



Response to the
Financial System Inquiry Interim Report

26 August 2014

AIST Submission

AIST

The Australian Institute of Superannuation Trustees is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public-sector funds.

As the principal advocate and peak representative body for not-for-profit super funds, AIST plays a key role in policy development and is a leading provider of research to the \$1.85 trillion superannuation industry.

AIST provides professional training, consulting services and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.

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1 Introduction

We appreciate the opportunity to be able to contribute to the Financial System Inquiry (FSI) and hope that our submissions help to provide important insights in so far as issues raised about the superannuation industry are concerned. We do not intend in this submission to cover all of the observations and questions raised in the Interim Report, only those where we believe that we can add value or need to bring the Inquiry's attention to significant issues.

The Interim Report¹ makes a number of key observations about superannuation and includes a range of possible policy options. This, our second submission to the Inquiry, focuses on these observations and policy options and should be viewed in the context of the broader views expressed in our first submission² to the FSI about the superannuation system. Where appropriate, we have made recommendations.

The views expressed in both AIST submissions to the FSI are based on the following key beliefs:

- Superannuation should exist to optimise retirement income in a sustainable way
- Australia's retirement incomes system is based on a three-pillar system
- Current default superannuation arrangements are fundamental for consumer protection in a compulsory superannuation system
- System sustainability is underpinned by high levels of disclosure, transparency and management of conflicts of interest

AIST welcomes the FSI's acknowledgement of the significance of the superannuation industry and the key role it plays in the nation's retirement income system and economy as a whole. AIST supports the mandated retirement savings system that is superannuation and recognises its valuable contribution to making Australia's financial system robust and better equipped to withstand shocks such as the recent Global Financial Crisis (GFC). Superannuation has resulted in Australia having a strong national savings record and it has clearly, at \$1.85 trillion under management, become a key segment of Australia's financial system.

While we recognise the need to consider financial product design, fees, disclosure, improved efficiencies and better regulation in an Inquiry such as this, we also encourage the Panel to consider the purpose of superannuation, its intended outcomes and how our policymakers can best deliver stability and consistency for the system over the long-term.

¹ Murray, D., Davis, K., Dunn, C., Hewson, C. and McNamee, B. (2014). *Financial System Inquiry Interim Report*. [pdf] Canberra: The Treasury, Commonwealth of Australia. Available at: <http://tinyurl.com/mzrwb4o> [Accessed 20 Aug. 2014].

² Australian Institute of Superannuation Trustees, (2014). *Initial Submission to the Financial System Inquiry*, Available at <http://tinyurl.com/oufvczq>.

AIST recognises the increasing relevance and influence that international standards and foreign regulators have had on Australian regulatory settings since the Global Financial Crisis. As such, many of our responses to the Interim Report observations – particularly in matters on governance, regulation and consumer protection - are framed in the context of international best practice.

AIST agrees with the Interim Report's findings that there is a need for consensus on the key objectives of superannuation, both to maintain confidence in the system and to ensure system sustainability. As the Inquiry has noted, the extent to which superannuation exists as one pillar in Australia's three-pillar retirement income system needs to be clarified and clearly articulated by policymakers, particularly the role of superannuation to reduce the heavy lifting of the Age Pension. Moreover, as the Superannuation Guarantee contribution rate moves towards 12% and the pool of superannuation savings grows larger, the calls for how this savings pool might be used or directed for other purposes will only get louder, fuelling further uncertainty unless the superannuation system's objectives are clearly articulated.

Defining the objectives of superannuation will allow the efficacy of the retirement income system to be measured. It will also enable a more reasoned assessment of the need for future policy changes and hopefully see an end to the ad hoc policy tinkering of the past two decades. The articulation of the objectives and system design principles will also help foster a bi-partisan, enduring commitment to the superannuation system, ensuring stability and long-term confidence in the system.

As part of this process, AIST believes the Inquiry should recommend the establishment of a working group to develop and enshrine these objectives so that superannuation becomes a protected aspect of Australia's social policy platform, and untouchable like Medicare.

In establishing these objectives, AIST encourages greater consideration of the interplay of superannuation with the Age Pension, health care, aged care and home ownership in retirement, just to name a few. AIST also supports a focus on promoting and delivering greater equity in the system to build retirement incomes over the course of every person's working life, as opposed to making superannuation a tax effective wealth creation vehicle and estate planning tool, for the few. All superannuation fund structures should be considered in that context. In response to questions raised about the effectiveness of the trust structure, this submission examines the findings of both Australian and international research and notes that Australia's superannuation system is globally acknowledged as one of the safest and most sustainable in the world. These findings strongly endorse the trust structure as being best placed to protect beneficiaries and their best interests, particularly those that are disengaged.

The Interim Report has questioned whether a lack of competition in superannuation is leading to higher costs and fees. This submission examines this issue in the light of the relatively recent introduction of MySuper and early research findings pointing to a downward trend in fees.

We also raise concerns about the emphasis on fees and costs, rather than net returns and value to members, in assessing the performance of Australia's superannuation system. This submission investigates

the current limitations and the paucity of data in comparing global pension fund performance. Further comparative work on global pension returns needs to be done before any meaningful conclusions can be made about Australian superannuation funds in a global context. This includes conclusions about costs, fees and returns of Australian superannuation funds and the benefit of alternative default fund structures.

The issue of vertical integration and its impact on fee competition is also addressed. The findings of research into related-party transactions are examined in the context of Australia's superannuation system being compulsory and trustee directors being required to act in members' best interests in seeking out the best value deals as opposed to conflicted decisions overriding the best interests test.

The Inquiry acknowledges the need for innovative products and policy changes to address post-retirement challenges. This submission examines some of the limitations in mandating retirement products and the need to recognise that the system is still immature with most Australians still having relatively small balances at retirement. We acknowledge there is need for a principles-based approach to designing a retirement income strategy and framework. A key part of this framework includes changing the language around superannuation from wealth creation (nest eggs) to retirement incomes.

Another key theme to emerge from the Interim Report is that product disclosure – both in banking and superannuation - isn't working. In particular, the tight legislative deadlines of previous industry reform agendas have led to unsatisfactory disclosure outcomes in some areas of superannuation.

We agree that a new approach to disclosure is needed but this submission also argues strongly that we mustn't give up on disclosure - it's how we do disclosure that matters. Disclosure should aid consumer understanding of superannuation and should pass consumer testing and cost/benefit outcomes for members. Disclosure is also about ensuring greater competition within the industry, and therefore useful disclosure properly reflecting fees and costs have an effect on competitive behaviour.

We agree with the Inquiry Panel that technology has a greater role to play in getting disclosure right and that there must be more emphasis on design and consumer testing.

The need to put more emphasis on technology is not limited to disclosure. As noted by the Inquiry, technology has moved at a rapid pace and it will increasingly impact on the consumer experience across superannuation. AIST supports continued innovation in this area and proposes that a full regulatory review be conducted to identify where barriers to e-commerce be removed.

This Inquiry also raises issues about regulation. As in our previous submission, we call for a strengthening of the role of the Council of Financial Regulators (CFR). Importantly, this would enable the CFR to develop and oversee measures of adequacy, sustainability and longevity. We also acknowledge the need for APRA to strengthen its oversight of systemic risk and for the funding of all regulators to be more transparent.

The FSI Interim Report makes a number of observations about superannuation tax concessions, noting that the majority of these concessions are accrued to the top tier of income earners. While we acknowledge

that tax matters are outside the scope of the Inquiry and will be examined by the upcoming Tax Inquiry, AIST would like to emphasise that growing tax inequity within the superannuation system - and in post-retirement - is a threat to the future sustainability of our retirement income system and, we would argue, the biggest challenge facing the superannuation industry and policy makers.

We also note that the superannuation industry has only just emerged from a long and arduous period of reform development and implementation and that public confidence in the system is fragile. While we accept that there will always be room for improvement and that further policy change is inevitable, , we strongly caution the Panel against recommending any significant structural changes to superannuation without hard evidence that such changes will lead to any real improvements. We believe many of the Stronger Super reforms – notably MySuper and SuperStream - need time to consolidate and play out before we can accurately assess whether they have delivered on their objectives.

Throughout this submission, AIST has recommended that a review of MySuper take place within a reasonably short horizon. A collation of the focus of this review may be found at Appendix One.

2 The trust structure

The Interim Report seeks views on the appropriateness, and cost-efficiency of the trust structure for the superannuation industry.

The most prevalent models for retirement savings systems are based in trust law or contract. AIST submits that trust law is the most appropriate legal foundation for superannuation for the following reasons:

- Our system is a compulsory one and the overwhelming majority of super fund members are disengaged with super and need additional protection for their savings
- The UK has both contract-based and trust-based pension schemes and they have concluded that trust-based schemes provide better protection for members
- Trust law provides better consumer protections than contract law, focusing on proactive duties rather than enforcement options after-the-fact
- Trustees are required to continually apply their discretion and decision-making powers to the best interests of the members, whereas that obligation does not exist with a contract, set at a point-in-time

2.1 The law of trusts and superannuation

In a compulsory defined contribution (DC) system, super fund members bear the risk for the monies invested on their behalf. Overwhelmingly, members of Australian superannuation funds are considered disengaged, having been enrolled with a fund by their employer and not making any proactive decisions concerning their super fund or preferred investment options.

In both the UK and Australia there has been a move away from defined benefit (DB) to DC schemes. Dr Claire Molinari says:

[B]eneficiaries are increasingly expected to guide their own pension outcomes....Along these lines, Clark and Urwin argue that '[i]n liberal democracies, there is a presumption in favour of individual autonomy such that it is the responsibility of the participant to be an effective decision-maker consistent with his or her long-term interests'. ...But beneficiaries are not all up to the task. In fact, the extent to which the average DC pension fund member is equipped to make informed decisions about investment strategy is questionable.³

³ Molinari, C. (2013). The Future of Fiduciary Obligations for Institutional Investors, p. 4. (Quoting Clark, G. and Urwin, R. (2011). DC Pension Fund Best-practice Design and Governance. *Benefits Quarterly, Fourth Quarter, 36 at p. 39*).

In our system, where 9.5% of a person's wages are compulsorily diverted to superannuation for their future retirement savings, the interests of the saver need to be protected to achieve the desired policy outcome of super as well as to engender trust in the system.

Trust law offers the best framework to achieve these outcomes. Alternative models, such as contract-based pension schemes have been critically reviewed and found not to offer the requisite protections to members of those schemes.⁴

The Kay Review concluded that where advice on investment decisions is required, and others have discretion over the investment of members, fiduciary standards should apply to those relationships.⁵ Fiduciary duties lie at the heart of trust law. A fiduciary relationship exists where there is discretion, power to act and vulnerability. Where the party receiving funds has greater knowledge or expertise than the person placing the funds, vulnerability is present.⁶ This is typical of the vast majority of superannuation fund members in Australia. The Kay Review explains:

The fiduciary invests on behalf of beneficiaries whose risk tolerance may differ from his own, and whose time horizons may not only differ from his own, but will frequently be longer than his own.⁷

The Kay Review also recommends:

All participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers. Fiduciary standards require that the client's interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services should be reasonable and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards.⁸

Commentators have suggested that fiduciary duties could be imposed on the providers of contract-based schemes through statute. The interaction of contract and fiduciary duties has been considered by the Australian High Court, however. In *Hospital Products Ltd v. United States Surgical Corporation* Justice Mason found as follows:

⁴ The Office of Fair Trading in the UK did a review, *Defined Contribution Workplace Pension Market Study* (September 2013) cited in Law Commission, *Fiduciary Duties of Financial Intermediaries*, UK (2014), available at <http://tinyurl.com/mhvmrzy>

⁵ Kay, J., *The Kay Review of UK Equity Markets and Long-term Decision Making: Final report*, UK (July 2012).

⁶ Kay, 2012, p.65.

⁷ Kay, 2012, p. 68.

⁸ Kay, 2012, p. 65.

