Financial System Inquiry

SuperRatings' Submission

August 2014

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1. Executive Summary

SuperRatings would like to thank members of the Financial System Inquiry for providing us with the opportunity to provide this submission in response to the Interim Report ("the Report") released on 15 July 2014. SuperRatings is an independent research house, which has been assessing and rating superannuation funds for more than 12 years. Given SuperRatings background in superannuation, our submission is primarily focussed upon the superannuation sector and its participants.

SuperRatings is pleased to see further analysis of the superannuation industry within the Report and recognises that formal inquiries such as this can lead to improvements within the industry and better overall outcomes for superannuation fund members.

In saying this, however, SuperRatings is of the view that some of the data and information relied upon within the Report does not provide a reasonable nor objective view of the current operation of the superannuation industry.

1.1. Focus should be on 'net benefit to member', not purely fees

In particular, we believe that the Report focusses too heavily on the fees charged by superannuation funds, without taking into account the overall benefit provided to members, which must take into account investment earnings as these, more than anything else, are the main driver of retirement outcomes. We recognise that the Report relied upon many of the findings of the Grattan Institute report, which have since been recognised by a number of superannuation experts as an uninformed view of the highly complex superannuation industry.

1.2. Industry competitiveness is evident

In terms of overall competitiveness of the superannuation industry, we disagree with the findings of the Report (which we note again relies on views outlined within the Grattan Institute Report) as we believe that sufficient competition continues to occur within the industry as a whole and within each of the Not for Profit and Retail Master Trust sectors.

Whilst we note that fees may be higher than other countries, it is important to recognise the different benefits afforded to Australian superannuation fund members (such as insurance and scaled advice at no cost) and the different investment philosophies spanning the globe (with many maintaining very low allocations to growth assets, unlike Australian superannuation funds). As noted earlier, whilst fees are important, we believe the net benefit provided to members (incorporating investment earnings, fees and tax) is paramount and on this basis, we believe that there continues to be a reasonable level of competition within the market, albeit the disengaged nature of the majority of superannuation members continues to make this challenging.

1.3. Passive investment management may detract from member outcomes

Similar to our comments above in relation to the importance of net benefit to member, SuperRatings agrees with the Reports comments in relation to many superannuation funds moving more of their investments to passive management in order to reduce fees. SuperRatings believe that many funds have successfully utilised active fund management to add value over the long-term and whilst we are of the view that there is a place for passive investment management for some asset classes, we believe the sole use of passive fund management will detract from member value over the longer term.

1.4. Lack of policy stability evident

SuperRatings agrees that the superannuation system lacks policy stability and continued legislative change undermines consumer sentiment towards the industry.

With the recent introduction of MySuper, SuperRatings believes it is too early to measure the success of this policy and recommends that more time is given before any further changes are made.

1.5. Developments in retirement products and income disclosure needed

We agree with the Report's findings in relation to retirement incomes and believe there is a huge opportunity for pension and annuity products to play a far greater role in a member's retirement. SuperRatings' notes through its most recent benchmarking that take up rates of pension and annuity products are very low across the industry, mainly due to a lack of engagement and understanding in relation to the benefits of these products.

SuperRatings believes that there is no single silver bullet for retirement products and the low uptake of many complex annuity-style products has evidenced this. Instead, innovation must come in the form of a menu of different products (such as account based pensions, lifetime or term annuities and deferred annuities) offered by superannuation funds to meet the needs of their membership.

SuperRatings is also of the view that the use of income projections on member disclosure documents, based upon standardised assumptions, would add value to member outcomes and would assist in aligning members' income expectations in retirement.

1.6. Improvements in fee disclosure required

SuperRatings is of the view that fee disclosure should be transparent and enable the comparison of fees and charges on a like-for-like basis. Based upon SuperRatings review of disclosure material and recent announcements and guidance released by the Australian Securities and Investments Commission, we believe that fee disclosure has become more opaque since 1 July 2014, with many funds bundling the majority of costs into the single Indirect Cost Ratio.

We believe this provides poor outcomes for members as superannuation funds become more difficult to compare based upon current disclosure methods. To ensure comparability, SuperRatings strongly believes that detailed guidance is required from the Regulator, outlining the specific manner in which funds must disclose fees, whilst ensuring greater transparency via the unbundling of separate disclosure of different fee types.

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The remainder of our submission supports our views outlined above, based upon the in-depth data that SuperRatings has collected over more than 12 years in relation to the superannuation industry.

