who voluntarily transfer	
Opt-out members who transfer to another fund of their choice.	Use standard roll-over statement and procedure.
Any members voluntarily moving to the new fund anyway.	Use standard roll-over statement and procedure.
Remainder of ISAT protocol does not apply to members who voluntarily transfer.	

Tax free component.	Carry over tax free components on data system, and also tax free 'proportion' for income streams.
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Pre-1 July 2007 transitional pensions.	Maintain transitional status on system.
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If SFT is used to also effect a transfer of accrued default amounts to a MySuper product.	Notify members 90 days in advance. [Combine with 1.2(a)]
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Defined benefits issues

Defined benefits issues	Action
Division 293 tax debt deferred until 'end benefit' paid	The closing fund should pass on information received from the ATO about deferred Div 293 debt to the new fund to enable the new fund to withhold when the 'end benefit' is ultimately paid. The closing fund does not advise the ATO that the involuntary SFT is an 'end benefit'.

Notional taxed contribution (NTC) grandfathering	[Although nominal contribution rates for defined benefits may exceed the concessional contribution caps, funds are only required to report contributions to the level of the caps in the grandfathered cases. So for example if the full-year notional contribution was \$100,000 the fund would still only report contributions of \$30,000 for the year (for a member < 50 years). However, since both closing and new funds must report pre and post SFT notional contributions separately, the aggregate amount reported may exceed \$30,000]. The closing fund and new fund should jointly contact the ATO to discuss waiver of excess concessional contributions reporting prior to the closing fund lodging its MCS. This is not an issue if the SFT is at the end of the day on 30 June [or start of the day on 1 July].
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REGULATORY IMPOSTS

Much was made of the costs in the Australian superannuation system in the FSI. We believe that there is considerable evidence that competition in the market has already driven down fees, and that recent initiatives, such as *MySuper*, will drive fees down further in coming years (along with improvements in digital capability some driven by SuperStream policies).

These fee reductions have occurred despite the industry experiencing conflicting pressures in having to invest in modernising administration platforms and increased regulatory imposts at a time when member engagement is growing along with a realisation of a need to develop the income stream suite of products to manage the various risks in retirement including, market, sequence, and longevity risks (at retail and wholesale level).

The costs of regulatory reform are a critical piece in assessing the efficiency of the system. The Commission has our confidential data but in research conducted for the FSC, ongoing regulatory reform in the financial services sector over the past five years has cost industry \$2.75 billion, and will rise to \$3 billion once reforms currently before Parliament are implemented.

The research also found that the cost of reform has contributed \$105 to the cost of superannuation for every Australian consumer.