That contractual and fiduciary relationships may co-exist between the same parties has never been doubted. Indeed, the existence of a basic contractual relationship has in many situations provided a foundation for the erection of a fiduciary relationship. In these situations it is the contractual foundation which is all important because it is the contract that regulates the basic rights and liabilities of the parties. The fiduciary relationship, if it is to exist at all, must accommodate itself to the terms of the contract so that it is consistent with, and conforms to, them. The fiduciary relationship cannot be superimposed upon the contract in such a way as to alter the operation which the contract was intended to have according to its true construction.⁹

2.2 The role of employers in contract-based schemes

In the UK employers are increasingly using group personal pensions whereby the employer chooses a contract-based scheme for the provision of pensions for their employees. The legal nature of the pension arrangements is such that a contract exists between each employee and the pension provider, though it may appear to the employee that it is a scheme run by the employer.¹⁰

The terms of the contract are written by the scheme provider, and the employee is often expected to 'take it, or leave it'. Because the employer is not a party to the contract they owe no duty to the employee with respect to the pension fund they choose. The employee bears all of the risk and has little to no bargaining power in the agreement.

In Australia, employers have higher obligations to their employees than this, and the default fund selection process protects employers in their default fund selection for their workforce. Members of default super funds are accordingly much better protected and in the long run, financially better off.

2.3 Contract-based schemes

Contract-based pension schemes are prevalent in the UK.

There are a number of practical differences between contract-based and trust-based pension schemes. Although contract-based schemes are established with a trust deed in the UK, these schemes do not have trustees in the traditional sense. The provider of contract-based pension schemes is usually an insurance company. The companies that provide contract-based pension schemes do not owe fiduciary obligations to members. Instead, the relationship between members and providers is governed by the terms of the contract between them. If a member of a contract-

⁹ *Hospital Products Ltd v. United States Surgical Corporation* (1984) 156 CLR 41 at 102

¹⁰ Law Commission, *Fiduciary Duties of Financial Intermediaries*, UK (2014), p. 147, available at <http://tinyurl.com/mhvmrzy>

based pension scheme wished to take the provider to court for failure to act in his best interests, he or she would have to point to a relevant contractual clause.¹¹

One concern identified by the UK Law Commission with the operation of contract-based schemes is that the contract is designed for a point in time, with no ongoing requirements to refine for continued suitability. The National Association of Pension Funds made the following observation to the Law Commission:

While an approach centred on point-of-sale might make a lot of sense for many retail products where the product is either simple or can be changed annually, pension savings products need to be looked at differently.¹²

The Law Commission concluded the following:

[T]here are serious problems with the law relating to contract-based pensions. The contract model assumes that savers are fully informed autonomous parties, able to make good judgements in the market place. Yet the evidence is that savers fail to engage with pensions. This has now become institutionalised by auto-enrolment, where people are placed in pensions schemes by default, without any conscious agreement to the charges or contract terms... [T]his leads to a lack of effective controls on high costs and charges. Schemes are chosen by employers, who may lack both the incentive and the skill to form complex judgements over charges that are paid for by the members. In trust-based schemes trustees are expected to make informed decisions on behalf of their members. Until now, there is no equivalent person within the contract system with a clear duty to monitor charges and costs.¹³

A 2013 investigation of contract-based pension schemes by the UK Office of Fair Trading¹⁴ found that buyers into the contract-based schemes were at a serious disadvantage and they identified a governance gap leading to inferior transparency, with little pressure to review investment strategies and keep fees low. As these schemes don't have an equivalent to a trustee board,¹⁵ no one is accountable for representing the ongoing and changing needs of the members, and this was identified as a problem leading to the recommendation that independent governance committees be incorporated into the governance

¹¹ Molinari, 2013, p. 7.

¹² Law Commission, (2014), p. 154.

¹³ Law Commission, (2014), p. 160.

¹⁴ Law Commission (2014), p. 164.

¹⁵ The governance structure can be complex, spread across a range of related entities.

arrangements of contract-based schemes. The Office of Fair Trading concluded from their review that the bargaining position of employees enrolled into the DC workplace pension market was one of the weakest they'd seen in their investigations in years.

Another key feature of the trust model that is not a condition in the contract-based system is the requirement to separate the trust assets from other assets. This is a vital protection that the trust system offers to members who are investing their retirement savings in the confidence that it will be available to them when they reach a condition of release.

2.4 Using the courts to enforce members' best interests

In a compulsory superannuation system, the legal structure should be one that promotes and encourages members' best interests, not one where people are required to enforce their rights after the fact. Using the courts to enforce fiduciary-type behaviour that protects members' interests is costly, inefficient and does not align with the purpose of a compulsory retirement savings system.

In the event that the members' interests were not protected leading to loss or damage, a court case can no longer prevent the practice or behaviour that led to the loss. The courts can only provide financial compensation. And more than likely, the loss sustained, might affect multiple subscribers to that contract-based scheme.

Molinari (2013) says that "[C]ontract law as a general rule assumes that parties to a contract begin on equal footing. The law of contract is underlined by the idea that commercial certainty is best achieved by courts refraining from intervening in arm's length agreement between people."¹⁶ This makes restitution and compensation difficult in a contract-based scenario.

The UK Law Commission said the following about using the courts to protect members' interest under a contract-based scheme:

*Judges can only decide the cases brought before them, and those most vulnerable to poor practice may be those least able to mount legal challenges. Many will be deferred by the uncertainty of this area of law. And even if a challenge is mounted, the courts may be reluctant to interfere with a commercial relationship, and will interpret the duties owed in accordance with the contract and with the regulatory rules.*¹⁷

The outcome can be quite different in trust-based schemes. Molinari says, "[T]he area of fiduciary obligation, in particular, is premised on protecting the interests of vulnerable parties when others make

¹⁶ Molinari, 2013, p. 8.

¹⁷ Law Commission, (2014), p. 205

decisions on their behalf. Thus those beneficiaries who are members of a trust-based pension fund are afforded a high level of legal protection, with courts predisposed to protect their interests.”¹⁸

In a regulated, trust-based system, there are ongoing duties and obligations that attach to the trustees, protecting the members of the fund. The law sets these out quite clearly and the Australian Prudential Regulation Authority (APRA) has broad powers to deal with concerns it may have with the decisions made by super funds. The combination of a strong regulatory framework and the flexibility of the trust law create better outcomes for superannuation fund members in Australia.

2.5 AIST’s position

AIST strongly supports the retention of the trust law structure for superannuation funds. The Super System Review in 2010 also supported the retention of the trust structure for APRA regulated superannuation funds.¹⁹ It is internationally recognised as the best structure to protect the long-term savings for retirement of working people and should be retained.

The trust-based system is also the most cost-effective model, particularly as it sets appropriate behavioural expectations and governance frameworks, and is therefore best-placed to avoid gross failures in the system that are costly to contain and rectify after-the-fact. Introducing a new model will add to the regulatory burden and the related expenses without evidence to support that it will deliver better retirement outcomes for superannuants.

¹⁸ Molinari, 2013, p.8.

¹⁹ Australian Government, Review into the Governance, Efficiency, Structure and Operation of Australia’s Superannuation System, Final Report: Part Two (June 2010), p. 221, available at <http://tinyurl.com/ng5pddb>.

3 Fees and competition

The Interim Report makes a number of observations about fees in the Australian superannuation system, international pension fund comparisons and the role of MySuper in putting downward pressure on fees.

AIST submits that value to members is critical and that a focus solely on fees will lead to poor outcomes for superannuation members. Operating costs and fees should not be looked at in isolation without regard to net investment returns, and certainly not without an explanation of the true value for money and services received by Australians in their super account.

The Grattan Institute²⁰ found that Australian superannuation funds that charged high average fees do not generate higher gross returns, and generate much lower returns after fees than low-fee funds. Cummings & Ellis²¹ found that not-for-profit superannuation funds (low-fee funds) earn higher risk-adjusted returns than retail superannuation funds (high-fee funds). Recent data aggregated²² by Industry Super Australia from the SuperRatings crediting rate survey shows that the not-for-profit sector has once again outperformed the retail fund sector over the one, three, five, seven and ten years based on balanced fund median rolling returns to 31 July 2014.

3.1 International comparisons

The Grattan Report claims that Australia's superannuation system is expensive by international standards. However there is very little focus on net returns or the lack of consistency in the way many pension funds around the world report and measure their fees and performance.

AIST submits that there is a dearth of reliable data with which to make international comparisons on pension fees and returns and draw any meaningful conclusions on which funds are best value for members. The objectives for each system, the regulatory framework each operates in and the restrictions on available asset classes for the investment pool – including in some cases foreign investment restrictions - differ greatly across jurisdictions, and accordingly comparisons are unreliable and potentially deceptive.

Indeed, in one of the very few academic studies to investigate the performance of private pension systems across countries, World Bank researchers, Musalem and Pasquini, note these limitations:

²⁰ The Grattan Institute (2014) Super sting: how to stop Australians paying too much for superannuation.

²¹ Cummings, J. R. and Ellis, K. (2011) 'Risk and return of illiquid investments: A trade-off for superannuation funds offering transferable accounts', *APRA Working Paper*.

²² Industry Super Australia, (2014). *More evidence of industry super funds outperforming retail funds | Industry Super Australia*. [online] Available at: <http://www.industrysuperaustralia.com/more-evidence-of-industry-super-funds-outperforming-retail-funds> [Accessed 26 Aug. 2014].

*Decisions by pension portfolio managers and, thus, patterns of pension fund returns are influenced by several factors including the set of available investment opportunities, regulatory constraints, preferences regarding risk, and the time horizon of investment decisions. Given these situation specific factors, defining “success” is methodologically problematic. This makes it difficult to establish uniform criteria for comparing the performance of pension funds across countries.*²³

While the authors nonetheless proceeded with their comparative analysis, the reliability of their results must be framed in the above context.

The RBA submission to the Financial System Inquiry²⁴ also points out, the limitations of comparing the costs of Australia’s system to international comparisons. It notes that any comparisons must recognise:

- The objective of universal coverage necessarily results in many more small accounts than would exist in a less comprehensive system
- The Australian system provides participants more choice than is present in most other jurisdictions
- The fragmentation of the system resulted from the decision in 1993 to employ private market participants to administer the monies mandated by the Superannuation Guarantee
- There are material differences in the tightness of regulatory settings in different jurisdictions
- Many of the systems to which the Australian system is compared are comprised predominantly of defined benefit schemes.

The RBA submission notes that the first four factors above are the result of policy decisions taken by government and are outside the control of market participants, while the fifth, the prevalence of DC schemes over DB schemes, makes the Australian system appear to be more costly, but only because the costs in other jurisdictions are understated. AIST endorses these distinctions between the Australian superannuation system and schemes in other parts of the world and submits that true international comparisons are complicated as a result. A simple comparison of fees and returns is unsafe and we caution against reliance on such assessments without making allowances for these significant differences.

3.2 MySuper has already brought about lower fees

AIST believes that MySuper has already commenced delivering efficiencies in the Australian superannuation system. Increased efficiencies and competition arising from the advent of MySuper and Super Stream will, over the medium to long term – further reduce fees. With funds under management growing and individual account balances also maturing, economies of scale will also allow for a reduction in fees. The

²³ Musalem, A. and Pasquini R. (2012) Private Pension Systems Cross-Country Investment Performance, *Social Protection & Labour Discussion Paper no.1214* [Online] p.6 Available at: <http://tinyurl.com/ouhf5uh> [Accessed 25 August. 2014]

²⁴ Cited in Donald, S. (2014) Financial System Inquiry: Costs in superannuation, Herbert, Smith, & Freehills Submission.

competition between funds, particularly not-for-profit and retail funds will also deliver greater efficiencies and lower fee structures. Further efficiencies can be brought about through improved disclosure of all fees and costs, and having value to members as the primary focus. In this respect, it is critical that all fees and costs are disclosed so that greater competitive pressure is brought to bear and members have a better opportunity to compare products and services.