For simplicity, SuperRatings has commented on each of the key observations, views and information sought by the Inquiry within the Report and has provided supporting evidence gleaned from our research and analysis of the superannuation industry.

Once again, SuperRatings would like to thank the Inquiry for the opportunity to prepare a submission to the Report and would be happy to discuss any aspect of this submission further, as required.

Feel free to contact any of the following should you have any questions or require further information:

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2. About SuperRatings

SuperRatings is an independently owned superannuation research company providing data analysis, information, consulting services and product benchmarking to the superannuation industry, corporate sector and the general public.

We actively promote engagement, education and ownership of superannuation through the provision of:

- Research Analysis;
- Ratings;
- Consultancy Services;
- Product reviews;
- Benchmarking; and
- Opinion.

Since its inception, SuperRatings have comprehensively reviewed hundreds of Australia's largest superannuation funds and service providers.

SuperRatings' currently maintains detailed information on over 580 products covering both superannuation (420+ products) and pension (160+ products). We believe we offer the most extensive industry coverage accounting for over $1.2 trillion in FUM and 22 million member accounts. This allows us to understand various costs, services and performance of superannuation funds against the broader market.

3. Focus should be on 'net benefit to member', not purely fees

SuperRatings believes that whilst fees are an important consideration in relation to a superannuation fund, they cannot be the sole determinant of the value provided to members.

3.1. Net benefit to member

Observation from the Report

That said, fees should not be considered in isolation. It is important that a focus on fees alone does not result in a shift towards lower-cost and lower-return asset allocations that would reduce after-fee returns. Ultimately, superannuation funds should be judged on their after-fee return for a given risk profile.

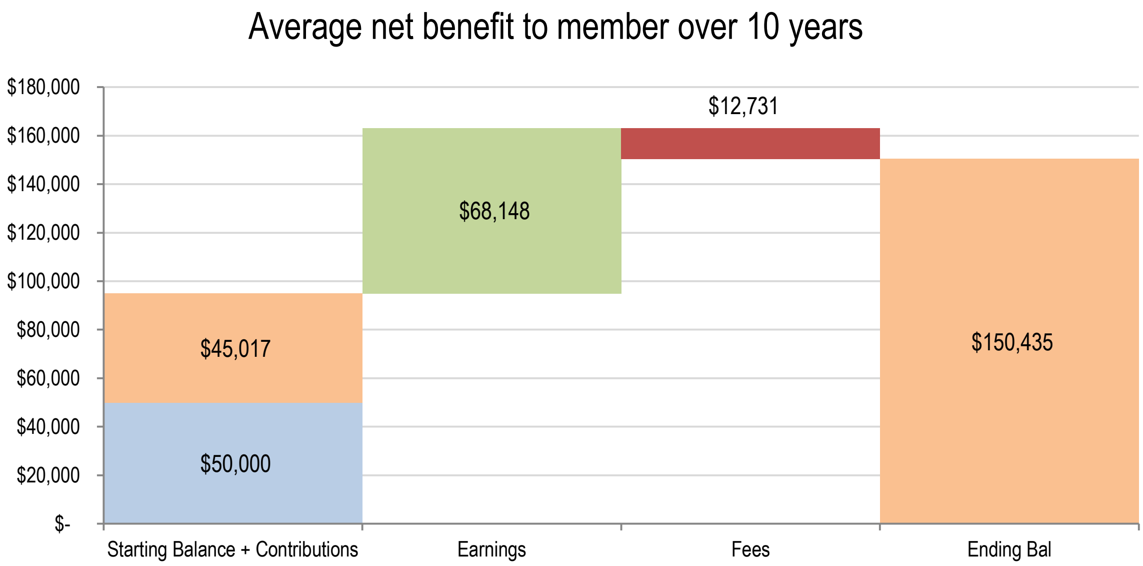
SuperRatings strongly agrees with this observation within the Report. SuperRatings believes that the net benefit delivered to members is of primary importance when assessing the value that a superannuation fund has provided. The net benefit is determined by analysing the investment return achieved by the superannuation fund net of all fees and taxes levied.

SuperRatings has developed a Net Benefit Methodology which considers both fees and returns achieved by every superannuation fund we assess over periods from 1 to 10 years in order to show the outcomes that would have been achieved by a member of each fund.

SuperRatings believe that the key strengths of this model are that it:

- Takes into account the actual fees paid by members of each superannuation fund (percentage and fixed dollar fees) over a 10-year period.
- Analyses the actual returns achieved by the Balanced-style investment option offered by each superannuation fund over a 10-year period; and
- Shows the interplay between fees and returns experienced by each superannuation fund (the net benefit to member) and ranks these in order.