Although the MySuper funds are in their early stages of operation, research commissioned by AIST with Rice Warner²⁵ suggests that MySuper will, over time, “have a profound impact on fees within the superannuation industry”. The research examined the change in fees for 98 MySuper products in 2013 against the fees recorded for the default options in the same funds as at 30 June 2011. It shows that average fees expressed as a percentage of assets, decreased from 0.92% to 0.73%, and that, “[t]he introduction of MySuper has been a driver of significant margin compression on the commercial master trusts and most have settled on asset-based fees just under 1% a year which is more expensive than the large industry funds, but much closer than their previous products (which also included the cost of advice)”. It further states that with the increased focus on lower fees we see the emergence of other means of reducing investment fees in both industry funds and retail funds such as:

- Reducing exposure to the more expensive asset classes, including alternatives
- Applying a margin squeeze to fund managers, and
- Increased use of in-house funds management to reduce costs.

While many retail funds have introduced new low fee MySuper products, they have very little funds under management, with large sums remaining in previous high-fee products.²⁶

Therefore, further – and potentially significant - fee reductions should be expected as accrued default amounts are transitioned to MySuper until 2017. To further reduce the fees in MySuper, the Inquiry should consider a recommendation to bring forward the transition timeline to provide a clearer picture of the impact that MySuper has achieved, and ensure that all default members benefit from the MySuper environment as soon as possible.

It should also be noted that there has been significant upward pressure on fees in recent times due to the increased costs associated with compliance in rolling out the new legislative and regulatory reforms pursuant to Stronger Super. The costs of reform implementation, including the higher levies to regulators, are additional costs in the system over the past couple of years that should now begin stabilise and deliver long term benefits as the reforms settle in. While high governance and regulatory standards provide

²⁵ Rice Warner (2014) Navigating the New MySuper Landscape, AIST and Rice Warner Research, available at <http://tinyurl.com/mhczs9x>

²⁶ Grattan, 2014.

ongoing benefits to members and are the key reason for which Australia's superannuation system is internationally renowned, it also needs to be acknowledged that these measures necessarily add to the costs of the Australian system.

AIST recommends that:

- MySuper be afforded the time to deliver on its expectations for members and the default system more broadly. The official launch date for MySuper was 1 January 2013 and many super funds are yet to transition default members to their MySuper product. The benefits and advantages of MySuper cannot be fully realised until the system has fully transitioned and had some time to operate.
- The final transition date of 2017 for transitioning monies into MySuper should be brought forward.
- A review of the efficiencies which MySuper has delivered should be conducted once all monies are transitioned to MySuper.
- Further efficiencies can be brought about through improved disclosure of all fees and costs, and having value to members as the primary focus.

3.3 Competition through better disclosure of true costs

Elsewhere in this submission, AIST points out that not all fees and costs are disclosed. We outline a series of examples, together with a suggested set of operating guidelines for disclosure, which could form the basis of a Disclosure Regulatory Guide.

In support of this, many Australian superannuation costs are borne from structural differences, which are not fully disclosed. One such difference exists between the not-for-profit model and the for-profit model of superannuation.

Liu and Arnold²⁷ explain that:

[I]n the case of a public-sector, corporate, or industry fund, the trustee is organised on a not-for-profit basis, and that in the case of a retail fund, though, the trustee (or the corporate group to which it belongs) has the strong expectation of profiting from its superannuation business. It also recognises that because retail trustees must reconcile their (group's) profit motives with their fiduciary duty to act in the members' best interest gives rise to agency risk.

²⁷ Liu, K. and Arnold, B. R. (2010) 'Australian superannuation outsourcing: fees, related parties and concentrated markets', Australian Prudential Regulation Authority Working Paper, p. 6.

They also found that trustees of retail funds pay related party service providers significantly higher fees than those to independent service providers, whereas the fees paid by trustees of not-for-profit funds to related parties are not significantly different to those to independent service providers. This profit motive becomes clearer with the finding that many funds in the retail sector have account fees significantly higher than their reported fund expenses, whereas fund expenses and account fees are quite closely related for many not-for-profit funds.²⁸ As argued elsewhere in this submission, more pressure to disclose and monitor related-party transactions would deliver greater value to members of funds where these transactions are not in their best interests.

The following also demonstrate potential agency risks:

- In a report prepared for the ATO, Colmar Brunton²⁹ found that 18% of businesses that were aware of the incentives on offer had been incentivised with financial discounts (for example, credit cards, home loans) and 14% with health care benefits.
- Not-for-profit funds have increased fees to cover capital expenditures and levies relating to the Stronger Super reforms as they have less latitude to absorb capital charges, whilst several for-profit funds owned by entities with deep balance sheets are imposing transitional levies on their members.³⁰
- While many retail funds have introduced new low fee MySuper products, they have very little funds under management, with large sums remaining in previous high-fee products.³¹

3.4 Active and passive investment

The Interim Report seeks guidance on the value of active versus passive management of investments and the value for members in pursuing the different styles of management.

Active management of assets is more expensive than passive management. However, not all assets are the same, or can be managed on an index basis. Certain assets will require more active management to realise their value than others, for example infrastructure investments. AIST supports competitive cost structures, but not when they come at the expense of retirement incomes for super fund members.

²⁸ Grattan, 2014.

²⁹ Colmar Brunton (2010a) *Investigating Superannuation: Quantitative Investigation with Employers Final Quantitative Report*, Prepared for Australian Tax office

³⁰ Grattan, 2014.

³¹ Grattan, 2014.

Rice Warner³² finds that pressure to reduce the headline fee of MySuper products has caused some funds to invest some of their assets passively rather than with active managers. Since the introduction of MySuper, their research indicates that:

- Some smaller industry funds have increased the proportion of passively managed assets in their portfolios to reduce costs
- Many industry funds continue to invest actively and have left their allocations unchanged
- Corporate and public sector funds have largely left their allocations unchanged
- Of a representative basket of leading commercial funds, the average percentage of assets passively managed has increased from 24% in 2011 to 46.6% in 2013

The Grattan Institute³³ found that industry funds tend to charge lower fees than retail funds and that they also have higher exposures to two asset classes that performed well over the period 2006-2013, namely unlisted property and infrastructure. This exposure to alternative assets, such as infrastructure, is seen as providing fund members with much-needed portfolio diversification.

Investing in assets such as infrastructure also assists with reducing short-termism, as the very nature of the investment is longer term. The Organisation for Economic Co-operation and Development, 2013³⁴ noted that 'infrastructure projects are long term investments that could match the long term duration of pensions liabilities. In addition, infrastructure assets linked to inflation could hedge pension funds liability sensibility to increasing inflation. ... Some large pension funds, particularly in Australia and Canada, have been actively raising their allocation to infrastructure over the last decade and allocations are as high as 10-15% among some pension funds...'. Investing in assets such as infrastructure is also recognised as providing wide-ranging long-term benefits to the Australian economy and the nation as a whole.

Retail funds on the other hand have adopted a larger exposure to passive investments for their MySuper investment options.³⁵

However many asset managers continue to support the use of active management, particularly in regards to finding value in Australian small cap stocks. Active management of small cap stocks is considered important given that the S&P/ASX Small Ordinaries Index has not proven to be a good representation of the small caps benchmark.

³² Rice Warner, 2014.

³³ Grattan, 2014.

³⁴ Organisation for Economic Co-operation and Development, (2013). *Institutional investors and infrastructure financing, OECD Working Paper on Finance, Insurance and Private Pensions, no.36*. Organisation of Economic Co-operation and Development, p.24.

³⁵ Rice Warner, 2014.

The narrowness of Australia’s equity market as measured by the S&P/ASX 300 is widely acknowledged, having become more concentrated in the last 10 years. Key sectors including information technology, consumer discretionary, health and utilities have very little representation in the Index and would fail to attract capital from superannuation funds were there to be a wholesale shift to index investing.

Asset managers also point out that negotiating a price should not be allowed to interfere with the process of selecting the best managers, who are more likely to exhibit top performance. Within certain asset classes, many funds are prepared to pay a significant premium to access the right managers with specialist knowledge and expertise to acquire the assets and manage them.

Passive management continues to play an increasing role, however, and its use must be considered on a client/portfolio-specific basis, taking into account various factors including investment objectives, fee budget, risk budget and available manager capacity.

3.5 Fee structures

Investment management fees account for the majority of costs incurred by superannuation funds. Moreover, it is recognised – particularly within the not-for-profit superannuation sector - that other key expense areas such as administration are operating under tight margins. .

Investment management fee structures –both for passive and active managers - are therefore an important side to the fee debate. Performance-based fees – which are the norm in some asset classes such as private equity and hedge funds - were criticised in the Cooper Review which recommended that they be the “exception rather than the rule”.

However, it needs to be recognised that even large Australians superannuation funds have found that they generally have insufficient bargaining power to dictate terms on the fees charged by some international fund managers.

Following AIST research³⁶ in 2010 with Rice Warner to explore ways to reduce costs in the investment management of listed Australian equities, AIST proposed a fee model where fees were determined on a fee-for-service basis with an upper limit, rather than as a percentage of assets. In addition, we recommended the use of performance-based fees as an alternative to higher initial fees that may be charged upon implementation of a new fee basis and highlighted the need for better fee disclosure and consistency. We note that to date, there has been little change in how most asset managers charge for their services.

³⁶ AIST, and RiceWarner, (2010). *Investment Management Fee Research*. [pdf] Melbourne: Australian Institute of Superannuation Trustees. Available at: <http://tinyurl.com/mrn7rt5> [Accessed 25 Aug. 2014].

As part of the focus on fees, the Inquiry might consider this model and whether there is a need for the development of an industry standard, covering all types of investment fees.

3.6 AIST's position

AIST believes that active investment management has a key role to play alongside passive management in providing value and important asset diversification for superannuation members.

4 Default superannuation arrangements in Australia

Superannuation is an entitlement associated with employment, and AIST believes it should continue to be regulated through the workplace relations system. In this regard, the process for the selection of default superannuation funds in industrial awards must be robust and transparent.

The current system has served members well and provides an important safety net. The implementation of Stronger Super reforms, including the introduction of MySuper products, will improve the prudential regulation of superannuation and vital consumer protections, particularly for disengaged members.

AIST supports a centralised system, where employees are connected with default superannuation arrangements which are most appropriate to them. Consideration of what is in the best interests of members is best reflected through fund features such as:

- **Default investments:** Different industries have different demographics. The default asset allocation or investment management style of a fund that supports younger employees in retail businesses may not be appropriate for a fund which serves older employees in the telecommunications industry, for example.
- **Insurance:** Where some funds have historically had great difficulty insuring higher risk occupations, other funds that service blue collar industries have been able to negotiate group insurance successfully with a history of value.
- **Customer facilities:** Provision of customer services such as intra-fund advice or online calculators usually depends on how financially literate a fund's membership is.

It is imperative that default arrangements reflect the demographics that they serve. AIST believes that selection of default funds must have the direct agreement of all stakeholders, including employers. The involvement of an expert panel within the Fair Work Commission ensures that alignment is provided between experts and workplace representatives. This ensures the continuation of a safety net, where quality is at the centre of agreements over industrial default retirement savings arrangements, and where a list of appropriate defaults can save time for employers when considering default arrangements.

We note that these supplement initial MySuper authorisation by ensuring that additional criteria recommended by the Productivity Commission for consideration are evaluated, including investment performance, fees and costs, governance and transparency, insurance, financial advice and administrative efficiency.

It's widely recognised that default members of superannuation funds typically do not chose their investment option. AIST believes that the care of these members requires enhanced duties that trustees are expected to provide in order to protect these members.

4.1 Default rights auction system – Chile

The Interim Report is seeking feedback on the benefits of auctioning default fund rights.

In 2008, the Chilean government introduced changes to their pension system, whereby contributions of new members are placed into a single default fund. The fund is chosen through a process whereby tendering funds – which are required to comply with a variety of criteria – are judged purely on the basis of pricing. Once initial complying requirements are met, no additional consideration is given to criteria such as investment performance, asset allocation, insurance coverage, or customer care.

The auction process takes place every two years. Funds are required to operate a multi-fund platform consisting of five strategies with the one fee structure, however restrictions apply to various classes of investment assets, in particular, a restriction on how much may be invested in foreign assets.

AIST has a number of concerns with a system such as the Chilean default auction system:

- Such a system would tend to have uniformity of design features on all fronts other than fees.
- The system requires a prescribed lifecycle investment strategy that in AIST's opinion does not optimise retirement incomes for all members.
- A prescribed lifecycle investment strategy may create an incentive to reduce actively managed investments.
- As considered by Sullivan and Xiong, 2011,³⁷ an increase in indexed investment reduces investment diversification and therefore creates an increase in systemic market risk.
- The lack of competition outside of the two-yearly auctions is not in the members' best interests.
- The regular auction process necessarily creates a short-term focus (a two-year cycle), and for long-term savers in a pension system this is contrary to their best interests.
- Such short-termism also affects investment mandates limiting the access to investments that optimise members' returns over the long-term.

In 2013, AIST released a discussion paper³⁸ which examined superannuation products released with 'no' or 'low' fees. One of the conclusions was that amounts retained by fund promoters could be used to game fee disclosure requirements. We note that any amount extracted from a fund by promoters, whether through explicit fees, or hidden in amounts such as gross interest margins has the net effect of reducing net returns to members. We believe that the criteria presently used in Chile might present such a commercial opportunity.

³⁷ Sullivan, R. and Xiong, J. (2011). "How Index Trading Increases Market Vulnerability". *Financial Analysts Journal*, Forthcoming.

³⁸ Webb, R. (2013). *The cost of 'low/no fee' superannuation products*. [pdf] (limited release). Melbourne: Australian Institute of Superannuation Trustees.

In addition to fee gaming as part of a tender process, we submit that the focus on fees alone distorts what is ultimately important to the member, net returns. Consider an example where two funds are tendering for the default in an auction. All other things being equal, fund A is charging 0.6% in fees whereas fund B is charging 0.5%. Discussion of fees in this case would represent illusory savings if, for example, fund A were out-performing fund B by even as little as a percentage point.

Funds that operate as default funds for employees in Australia must now be authorised MySuper providers. Superannuation funds, when constructing a MySuper asset allocation, must be mindful of the duty to promote the financial interests of members of a MySuper product.³⁹ This duty requires trustees to consider the beneficiaries who are members of their MySuper option, in order to ensure the best result for them, with a particular focus on net returns.

We consider that one centralised default superannuation fund is in no position to conduct the necessary investigation required to construct a portfolio for two years' worth of new members. Under the Chilean system, the investment strategy design must follow a lifecycle approach.

In Australia, superannuation funds are able to profile new or existing members and construct a portfolio that is appropriate for those members. Imposing a set of rules on the trustees about how this portfolio or benefit should be designed will prevent trustees from exercising their judgement in satisfying this requirement in a way that is appropriate to their particular membership.

The Chilean system has an increased level of concentration risk, with investment decisions made by one entity. This represents an increase in manager risk, where the entity making decisions is responsible for the retirement savings of all new members in a two-year period in the same investment pool. Under our current system, the reduced concentration risk means that members have some insulation from systemic risk.

AIST notes that a period between auctions runs contrary to the long-term investment principles that underpin superannuation. Financial advisers and super fund trustees say that one should spend time in the market, rather than attempt to time the market. However, short periods between auction periods means that a level of short-termism is encouraged in the Chilean system.

This short-termism, combined with the limitations and controls on asset classes, has the effect of limiting the potential for optimal returns to members. We point, in particular, to the impact such decisions may have upon investment in asset classes such as infrastructure, private equity or direct property, noting that these asset classes typically have long times to maturity.

³⁹ *Superannuation Industry Supervision Act 1993* (Cth), s.29VN(a).

AIST supports a fair and transparent process where employers and employees come together to choose default arrangements that are in members' best interests, rather than a universal system that is applied to all new default accounts, such as the Chilean default auction system.

We support the trustees of a superannuation fund being able to exercise their discretion to ensure that monies invested on behalf of members who are invested in default superannuation arrangements are invested appropriate to their needs. We also support the unfettered ability of trustees to provide services that best promote their members' financial interests. A default auction system such as exists in Chile, does not deliver on those objectives.

4.2 Short-term focus issues

The Interim Report questions whether short-term returns are an area of undue focus for superannuation funds?

AIST submits that there are several reasons to why there is, at times, a focus on short-term investment returns:

- The proliferation of performance data released by commercial Rating Agencies which, in turn, fuels media interest in short-term investment performance, often as short-term as monthly or yearly returns.
- Peer pressure between superannuation funds subsequent to such performance data and rating systems.
- Constant change of superannuation policy in a system that should have a longer-term focus may encourage short-termism.

Prudential Standard *SPS 530: Investment Governance* requires an RSE licensee to implement a sound investment governance framework, including the setting and reviewing of measurable investment objectives. This prudential standard has been in operation for just over 12 months, and APRA's supervision under the new requirements should be given time to take effect.

Long-term considerations also form part of the default fund selection process. The first stage criteria for being listed as a default fund by Fair Work Australia includes:

- The appropriateness of the MySuper product's long-term investment return target and risk profile
- The superannuation fund's expected ability to deliver on the MySuper product's long-term investment target return given its risk profile
- The stated long term investment return target and risk profile
- The net returns on contributions invested in the MySuper product.

At a fund and regulatory level, SPS 530, the MySuper authorisation requirements, as well as the new investment covenants combine to ensure a longer-term approach. AIST does not believe that there is

undue focus on short-term results from within the superannuation industry and submits that sufficient controls are in place to encourage longer-term strategies.

AIST also cautions that too much focus on fees may lead to a short-term focus, which is not in the best interests of members.

4.3 Switching and cash flow management

The Interim Report raises the issue of appropriate pricing and liquidity management for the switching behaviour of members.

The Interim Report raises the issue of appropriate pricing and liquidity management for the switching behaviour of members.

Since the introduction of Choice of Fund Legislation in 2005, the rate of member switching between funds has generally been very low, reflecting in part the general lack of community engagement with superannuation and low levels of financial literacy. Based on survey evidence, the percentage of members switching funds within a 12 month period is around 3 to 4 per cent.⁴⁰ About half of this switching is passive rather than active; that is, it resulted from a change in employment or an employer's change in default fund.⁴¹

It is estimated that the rate of active switching is therefore around 1-2 per cent on an annualised basis.

While most superannuation fund members did not exercise investment choices during the GFC, there was an increase in the number of members requesting shifts to low risk investment choices, including cash.⁴² Notwithstanding that some funds with high exposure to unlisted infrastructure assets did come under cash-flow pressure, the continued inflow of superannuation contributions during this time meant that most superannuation funds were able to accommodate investment choice switches without needing to sell assets.

But there are other liquidity pressures on funds in addition to switching rates. Research on cash-flow trends by SuperRatings⁴³ also points to pressures such as that from an ageing population on fund cash flows.

⁴⁰ Fear, J and G Pace, "Australia's Choice of Fund Legislation: Success or Failure?", Rotman International Journal of Pension Management, 2, 2009.

⁴¹ Fear and Pace (2009).

⁴² Gerrans, Paul "Member Investment Choice Response to the Global Financial Crisis" Centre for Retirement Incomes and Financial Education Research, Edith Cowan University, report for the Australian Institute of Superannuation Trustees (2009)

⁴³ SuperRatings Benchmarking Reports 2005-06 and 2012-13, not publicly available documents.

This research found that net cash retained by funds across the industry superannuation fund median - has nearly halved over a seven year period:

- In 2005-06, the funds reviewed kept \$0.64 cents in every dollar they received.
- By 2012-13, these funds kept \$0.31 in every dollar they received.

The research reviewed in excess of 100 industry, public sector, master trusts and retail superannuation fund products. The research is based on 30 June audited accounts and looks at all monies received and exiting funds (including rollouts to other funds, cash payments, total and permanent disability payments, etc.).

Following the GFC, APRA increased its scrutiny of the way in which superannuation funds managed their unlisted assets. APRA's Investment Governance Prudential Standard (SP530), which became effective on 1 July 2013, requires superannuation funds to formulate and implement a liquidity management plan and to undertake comprehensive stress testing.

While the implementation of this Standard should lead to more careful monitoring of liquidity, AIST believes that more work on understanding the drivers of member switching and other pressures on cash flow - such as ageing memberships - needs to be undertaken, including a thorough examination of the flow of money within the superannuation sector.

4.4 Tailoring asset allocations

The Interim Report requests information on the tailoring of asset allocations to suit the demographics of members. It also seeks clarification on relative benefits of lifecycle versus other balanced investment structures.

AIST strongly supports the appropriate tailoring of a fund's products and services, including investments, to suit the demographics of its members. The not-for-profit sector has historically done this well, aided by the equal representation governance model and a highly developed understanding of the membership demographics. RiceWarner⁴⁴ noted that when implementing MySuper, many of the industry funds had already tailored their balanced default investment strategies to meet the needs of their membership. Moreover, those industry funds catering to specific sectors, or with more homogenous workforces, were able to tailor to a higher degree than their multi-sector/multi-industry counterparts. This is also demonstrated by the high degree of variation in the target asset allocation of the balanced type MySuper products in the market.

⁴⁴ RiceWarner, (2014). *Navigating the New MySuper Landscape*. AIST and RiceWarner research. Australian Institute of Superannuation Trustees.

RiceWarner also researched the structures of MySuper products, and considered the relative benefits of the different approaches. Commentators in the market have concluded that a typical cohort Lifecycle MySuper will reduce the expected retirement income compared with a typical balanced MySuper due to lower levels of volatility at older ages and the impact of money weighted returns being greater at older ages. RiceWarner conclude that whether or not a Lifecycle MySuper will outperform a typical 70/30 Balanced MySuper depends on many factors which include:

- The probability that the Balanced MySuper will meet its objective
- The Strategic Asset Allocation of each cohort in the Lifecycle MySuper
- The frequency and magnitude of changes in the fund's Dynamic Asset Allocation.

As previously noted, RiceWarner drew attention to the tailoring of MySuper investment options, with a higher degree of tailoring being evident in industry funds. RiceWarner forecast that greater tailoring of MySuper investment options could occur in the future through, for example, adopting a 'through retirement' rather than a 'to retirement' approach. For example, asset allocations could be managed through to members aged 85 rather than 65 years of age.⁴⁵

AIST believes that trustees must implement investment strategies that are developed to meet member demographic needs. The structure of that strategy may involve a lifecycle approach, but AIST submits that this will not be the best approach in all cases. However, as AIST states elsewhere in this submission, lifecycle cohort strategies with one fee must properly disclose their costing methodologies so that members are able to meaningfully compare fees.

4.5 Projecting retirement incomes on superannuation statements

The Interim Report requests information on the benefits of including retirement income projections on superannuation statements.

Retirement estimates are a vitally important piece of information for members but they must provide the full picture. One of the most worrying myths about superannuation is that individuals need at least \$1 million in superannuation to retire in comfort. Such commentary ignores or fails to account for the role of the Age Pension in supplementing the retirement income of the majority of Australians. Even after a full working life with a superannuation contribution rate of at least 9.5 per cent, treasury estimates are that the majority of Australians will still draw a part-pension in retirement.

The questions members ask most frequently are:

- How much superannuation do I need?

⁴⁵ RiceWarner (2014).

- How much will I get?

While the ASIC Regulatory Guide 229, *Superannuation Forecasts*, enables funds to provide retirement estimates on benefit statements, there still exist some regulatory barriers to providing members with the full information they need (including the Age Pension in projections) or enabling members to interact with the retirement projections online.

AIST supports the implementation of retirement projections provided the projections reflect the member's actual situation, Age Pension entitlements if applicable, and that the projections are framed in terms of income.

AIST's recommends that there should be strong consideration given to super funds only communicating to members in retirement income terms, not account balances. The ASIC Regulatory Guide 229, *Superannuation Forecasts*, should be updated to enable funds to communicate with their members on a retirement income basis. To make this communication more meaningful and relevant to members, the Age Pension should be included in the projections, where relevant.