The following graph provides detail of the average net benefit to member delivered over the last 10 years (based on those funds with at least 10 years of performance data):



This modelling, which includes all products within SuperRatings Database with a 10 year return, shows that the average fund generated $68,148 in earnings while charging $12,731 in fees and provided a member with a starting balance of $50,000 and contributions made in line with Superannuation Guarantee obligations an ending balance after 10 years of $150,435.

SuperRatings believes that the benefit of this model is that it provides a true historical comparison of the outcomes delivered to members of every superannuation fund and recognises that those funds that may charge members higher fees may also deliver stronger returns, thus achieving better overall outcomes for their members.

As a further example, SuperRatings takes the view that focusing purely on investment fees is not in a member's best interests. Fees should be efficient but recognise that different assets classes may be more expensive, especially when disclosed in line with best practice. It would be a less than favourable outcome for members if funds were to invest in assets based solely on their cost profile rather than their return profile. Additionally, as average account balances rise, there is an ever increasing need for risk-adjusted returns to become a stronger focal point. The diversification benefits of alternative assets may not be adequately considered under a strong focus on investment fees, due to the costs associated with investing in these assets.

On this basis, SuperRatings is of the view that the net benefit to member, rather than purely the fees charged by superannuation funds, provides a far more relevant comparison of the competitiveness of superannuation funds and will drive far better outcomes for the industry as a whole.

4. Industry competitiveness is evident

4.1. The Australian fee landscape

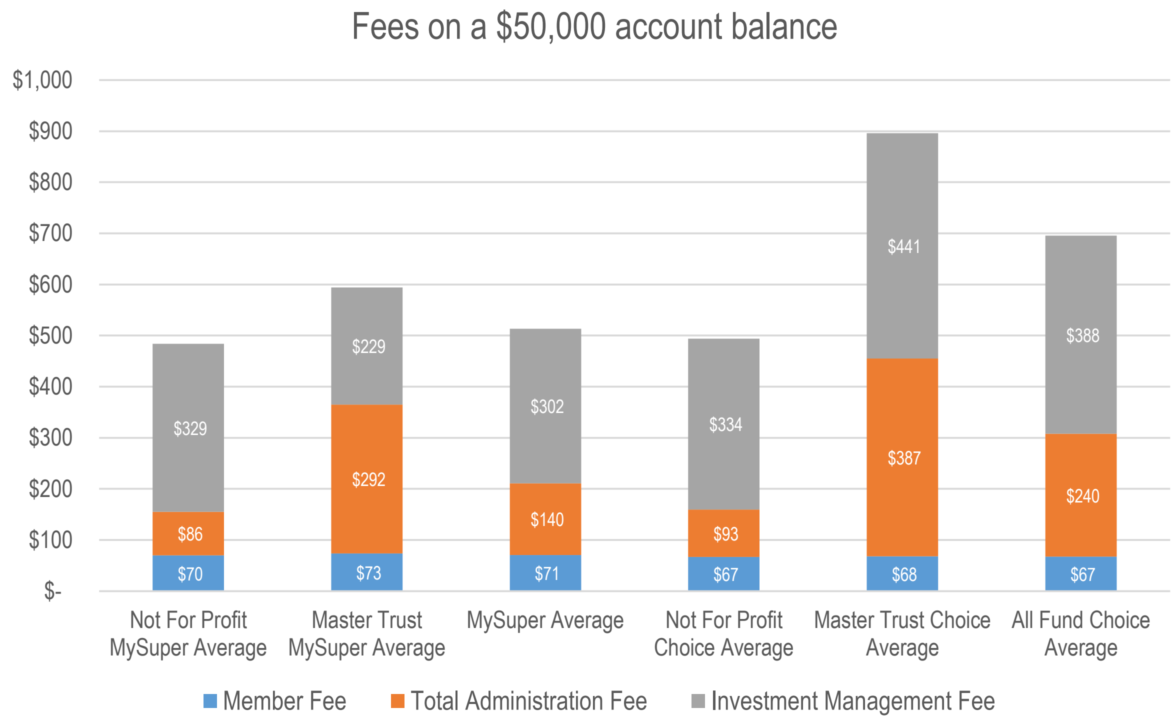
Observation from the Report

There is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system.

A key issue raised in the interim report is that operating costs and fees appear high by international standards. To assist in the analysis of the Australian superannuation industry, SuperRatings provides the following insights into the current fee and operating expense landscape.