4.6 Liquidity - Three-day portability rule

The Interim Report questions the suitability of the three-day portability rule, its impact on liquidity management and whether a principles-based approach might better serve the industry than a prescriptive requirement.

Easy portability (inter and intra) is important in a compulsory superannuation system and particularly in a default MySuper product. AIST supports the three-day rule with MySuper products but recognises that such flexibility could be problematic with Choice products.

Based on current low levels of switching, the three-day rule in the MySuper arena does not impact on most funds' investment strategies. Additionally, funds' MySuper options are not likely to have liquidity problems, due to strong cash inflows, higher cash portions (as part of strategic asset allocations) and a larger volume of funds.

That said, more monitoring needs to be done to assess whether the three-day portability rule is impacting on liquidity at a systemic level.

However in the Choice environment where there may be less-diversified portfolios, there could be unintended consequences from mandating too-short timeframes for the portability of member funds. Less investment in illiquid, high-return assets, such as infrastructure, may result to satisfy portability rules. This is not in the best interests of members, who are investing for the long-term and looking to maximise their returns.

We provide as an example the situation where a member of a superannuation fund may use an investment option which is substantially illiquid, for example, an infrastructure option. This member decides to send through a transfer request to have their benefit moved to a different provider.

In order to comply with the three-day rule on transfers, the fund may need to maintain a higher than optimal level of cash in this investment option. Such a holding of cash may have the net effect of reducing investment returns for all members of this option, in order to comply with requirements for only this impacted member.

Liquidity is an important consideration within a superannuation fund. For most members, the requirement for liquidity is easily satisfied, as the majority of members in most superannuation funds will be in a fund's MySuper option where liquidity (whilst needing monitoring in accordance with the Liquidity Management Plan) is unlikely to be a problem.

AIST recommends that the three-day portability rule remains in place for MySuper, however that it is not appropriate for all Choice products. Systemic liquidity management is something that should be given greater focus both with the supervision of systemic risks by APRA.

5 Vertical integration

5.1 Fees, costs and net returns

The Interim Report refers to the trend in the wealth management and superannuation sectors for greater vertical integration. The report requests further information on the issues of competition and fees, advice and the benefit to members.

The fees charged by superannuation funds relate to a range of services provided, such as investment, administration, custodial, legal and insurance services. Many of these services are outsourced to entities that have financial links or are wholly owned by the superannuation funds resulting in vertical integration in the wealth management and superannuation sectors.

Such related-party outsourcing arrangements are, in themselves, not a bad thing. The critical issue is whether these arrangements are in the members' best interest or, conversely, are intended to benefit the service provider at the expense of the members. In 2009 and 2010, two APRA Working Papers by Liu and Arnold examined the pattern of outsourcing by superannuation trustees and the terms on which service providers were retained. The authors concluded that:

- While outsourcing (be it by related-party or independent providers) minimised costs to members of not-for-profit funds, some trustees of retail superannuation funds were prone to paying higher fees to related service providers which were found to be both statistically and economically significant for members.
- In the 2010 paper, the authors comment: "Outsourcing does not necessarily reflect whether the trustee has the appetite and/or capabilities to render the service, but for some retail funds might be viewed as part of the business model."⁴⁶

A third and more recent paper by the same authors,⁴⁷ found similar issues in regards to insurance services offered by for-profit providers. The researchers queried whether this pattern of behaviour was consistent with the legal obligations of the trustees to act in members' best interests.

APRA has since moved to strengthen the legal obligations of trustee directors in regards to managing conflicts of interests and related-party transactions with the introduction of prudential standards SPS 510 (Governance), SPS 521 (Conflicts of interest) and SPS 231 (Outsourcing) in 2013.

⁴⁶ Australian Prudential Regulation Authority, (2010). *Working Paper: Australian superannuation - the outsourcing landscape*. Canberra: Australian Prudential Regulation Authority, p.5. Available at: http://www.apra.gov.au/AboutAPRA/Documents/SA_WP_ASOL_072010_overview-3.pdf

⁴⁷ Australian Prudential Regulation Authority, (2012). *Working Paper. Superannuation and insurance: Related Parties and member cost*. Australian Prudential Regulation Authority.

After only 15 months of operation, the effectiveness of these new standards in reducing for-profit superannuation funds paying higher fees to related-party service providers is still to be determined. This is certainly the case in the Choice-of-fund environment, where superannuation fees are at their highest. It is also however the case with MySuper. Elsewhere in this submission AIST examines in detail how MySuper costs might also be cross-subsidised, or net investment returns are being diminished, in MySuper products because of vertical integration issues. In January 2014, a special investigation by *The Age*⁴⁸ reported that the four major retail banks were funnelling their superannuation customers' cash investments exclusively into their parent banks "for relatively low returns". In failing to diversify this cash investment and shop around for the best returns, the for-profit superannuation trustees were accused of failing in their fiduciary duty. The regulators, in turn, were accused of side-stepping the issue.

Equally anti-competitive, and also borne out of vertical integration, is the practice of fee-gaming, which ASIC identified as occurring in the superannuation industry in its *Report 398 Fee and Cost Disclosure*.⁴⁹ Fee gaming is defined as issuers taking deliberate actions (for example, structuring investments, operations or other arrangements with third parties) with the objective of intentionally disclosing lower fees and costs than would otherwise be disclosed. ASIC has acknowledged that any undisclosed fee reduces the investment return reported to investors.

While AIST has welcomed moves by ASIC to improve the monitoring of fee disclosure and fee-gaming, more needs to be done to ensure super fund trustees meet their obligation to procure services – including investment services - at the best value for money.

AIST recommends:

- That APRA be better resourced to monitor, report and supervise related-party outsourcing arrangements pursuant to their new standards to ensure trustee directors are meeting their legal obligations to procure services in members' best interests.
- That more research be conducted to update the Liu & Arnold findings from 2010 with a view to informing the current impact of related-party transactions on fee levels.
 - A review of MySuper fees, costs and net investment returns. To ensure that the impact of vertical integration on MySuper is assessed, the review should include (but not be limited to) the following:
 - An analysis of whether MySuper investment returns are diminished because of vertical

⁴⁸ The Age Newspaper, 29 December, 2013. *Superannuation Banks eating into saving* Australian Prudential Regulation Authority, 1 November, 2012 *Superannuation and insurance: related parties and member cost* available at http://www.apra.gov.au/AboutAPRA/Documents/SA_WP_SIRPMC_102012_ex.pdf

⁴⁹ ASIC, July 2014.

integration issues, for example, MySuper members are receiving lower returns because cash margins are taken via the banking arm in which the superannuation cash monies are invested.

- Whether MySuper business stems from offering incentives or other services (such as clearing houses/gateways) to employers
- Further recommendations are contained in the Consumer Outcomes section of this submission.

5.2 Advice

The Interim Report seeks additional information on consumer access to financial advice conflicted remuneration arrangements in an advice setting.

The degree of concentration of financial advisers in the banking sector, coupled with remuneration arrangements offered to financial advisers (or those making referrals in the supply chain) should be a matter for concern in so far as this impacts on the best interests of members. The ability to influence a person's decision, without the duty to act in the person's best interests is a cause of great concern to AIST in a mandatory retirement savings system where people's interests should be protected.

Conflicts of interest can exist between the fiduciary duty to act in the best interests of members and beneficiaries, and making profits for shareholders. This is supported by the International Organisation of Pension Supervisors.⁵⁰

This is certainly true in relation to financial planning and the distribution arms of for-profit organisations. Failure to carefully examine the implications of vertical integration in an advice setting raises serious issues where behaviours may lead to members and beneficiaries either losing or having lower retirement savings and therefore seeking government subsidy.

The underlying data demonstrates how concentrated the financial planning sector is:

- According to the Customer Owned Banking Association, Australia has the most concentrated banking sector of any G20 country.⁵¹
- Rainmaker⁵² noted that the four largest banks, their wealth arms and AMP have coverage of over 55% of all financial planners and 79% of all platform advisers.

⁵⁰ International Organisation of Pension Supervisors, (2010). *Managing and Supervising Risks in Defined Contribution Pension Systems*. Working Paper No.12. Available at: <http://tinyurl.com/mzwo6dn>

⁵¹ Asia-Pacific Banking & Finance, (2014). Too-big-to fail banks getting bigger. [online] Available at: <http://tinyurl.com/pvbdmfl> [Accessed 21 Aug. 2014].

⁵² Rainmaker's Financial Planning Report, Volume 3, No.1 February 2014

The impact on consumers of this degree of sector concentration, and vertical integration through bank distribution and advisor networks is as follows:

- Roy Morgan Research⁵³ found that financial planners continue to recommend in-house products, while in 2014 found that consumers are confused about which financial planners are independent.
- Banks are now able to sell their superannuation and insurance products over the counter, without the need to go through a financial planner. This advice would be considered general advice, with no account of the customer's individual circumstances. Bank tellers can also receive financial benefits for selling such products.

The recent Future of Financial Advice (FoFA) amendments mean that:

- The member confusion which exists regarding the differences between factual, general, and personal advice has been exacerbated through FoFA only dealing with personal advice. All members accessing information - whether it is factual, general or personal - are entitled to competent, diligent and safe advice.
- Best interests test has been substantially watered down.
- Allowing clients and advisers to agree on the scope of advice could be subject to manipulation, as the level of knowledge and expertise is weighted to the adviser (being in a position to exert a higher degree of influence).
- The removal of the opt-in provisions reduces the likelihood of clients knowing what they are being charged.
- There is no mention of how discounts stemming from scale-based efficiencies in volume-based shelf fees will be passed onto members.

AIST strongly rejects any legislative impediments to members gaining competent, diligent and safe financial product information or advice.

AIST's recommends:

- The primary requirement to take into account the member's best interests be reinstated. AIST therefore is recommending that the recent amendments to FoFA be overturned.
- The provision of general advice over the counter without any account of the customer's circumstances should be prohibited. As a minimum, payment of any form of commission must be banned.
- The provision of general advice over the counter and its impact on member switching should be included within a review of MySuper.

⁵³ Roy Morgan, 2013 and 2014.

- There should be a form of terminology that makes it more obvious whether the giver of the advice is independent of, or tied to, a financial institution.

5.3 Employer arrangements and inducements

In this submission, AIST recommends that default fund selection should be on the basis of choosing a MySuper product, coupled with a quality filter (an expert panel of the Fair Work Australia) such as ensuring that the fund has designed its products and services, taking into account the particular member demographics. In the default fund selection process, there is a potential for conflicts of interest to arise from vertical integration of products and services.

While some legislative prohibitions against offering inducements from a superannuation provider to an employer currently exist,⁵⁴ there are some goods and services that are not covered by the current prohibitions. These include the supply of:

- An administration service where it relates to payment of contributions to the fund.
- A business loan on a commercial, arms-length basis.
- A clearinghouse service.

In Colmar Brunton's research,⁵⁵ it is noted that while 4% of small and medium businesses were aware that incentives had been offered, the incidence went up to 11% with large businesses.

AIST submits that all forms of incentives and remuneration practices that may impact the members' best interest must be either banned (where warranted) or disclosed to members.

AIST recommends that where banks (and their related entities) provide the main banking services to an employer, as well as providing the default superannuation fund services, that this be flagged as a potential conflict and that it be managed appropriately, with oversight from the regulator.

⁵⁴ Section 68A of the SIS Act

⁵⁵ Colmar Brunton Social Research, (2010). *Australian Taxation Office Investigating Superannuation: Quantitative Investigation with Employers. Final Quantitative Report*, Australian Taxation Office, p.56. Available at: <http://tinyurl.com/m9go3ww>

6 Technology

The Interim Report poses a number of questions concerning the use, accessibility and regulation of technology in financial services.

AIST has been actively involved in the design and implementation of technological advances to support the back-office capabilities of super funds. We recognise the importance of technology in the advancement of transaction processing and consumers' growing expectations in modern society for data, information and money to move quickly, easily and safely. AIST supports the increased use of technology to improve the efficiency and lower the cost of financial transactions, provided they are, in a superannuation context, in the best interests of members.

6.1 Technology and e-commerce

AIST supports the SuperStream reforms and continues to support the implementation of e-commerce-based improvements to technology and payments. We believe that new improvements in this area can be developed further by removal of all barriers to full e-commerce solutions. AIST would support a regulatory review of e-commerce arrangements to ensure that all systematic barriers are identified for removal.

Furthermore, we consider it appropriate that e-commerce improvements be implemented as default arrangements on an opt-out basis, only.

6.2 Open and global standards

AIST supports the removal of barriers to entry, implementation and execution of technology within the industry. To this end, we support the adoption of global and open standards to facilitate technological change in financial services. Open and global standards provide a way to ensure consistency and technological neutrality. Consistency ensures uniformity in consumer expectations. Technological neutrality allows entities to choose technology that is most appropriate and suitable to them, without being dependent on technical knowledge that is purely information or data.

Utilising open standards is consistent with Australia's aim to become an international financial services hub. Standards that have been defined by organisations such as Ecma, the International Standards Organisation or the International Electrotechnical Commission provide well-documented technical standards which could be considered in the Australian context.

6.3 The role of financial regulators

As the Interim Report identifies, Australia is well represented internationally in the field of standard setting. A holistic regulatory framework for technological advances in financial services, however, should include the Australian Taxation Office (ATO).

The ATO is a standards-maker, regulator, and is also a service provider to the industry, having taken over the operations of the small business superannuation clearing house. The ATO has also been instrumental in prescribing the way that SuperStream has unfolded. AIST supports the promotion of integrated solutions, where data and payments are considered together.

As outlined elsewhere in this submission, AIST supports an expansion of the Council of Financial Regulators (CFR) membership to include the other regulatory bodies such as the ATO, AUSTRAC and the ACCC. The area of technological innovation in financial services should be an area of responsibility for the CFR.

We consider that a prudent approach by regulators in the technology area is to consider international standards and regulation as an initial strategy. However, we also support this being balanced with appropriate risk management and change management mechanisms, particular where it is necessary to tailor these to Australian circumstances.

The International Telecommunications Union and infoDev (part of the World Bank Group) have both highlighted the difficulty in determining the degree of regulation that is needed to ensure technological neutrality. That said, both organisations concluded that basing regulation upon principles including compatibility, service quality, data speeds and infrastructure selection would allow for optimal outcomes that did not stifle technological advancement.⁵⁶

In the context of superannuation, AIST also supports regulation that prioritises compatibility, service quality, data speeds and infrastructure selection broadly, without providing advantages to technologies between markets in differing services.

AIST suggests that APRA and the CFR set objectives in regulatory requirements that promote efficiency in technological services on a members' best interests basis.

6.4 Technology and consumers

AIST recognises the difficult balance between a member's rights to privacy and the convenience members expect in using technological solutions. We realise that a variety of measures that assist consumers, could potentially also inconvenience them. In particular, we draw attention to the world of privacy.

AIST welcomes moves to reduce the identification load on members when they are required to produce this to superannuation funds. On the other hand, we also welcome initiatives to simplify the flow of data between superannuation funds to further the consumer experience with their superannuation.

⁵⁶ ICT Regulation Toolkit, (2014). *Technologies for Universal Access and Service*. [online] www.ictregulationtoolkit.org . Available at: <http://tinyurl.com/me3lg9> [Accessed 22 Aug. 2014]

AIST would support the implementation of a principles-based digital identity strategy whereby superannuation funds could ensure that they have policies and processes in place to accurately identify their members remotely. We do not believe that a 'one size fits all' approach is always appropriate, and point to the 'Know Your Customer' requirements under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* as providing a model of how this could be implemented.

AIST believes that an all-encompassing digital identity strategy could also be a key defence against cyber-security threats.

6.5 Portability

AIST considers that there should be no artificial brakes on the capability of technology to serve consumers unless such brakes serve the need to manage risks. The development of technological solutions should be encouraged so that the Australian superannuation system can keep pace with global trends and serve the best interests of all members, not just individual members.

AIST recommends that:

- An approach to technology and payments be required to serve the best interests of members. As previously stated, for some Choice products, we recommend that consideration be provided to relaxing the three day maximum time period on transfers in situations where this is appropriate and in the best interests of members.
- Technological neutrality and consistency should be pursued as objectives, through the use of global and open standards.
- The CFR be expanded to include the ATO and that its remit be broadened to include review of technological innovation in the financial services industry.
- The overriding objective should be to promote efficiency but on a members' best interest basis.
- We recommend a regulatory review to identify systematic barriers to the implementation of e-commerce so that these may be removed, for example, opt-out requirements for e-commerce.
- The implementation of a principles-based digital identity strategy, whereby funds develop appropriate frameworks to accurately identify members remotely.

7 Retirement incomes

The Interim Report queries the range of options available in the Australian retirement income system, seeking further input from stakeholders regarding possible barriers for consumer take-up and default options, product design and incentives.

AIST agrees that the retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees. We accept that most of the superannuation industry's attention in recent times has been strongly focussed on the accumulation phase of superannuation, with the drawdown phase relegated to the sidelines. But we also believe that Australia has time to think deeply about designing a retirement income system and should not rush into solving issues, perceived or otherwise, with products or myopic policy fixes.

To design a world-class post-retirement system, numerous economic levers will need to be adjusted – a primary one being tax policy. Social security and aged care policy are also key considerations.

To this end, it is unfortunate that the retirement income system is effectively being reviewed concurrently in three separate reviews – this one, the Treasury discussion paper on Retirement Income Stream Regulation and the proposed Tax Inquiry due to commence at the end of 2014.

We understand that the Treasury discussion paper forms part of the Government's legislative agenda and AIST will make a submission. Essentially, we will be arguing that barriers preventing the development of retirement income products be removed, whilst maintaining an equal playing field for retirement solutions. Retirement is an individual experience and no single cohort should be advantaged through government policy.

AIST believes that the biggest impact in the post-retirement space will come from a review of the tax system. We therefore propose that the scope of the upcoming Tax Inquiry necessarily include development of a retirement income system.

As set out earlier in this paper, AIST is of the firm view that the objective of superannuation needs to be clearly defined and this includes recognition that the retirement income settings are critical to delivering equity, adequacy and sustainability. A long-term objective will make it easier to make significant changes with reasonable transition periods.

AIST recommends that superannuation funds be required to develop a strategic framework that examines how they address retirement incomes for their members. Such a framework would consider rules, fund features, retirement income strategies, reversionary arrangements and tax.

7.1 Default options

AIST supports the ability for funds to develop a default pension option – or default transition - where this is in the interests of a fund’s membership base. We have defined the term ‘default transition’ to mean a situation where, in the absence of other instructions to the trustee, a member’s account transitions from the accumulation phase to the drawdown phase.

We accept that for some funds, an appropriate default transition strategy may not be possible, or desirable. We consider that inclusion of a default transition in a fund’s post-retirement strategic framework will depend on whether trustees establish that this is in their particular members’ best interests.

How a fund might structure its default transition is subject to one main consideration: When is it in members’ best interests for assets to transition in consideration of the taxation differential between accumulation and drawdown phases. This reinforces how critical tax policy is when designing or re-designing Australia’s retirement income system.

The following criteria, at a minimum, would need to be considered to allow default transitions to occur:

1. Trigger events

A fund would need to set a trigger event, such as an age, as to when this event takes place. A fund may, for example, consider the unrestricted age (65) to be appropriate, where another fund may opt for the Age Pension age. Yet another fund might opt for the age where personal contributions may no longer be made (75). These considerations should be appropriate to the fund’s particular membership.

Consideration of criteria other than an age may also be appropriate. The trigger event may also be contingent upon other events, or lack thereof. One example of this might be cessation of contributions for the previous six months.

2. Default payment processes

A fund would need to develop a default payment process for income payments. If this is to be via direct credit of the member’s bank account, details such as BSB and account number would need to be collected, in addition to a fund’s existing information set.

3. Which members?

Consideration would need to be given as to whether default transitions should only extend to MySuper members, or whether all members automatically have a default transition profile assigned to them.

4. Structure of income payments

Rules relating to income payments and income stream strategies should be appropriate to the fund’s particular members. A fund that caters to a predominantly blue-collar member base that may have lower

life expectancies, for example, would find it very difficult to justify developing a longevity-based retirement income strategy as a default solution.

5. Default investments

A default investment option should be chosen, if an account-based income strategy or similar is chosen by the fund. This could be a single investment option, or could be part of a staged lifecycle approach. The investment strategy should consider what is appropriate to a fund's particular membership.

6. New contributions

Consideration of a fund's rules may need to allow for separate member accounts to be set up for a fund to continue to receive contributions in the accumulation phase whilst paying income in the drawdown phase.

Further consideration of this aspect may require rolling both accounts back into the accumulation phase once a year and recommencing an income stream on an assigned date, for example, 1 July annually. Such a process could be automated or in fact consideration could be given to allow pension top-ups.

7. Ability to opt-out

AIST supports the ability to opt-out of a default transition by members. This would be in the form of a member providing alternative instructions to trustees.

Such alternative instructions may include alternative retirement income strategies to those chosen by trustees as their default strategy. For example, a trustee may operate an account-based income stream as a default, but may also make a non-account-based income stream available upon request.

8. Preservation of the right to lump sums

AIST supports the right of members to lump sums; however as member retirement balances grow there may be the need to introduce a cap on the lump sum withdrawal amount.

In the interest of choice, AIST also supports a variety of solutions for members. . We acknowledge that a default retirement income policy is not going to be preferred by all members, in the same way that default investment options are not appropriate to all members.

7.2 Product design

Products that address longevity, such as annuities, are not new products. The reasons that longevity products have not been adopted by investors have more to do with lack of demand from consumers than with product design. Barriers to the take-up of these products include:

- Financial incentives to invest in annuities provided through tax or social security concessions have long been abandoned. This has, understandably, reduced the attractiveness of these products.

- Concerns about lack of diversification: When viewed through the lens of portfolio theory, an annuity in a portfolio is equivalent to a single fixed interest investment. This means that such an investment will only be appropriate to niche investors who are either ultra-defensive yet uninterested in the benefits of diversification, or where the investment forms part of a diversified portfolio of fixed interest investments.
- Legacy Issues: There is a stigma attached to longevity products from times past that they are expensive, inflexible and designed with the benefit of the provider as opposed to the consumer.

AIST supports broader dialogues on retirement income, where strategies are explored that are appropriate to a fund's particular membership. We encourage strategies that maximise retirement income, at the same time as addressing all areas of investment risk, and other disadvantages associated with retirement income strategies.

In addressing longevity risk, some areas of investment risk are often increased, including concentration risk, mortality risk, counterparty risk, liquidity risk, interest rate risk and inflation risk.

On the other hand, addressing longevity risk can also act to reduce market risks, including sequencing risk.

7.3 Consumer improvements

If longevity products are reintroduced into the Australian market, the following list of features should be considered to make the products more effective and appealing for Australian consumers:

- Greater availability of commutations – i.e. greater protection of the capital in the event of early death
- Greater resale and/or termination rights
- Ability to change provider
- Improved transparency regarding the investment pool of the product provider
- Improved disclosure regarding related party payments and implied costs to investors such as gross interest margins.

7.4 Incentives

We recognise that product incentives can create unfair advantages for certain classes of member. However, in the case of annuities there may be a need to provide incentives to encourage acceptance. Consideration should be given to linking incentives to the provision of aged care or health care.

Demand-side incentives such as tax or social security concessions are no longer available for certain retirement income streams. However we believe that social security concessions could be reinstated, including full or partial exemptions from Age Pension means testing.

We note a variety of retirement income products available in the market presently, such as account-based pensions, and the absence of any evidence to suggest that these do not work. More could also be done to

incentivise the use of non-account based pensions, but the market needs to mature to make these products more affordable and attractive.

We also note that a number of these matters are being dealt with in the Treasury Retirement Income Stream Regulation paper.