Based upon SuperRatings analysis, there is no doubt that average superannuation fees have reduced as a result of the introduction of MySuper. Prior to the introduction of MySuper, the average fee on a $50,000 account balance was $728. This compares to the current MySuper average fee of $513, which reflects a 30.9% drop in fees over this time and shows the increase in fee-based competition emanating from the introduction of MySuper.

The table below provides a more detailed breakdown of the average fees charged between the Not for Profit and Retail Master Trust sectors and the split between the various fee types:



There are three main themes in relation to fees within the superannuation industry:

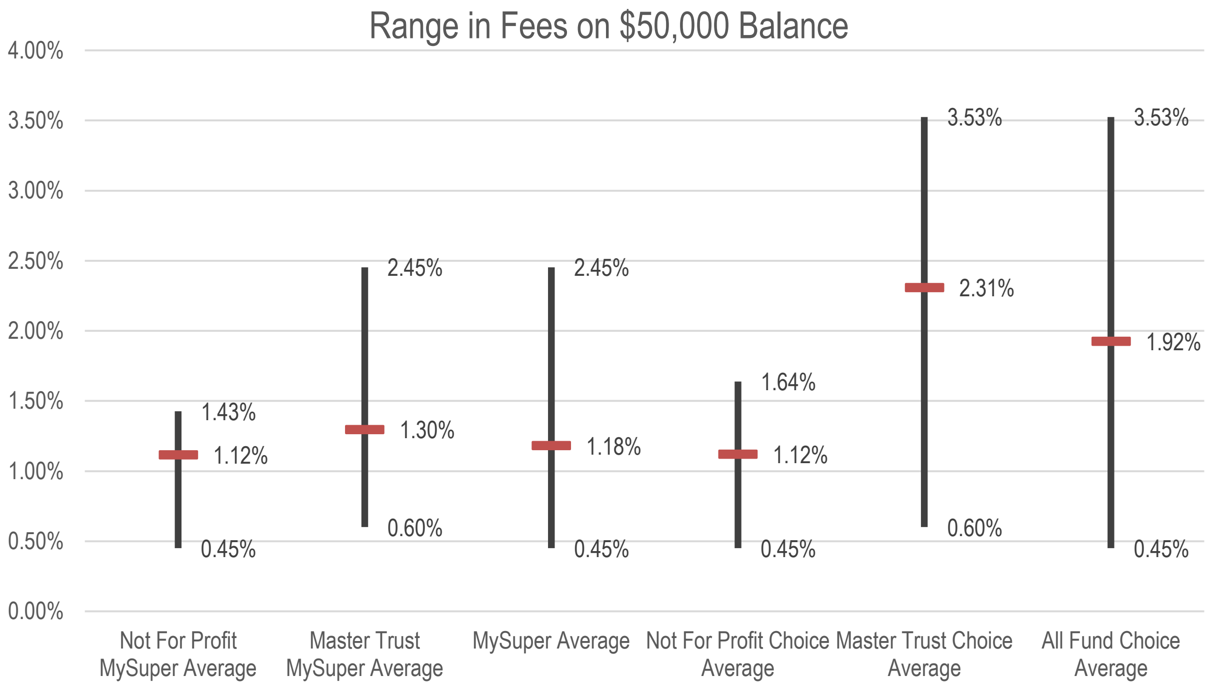
Not for Profit Sector: There is minimal variance between fee structures in relation to Not for Profit MySuper and Choice products. Generally, Not for Profit funds have rebadged their main Balanced-style option and have used this as their MySuper option and have maintained their existing member fees, administration fees and investment management fees. To this end, Not for Profit fund fee structures have effectively remained unchanged pre and post MySuper.

Low Cost Master Trust Sector: MySuper heralded the introduction of a range of new lower cost Master Trust MySuper products, which have generally been focused at retail customers, utilising strong bank distribution channels to attract new members. In comparison to pre-MySuper products, there is no doubt that these products have been designed to drive greater fee-based competition within the superannuation industry.

The reduction in fees in respect of these products has largely been driven by a shift from active investment structures to passive ones, which has seen the average investment management fee reduce from 0.88% to 0.51% per annum. In addition, a reduction in the average administration fee has also been evident, decreasing from 0.77% to 0.53% per annum.

Historical Master Trust Products: Although we have seen the advent of newer, cheaper MySuper products the reality remains that, unless a member exercises choice, their balance will remain in a higher cost legacy product potentially until 2017 until they are required to be transferred into MySuper products under the accrued default amount requirements. For these products, administration and investment management fees remain substantially higher than their MySuper counterparts.