Rather than mandating the uptake of post-retirement products, AIST supports policy incentives that encourage retirees to purchase retirement income products that help them deliver their optimal retirement experience.

We support the ability of superannuation funds to develop a post-retirement strategic framework.

AIST recommends:

- Superannuation funds should be required to develop a strategic framework on retirement incomes for their members. This would include the decision to provide (or not) a default transition from accumulation to drawdown.
- A fund's post-retirement strategic framework on retirement incomes must consider solutions that are in the best interests of a fund's members.
- Default transitions must be in the best interests of members and should not be mandatory but consideration should be given to incentivising products that help retirees manage all their investment risks, not just longevity.
- An accepted tax minimisation strategy exists to migrate super fund assets between accumulation and drawdown phases of superannuation funds. A logical migration of assets between phases must be considered as part of a funds' strategic framework.

8 Leverage in superannuation funds

The Interim Report questions the vulnerability of the financial services system, including superannuation, to direct leverage. The Report recommends that the general prohibition on leverage in super be restored.

The interim paper argues that the “general absence of leverage in superannuation funds meant that losses were not magnified,” enabling the superannuation sector to “have a stabilising influence on the financial system.”

In recent times, a case has been made for direct, albeit limited, leverage in superannuation. This was cemented in 2007, when the SIS Act was amended to allow investment in instalment warrants, a derivative instrument that allows for piecemeal investment in assets. Previously, these were limited to shares, however, since these were allowed under the Act, a variety of funding solutions were created, most notably over real property. Leverage itself is generally only allowed in situations where liquidity in the form of very short term cash flow was required to be addressed.

The Interim Report also points to the fact that risk is magnified across the financial system by leverage. Types of financial risk impacted by leverage include market risk, credit risk, manager risk, and liquidity risk and are increased at both an investor level, as well as a macroeconomic level. The interlinked nature of the financial system means that should failure in the form of defaults by borrowers become widespread, the spill-over effect may be unable to be contained by ordinary provisioning. This effect is noted in the Interim Report, and is generally deemed to fall within the definition of systemic risk.

We point to the fact that the size of the superannuation industry – currently \$1.85 trillion in assets under management, with only \$6.2 billion in borrowings in 2012 – is now so large that exogenous shocks, such as the global financial crisis, or shocks created within Australia, may be cushioned to a large extent by the passive investment in unleveraged assets. This stabilising influence is reduced as leverage increases.

Superannuation’s unleveraged nature meant that the GFC was not as pronounced in superannuation. This, in turn, acted as a stabilising influence on the financial system and the effect of interconnectedness was not magnified.

We contend that an unleveraged superannuation sector assists management of systemic risk. AIST supports a return of a prohibition on leverage in superannuation.

9 The management of systemic risk

The Interim Report recognises the macroprudential tools used to assess systemic risks in other sectors and around the world and has asked for more information from stakeholders on the value of such tools. The Interim Report also questions whether material service providers such as administration services and technology providers should be regulated.

The possibility of systemic risk in the Australian superannuation industry arises, we submit, through the highly concentrated interconnectedness of providers within the system. AIST notes and supports the comments made by the Centre for Law, Markets and Regulation UNSW/Law⁵⁷ that linkages between the component parts of the Australian superannuation system can mean the impact of local failure can be felt on a much wider scale.

In our Initial Submission to the Financial System Inquiry, AIST noted that while there are a number of supervisory tools to identify and respond to risks in the industry or at system level, generally APRA's approach has been to focus on individual entities and their separate operations within the superannuation system. AIST believes an additional, industry-wide focus for the regulator is warranted.

AIST concurs with the comments in the Interim Report that the effectiveness of macroprudential tools used overseas has not yet been established.

The Financial Stability Board (of which Australia is a member) has to date concentrated on banks and insurers. A 2014 report proposes methodologies to identify non-bank non-insurance financial entities whose distress or disorderly failure - because of their size, complexity and systemic interconnectedness - would cause significant disruption to the global financial system and economic activity across jurisdictions. The report acknowledges the difficulty in determining the pool of entities to be reviewed, and seeks views on certain materiality thresholds including the size of funds managed by the entity. As yet, no conclusions have been released.⁵⁸

The European Systemic Risk Board, established post the GFC, is currently examining whether large defined benefit pension funds should be included within their framework. This approach is not relevant in Australia where defined contribution schemes predominate.

⁵⁷ Centre for Law, Markets and Regulation UNSW/Law, (2013). *The implications of complexity for systemic risk in the superannuation system*. CLMR Research papers Series; Working Paper no. 13-3. Sydney: CLMR. Available at: <http://tinyurl.com/pjj8f9b>

⁵⁸ Financial Stability Board and International Organisation of Security Commissions, (2014). *Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Globally Systemically Important Financial Institutions. Proposed High-Level Framework and Specific Methodologies*. FSB and OICU-IOSCO. Available at: <http://tinyurl.com/mgst3ua>

The Financial Stability Oversight Council, established in the USA in 2010 is similarly reviewing whether large, non-bank financial institutions should be included in its mandate.

Some European Pension groups have advocated that the failure of a pension fund would be unlikely to pose a systemic risk to financial markets, as funds are merely users of those markets and not a part of them. AIST submits that since the main focus of Australia's superannuation system is to provide an adequate and sustainable retirement benefit, and members bear the risk in a defined contribution system, the methodology of identifying systemic risk issues (in addition to individual entity risks) is worthy of consideration within the Australian superannuation context.

Due to the interconnectedness of superannuation entities in Australia, however and the purpose of our system, we support additional prudential supervision responsibilities for APRA to focus on risks across the whole of the system, not just at an individual entity level.

9.1 Regulation of service providers

A vast array of services are outsourced in Australia's super system, however, AIST does not support the regulation of large service providers to the super industry. Service providers that, for example, provide general or personal advice (such as administration companies) are required to have an appropriate Australian Financial Services Licence.

Bringing service providers under conduct regulation would undermine the responsibility for the best interests test that rests with superannuation fund trustees. Also, outsourcing requirements are covered within the new prudential standards framework, and therefore material service provider arrangements are being closely supervised. If more is needed in the area of trustee responsibilities for material outsourced services, then this is within the scope of the current regulatory framework.

A considerable amount of discussion has taken place regarding the need for regulators to more closely scrutinise the activities of service providers to superannuation funds, with regards to technology risks. These entities can operate as agents of funds, including administrators and custodians. In other instances, entities may not represent funds at all, such as gateway providers.

AIST considers that there are sufficient checks in place on outsourcing arrangements. However, we consider that APRA's Probability and Impact Rating System (PAIRS) may be appropriate for assessing technology risks contained within the superannuation system.

AIST recommends the following additions to APRA's supervision responsibilities:

- Further guidance should be provided by APRA regarding the definition of systemic risk within the Australian superannuation system.
- PAIRS should be reviewed and expanded to include, for example:
 - Analysing the degree of interconnectedness of the superannuation system and its

components

- Examining any systemic risks arising from behavioural issues within financial institutions such as the growing vertical integration of financial services
- The assessment of technology risks
- Determining how data collected by APRA and the ATO could be used to help identify the possibility of systemic risk events
- Rating systems used by the Financial Stability Board, if deemed appropriate
- Whether key themes in the industry or components (for example, the use of alternatives by managed funds or use of property by SMSFs) may, while seemingly not systemic, give rise to systemic risks.

AIST does not support service providers being brought under regulation. Trustees should maintain ultimate responsibility for ensuring that the best interests test is met.

9.2 Increasing competition – sustainability as the key focus, not scale

The Interim Report refers to enhancing competition with economies of scale. In particular, the Interim Report refers to whether MySuper will provide sufficient competition to ensure future economies of scale being reflected in higher end returns.

In order to gain a MySuper authorisation, the RSE licensee must attest, on an annual basis, whether members who hold a MySuper interest are disadvantaged by insufficient scale compared to members who hold a MySuper interest in other funds.⁵⁹ Due to this new requirement, funds are legislatively required to consider scale as part of their strategic focus.

AIST recognises that within economic theory, it is generally accepted that scale can deliver economic benefits, at least up to moderate size levels. While some research points to larger funds outperforming, there is also evidence that smaller funds also perform strongly in the higher quartiles. Aligning success in achieving high net returns purely with scale is a blunt instrument that does not always deliver the same outcome. Accordingly, AIST strongly contends that in order to ensure that members receive the best retirement outcome, the appropriate test should relate to fund sustainability rather than scale.

AIST believes that the MySuper authorisation and review process should refocus from scale to the broader focus on a fund's sustainability and that the current regulatory framework in this area should be reviewed.

⁵⁹ Section 29VN(b) SIS Act

AIST suggests that the following types of matters could be taken into account when defining on what is meant by a fund's sustainability:

- Net return to members over the long-term
- The fund's delivery of the matters covered in its Investment Governance Framework
- Scale
- While qualitative, the fund's view on the delivery of its strategic objectives and how well it is positioned to be competitive
- Management of the net flow of members and funds under management. This could be viewed in both a quantitative manner (historical and projected flows) and qualitative (the fund's delivery of its strategic objectives).

AIST recommends that the MySuper regulatory framework move from a focus on scale to one of sustainability.

9.3 Regulator funding processes

The Inquiry requests information on the funding processes and transparency of the regulators.

AIST believes that regulator funding processes should be fair and equitable as well as transparent. Levies on superannuation funds have significantly increased with recent reforms to the system and AIST submits that a more autonomous funding process should include greater transparency to those entities being levied. Levies are currently being raised which do not follow the processes in the Australian Government's *Cost Recovery Guidelines* July 2005 (CRG). While it has been announced that the CRG is to be revised and then applied to future levy raising, this is yet to occur.

AIST believes regulator levies should be raised and apportioned in an equitable fashion and in accordance with the revised CRG. The methodology should include that all sectors of the superannuation system should be paying their share of the levies, including SMSFs (which have benefitted from the new data transfer standards).

9.4 Increasing the role of the Council of Financial Regulators

The Interim Report considers increasing the membership and remit of the Council of Financial Regulators.

AIST acknowledges the important role which the Council of Financial Regulators (CFR) plays. The Interim Report reflects that the four existing CFR members (RBA, APRA, ASIC, Treasury) do not have direct responsibility for anti-competitive behaviour, anti-money laundering legislation, or compliance-based regulation of self-managed super funds (SMSFs). The Interim Report also suggests that the inclusion of other agencies with much broader mandates may divert the focus of the CFR.

The size of Australia's superannuation system exceeds its GDP. Regulatory structures have, in fact, changed. AIST believes these changes trigger the need to extend the membership of the CFR:

AIST submits that membership to the CFR of the Australian Taxation Office (ATO) is critical. The ATO now has responsibility for over one-third of the superannuation sector via SMSFs. While it might be argued that SMSFs bear investment risks themselves, AIST contends that vehicles which represent one-third of the superannuation sector must be taken into account when considering adequacy, sustainability and longevity issues as any detrimental flow-on effects may impact the system overall and the cost of providing the Age Pension.

The ATO also has responsibility for the governance arrangements of the superannuation gateway system. While APRA collects data from financial institutions, the ATO has data on individual behaviours. This is critical from a financial institution regulator viewpoint in the management of systemic risks (while recognising that APRA has this as a primary responsibility).

There are anti-competitive behaviours within the superannuation industry such as vertical integration that should be considered by the ACCC.

AUSTRAC has responsibility for anti-money laundering and counter-terrorism financing.

AIST recommends that the CFR membership be extended to include the ATO, the ACCC, and AUSTRAC.

10 Consumer outcomes

The Interim Report queries the value of existing disclosure requirements for consumers.

Australia's superannuation system provides participants with more choice than in most other jurisdictions. AIST believes that the ability of individuals to fine-tune their superannuation in a compulsory system is important. The capacity for individuals to make choices was a fundamental element of the model underpinning the Stronger Super initiatives.

While recognising that heightened duties apply for trustees in the MySuper environment, AIST strongly holds the view that where members are in a pooled superannuation fund – be it a MySuper or a Choice product – working Australians must be given the same levels of consumer protection:

- Any decision made by trustees must be in the best interests of members
- Disclosure must be on a level playing field
- Prudential Standards must continue to apply to both MySuper and Choice products.

Whether members are in MySuper or a Choice option, superannuation is still a compulsory retirement savings system, and the protection of consumers, and their ongoing confidence in the system, remains paramount. This is particularly important given that many members are currently in Choice options during the retirement phase of their superannuation.

10.1 Disclosure

AIST strongly supports transparency and the disclosure of information that assists members in understanding their superannuation, the costs associated with it, any conflicts or related party information as well as information that allows them to compare their choices against other offerings. While the disclosure regime has been significantly bolstered following the implementation of Stronger Super, it is clear that disclosure isn't working well in some areas.

10.1.1 Removal of disclosure requirements

AIST continues to support a strong regulatory and disclosure regime and we believe that care must be taken if any changes are made to the disclosure requirements. Disclosure is for the benefit of members but it also assists competition between funds and providers.

AIST strongly supports the G20 High-Level Principles on Financial Consumer Protection,⁶⁰ which include product comparability. While MySuper has furthered the delivery of comparable product disclosure, there are still a number of areas where key matters are not being fully disclosed. This leads to:

- A reduction in the degree of regulatory protection for members
- A lack of comparability and protection at member level
- A diminution of the capacity of the Regulators to understand the totality of fees and other costs in the Australian superannuation system
- A reduction in competition within the system itself.

The International Organisation of Pension Supervisors comment that “...the limited capacity of individuals to choose what is best for them means that competition and markets rarely work effectively within pension systems – leaving too much power in the hands of pension providers. The problem is only exaggerated when pension providers are commercial financial institutions. Conflicts of interest can therefore exist between the fiduciary duty to act in the best interests of the pension fund members and beneficiaries and making profits for shareholders.”⁶¹

These conflicts have created instances in the current regulatory regime where the member is not sufficiently protected. Examples include:

- Costs may be rolled-up within group service charges. Discrepancies between advertised deposit rates and deposit rates paid to cash within a superannuation fund should be reported to consumers along with the reasons for the discrepancies.
- The advent of MySuper has led to further development in lifecycle and cohort default investment options. Some funds, for example, have a single fee across all cohorts. This makes it difficult for the member to compare or understand the degree of cross-subsidisation across the cohorts.
- Shelf-space fees should reflect the true underlying costs to particular platforms.

10.2 Disclosure operational principles

AIST strongly believes the G20 High-Level Principles on Consumer Protection could be strengthened in Australia through the responsible regulator issuing a set of operational which could assist when new products and services are being contemplated or delivered in superannuation. AIST suggests the following operational guidelines:

⁶⁰ Organisation for Economic Co-operation and Development, (2011). *G20 High-Level Principles on Financial Consumer Protection*. Paris: Organisation for Economic Co-operation and Development. Available at: <http://www.oecd.org/daf/fin/financial-markets/48892010.pdf>

⁶¹ International Organisation of Pension Supervisors, (2010). *Managing and Supervising Risks in Defined Contribution Pension Systems*. Working Paper No.12. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1809741

- The whole picture as disclosed should not be misleading through omission even if the component parts comply (for example, rolling up of group service charges).
- Costs and fees should not be obscured through the use of intermediaries
- Disclosure of costing methodologies where they vary across a default investment option
- Disclosure of apportionment methodology where costs carry across platforms
- Disclosure of payment and utilisation of contractual benefits (for example, group insurance profit sharing)
- Disclosure of fees arising from the separation of ownership of assets from those who manage the assets
- Calculation methodologies should be set whenever outcomes affecting member benefits need to be disclosed
- Key terms in disclosure documents need to be consistently labelled and defined.

The matters covered by the last three dot points above are being dealt with by ASIC and AIST strongly applauds ASIC's work in this area. The remaining items should however also be addressed. AIST believes that operating principles will benefit the system and improve consumer confidence in it.

10.3 Remove current disclosure requirements that are ineffective

The Interim Report requests further information on the costs, benefits and trade-offs of removing disclosure requirements and new ways of providing information to consumers.

ASIC has extended the interim class order relief from the shorter form Product Disclosure Statements for multi-funds, superannuation platforms and hedge funds until 30 June 2015. Within such an environment, AIST submits that:

- Substantive disclosure requirements should not be removed until a MySuper review takes place
- Any improvements to the current requirements based on consumer testing should be considered. For example, the development of a risk measure which helps members understand the risk/return trade-off as well as the need for members to achieve real long-term returns in order to meet their retirement objectives.

Studies from around the world show that decisions about how much to contribute, which plan to join/provider to use, how to invest assets, or what product to purchase at retirement, are not decisions that most members are well equipped or disposed to take, even if the supervisory regime ensures that they are given sufficient information for this purpose.⁶²

⁶² International Organisation of Pension Supervisors, (2010). *Managing and Supervising Risks in Defined Contribution Pension Systems*. Working Paper No.12. Available at: <http://tinyurl.com/mzwo6dn>

AIST recommends a regime of consumer testing, cost/benefit analysis, and a review of proposed superannuation changes against agreed objectives prior to implementing more changes. In the case of MySuper, parts of the Stronger Super disclosure framework were rolled out to superannuation fund members without road-testing the concept. Driven by tight legislative deadlines, regulators had little time or resources to conduct adequate consumer testing. This has led to disclosure practices that some in the industry fear are actually making consumers more confused: Product Dashboard is an example of this.

10.3.1 Roll-out of disclosure requirements

AIST acknowledges the difficulties associated with balancing consumer understanding, providing sufficient regulatory protections, and ensuring competitive behaviour by providers within a compulsory superannuation system. Even in those pension systems where superannuation is not compulsory, commentators such as the OECD highlight the lack of consumer understanding. Greater consumer testing and longer lead times are needed prior to policy changes to assist with improving the disclosure regime.

Superannuation funds and their members are not yet fully benefitting from the electronic delivery of information to members. There are legislative blocks to providing electronic information to members unless members opt-in to receiving electronic information. While superannuation funds collect and store email addresses for members through various marketing campaigns (including requesting the email address if a member calls), there is no imperative for a member or their employer to provide their email address.

This has a huge cost impact on superannuation funds and therefore their members. Many funds are spending many millions of dollars in posting information to members.

AIST strongly supports the use of providing information electronically to members as a default option rather than on an opt-in basis.

AIST recommends:

- Disclosure should be improved to capture issues such as conflicts arising through vertical integration and third party arrangements, setting calculation methodologies for critical items such as default investment options, and disclosure of apportioning platform fees.
- Disclosure would be improved through the development of operational guidelines being issued through a Regulatory Disclosure Guide.
- Substantive removal of disclosure requirements should not occur prior to a review of MySuper's effectiveness.
- Longer lead times and greater testing is needed before major policy changes take place.
- There should be a legislative review to identify any barriers to providing members with information electronically, for example, positively state that if a superannuation fund has an email address for a member, the fund may send all information to that address.
- Consideration be given to requiring employers to remit workplace email addresses for members.

11 Policy stability

The Inquiry observed a lack of stable policy settings for superannuation impacting on long-term confidence and trust in the system.

Much has been said about piecemeal and short-term policy changes within superannuation. AIST supports the development of clear objectives for superannuation in a policy setting, and strongly supports the development of clear parameters against which future changes can be measured and assessed.

AIST suggests three courses of action to avoid future piecemeal and short-term policy reform:

- Bipartisan support for the objectives of the superannuation system. These objectives should include the provision of equitable, adequate and sustainable retirement incomes and set clear expectations on the extent to which superannuation will work in tandem with the Age Pension, both now and in decades to come. The interplay between superannuation and aged and health care should also be taken into account. This is in line with comments made by the World Bank.⁶³
- While there are various definitions of adequate retirement benefits in use, AIST notes that there is no uniformly accepted definition that drives policies such as concessional tax contributions, taxation of investment returns, or taxation of end benefits.
- There are various benchmarks for comparing the sustainability of our system with other pension systems, but none for the internal Australian system. Within Australia, the Intergenerational Report assesses the sustainability of the Age Pension.

When examining cost/benefits of the constant changes to the superannuation system, AIST submits that greater transparency is needed to promote efficiency. Any proposed changes to the superannuation system should take into account:

- Strengthening the requirements for a costs/benefits analysis
- Whether lead times are reasonable
- Consumer understanding and relevance
- Strengthened risk assessments
- How the equity, adequacy and sustainability benchmark might be impacted.

In this regard, AIST recommends that the CFR's role be extended to develop and monitor benchmarks on adequacy sustainability and longevity. These benchmarks should be a legislative requirement, designed to give greater certainty and transparency to the Australian superannuation system. The benchmarks could be

⁶³ World Bank, (2014). *Global Pension Systems and their Reforms: World Wide Drivers, Trends and Challenges*. Social Protection & Labor Discussion Paper No. 1213. World Bank, p.7. Available at: <http://tinyurl.com/k2ennj5>

used by the CFR to weigh the costs of any proposed changes against adequacy and sustainability benefits, as well as the stated objectives of the super system.

While AIST notes the Interim Report comments that new matters coming under the CFR may deflect its focus, AIST strongly believes that an entity needs to be tasked with the role of ensuring that proposed policy changes meet adequacy, equity and sustainability benchmarks, and that the cost versus benefit analysis (and consumer testing results) warrant any policy change.

AIST recommends that greater policy stability is needed through legislating that benchmarks covering the key areas of the superannuation system – adequacy, sustainability, and equity – be developed and monitored by the CFR. The FSI should recommend the setting of clear objectives for superannuation to instil confidence in the system and avoid further ad hoc policy changes.

12 Conclusion

AIST believes in Australia’s superannuation system, its role in the economy and the financial system, and its role in delivering retirement incomes as part of our three-pillar system.

The trust structure coupled with our strong regulatory framework safeguard the retirement savings of Australian workers. Greater policy stability is needed, and further changes to the system – particularly in regards to newly-introduced reforms such as MySuper - should be carefully considered and evidence-based. Australia’s superannuation system is well-regarded globally, and while we should always strive for continued improvement, wholesale structural changes should align with the objectives of super and instil long-term consumer confidence in our compulsory retirement savings platform.

AIST would be pleased to offer further information, if the Inquiry requires it.

13 Appendix One: Recommended focus of a review of MySuper

Throughout this submission, AIST has made a number of recommendations regarding a review of MySuper. AIST recommends that this review take place within the near future. The following is a collation of the recommendations AIST has made regarding the focus of a MySuper Review:

1. To further reduce the fees in MySuper, the Inquiry should consider a recommendation to bring forward the transition timeline to provide a clearer picture of the impact that MySuper has achieved, and ensure that all default members benefit from the MySuper environment as soon as possible.
2. A review of the efficiencies which MySuper has delivered should be conducted once all monies are transitioned to MySuper.
3. A review of MySuper fees, costs and net investment returns. To ensure that the impact of vertical integration on MySuper is assessed, the review should include (but not be limited to) the following:
 - a. An analysis of whether MySuper investment returns are diminished because of vertical integration issues, for example, MySuper members are receiving lower returns because cash margins are taken via the banking arm in which the superannuation cash monies are invested.
 - b. Whether MySuper business stems from offering incentives or other services (such as clearing houses/gateways) to employers
4. While the implementation of APRA's Investment Governance Prudential Standard (SP530) should lead to more careful monitoring of liquidity, AIST believes that more work on understanding the drivers of member switching and other pressures on cash flow - such as ageing memberships - needs to be undertaken, including a thorough examination of the flow of money within the superannuation sector.
5. AIST believes that trustees must implement investment strategies that are developed to meet member demographic needs. The structure of that strategy may involve a lifecycle approach, but AIST submits that this will not be the best approach in all cases. Given the variety of defaults in MySuper, disclosure of fees and costs is critical to ensuring members can compare products and that there is competitive market place pressure. For example, lifecycle cohort strategies with one fee must properly disclose their costing methodologies.
6. The provision of general advice over the counter and its impact on member switching should be included within a review of MySuper.