The use of whole of industry average fees may, however, not appropriately recognise the true fee landscape. In reality, there is a wide range of fees being levied across the industry and SuperRatings has compiled the spread currently evident on a $50,000 account balance across Balanced options within the industry:



We believe this further evidences that minimal fee-based competition was evident prior to the introduction of MySuper, other than that between the Not for Profit and the Corporate Master Trust sectors, which has largely been driven by competition between funds to attract employers. With the development of lower cost Master Trust MySuper products, fee-based competition is apparent and will continue to play out in coming years. We are also of the view that the broader review of default award superannuation being conducted by the Fair Work Commission could drive further competition within the sector.

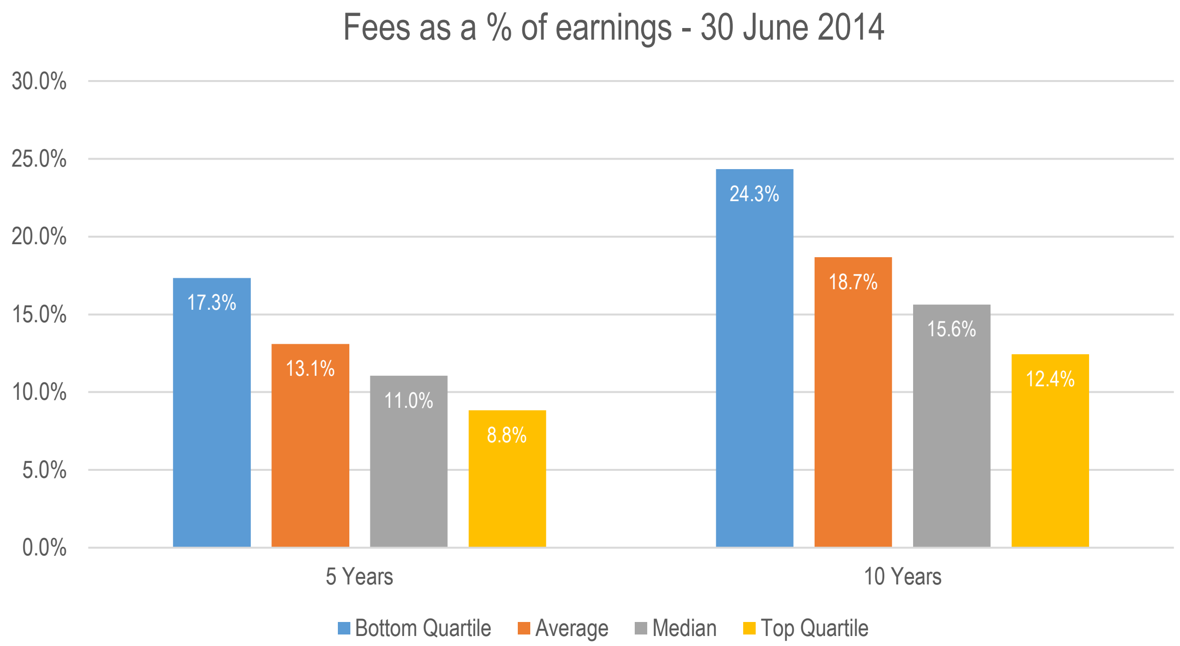
Some encouraging statistics exist to support this recent increase in competition. The active member ratio (those members receiving contributions within the last 12-months) rose from 60% in 2011/12 to 64.2% in 2012/13, which shows consolidation of accounts occurring and a higher proportion of members contributing to a main fund.

Competition is also being exemplified by increasing transfer contributions between funds, showing greater flows of assets between providers. The net outflow ratio measured by SuperRatings, which tracks the level of outflows from a fund (through benefit payments and rollovers) and compares this to the levels of inflows (through contributions and rollovers in) has increased from 48% in 2010 to 69% in 2013 on a whole of industry basis, further indicating that competition between funds is increasing.

Observation from the Report

The Grattan Institute estimates fees have consumed more than a quarter of returns since 2004.

SuperRatings data does not support the finding that fees have consumed more than a quarter of returns as mentioned in the Report. Based on SuperRatings' Net Benefit Methodology (as discussed in Section 3 of this submission), we found the following proportions of fees relative to earnings achieved over relevant time periods to 30 June 2014:



This analysis uses fixed dollar and percentage administration fees as well as investment fees (including performance fees) during the relevant time periods. For this analysis, the largest Balanced option (defined as having 60-76% assets) was used for each provider as this is where the majority of a fund's assets lie. This included all accumulation products researched by SuperRatings with the required returns history.

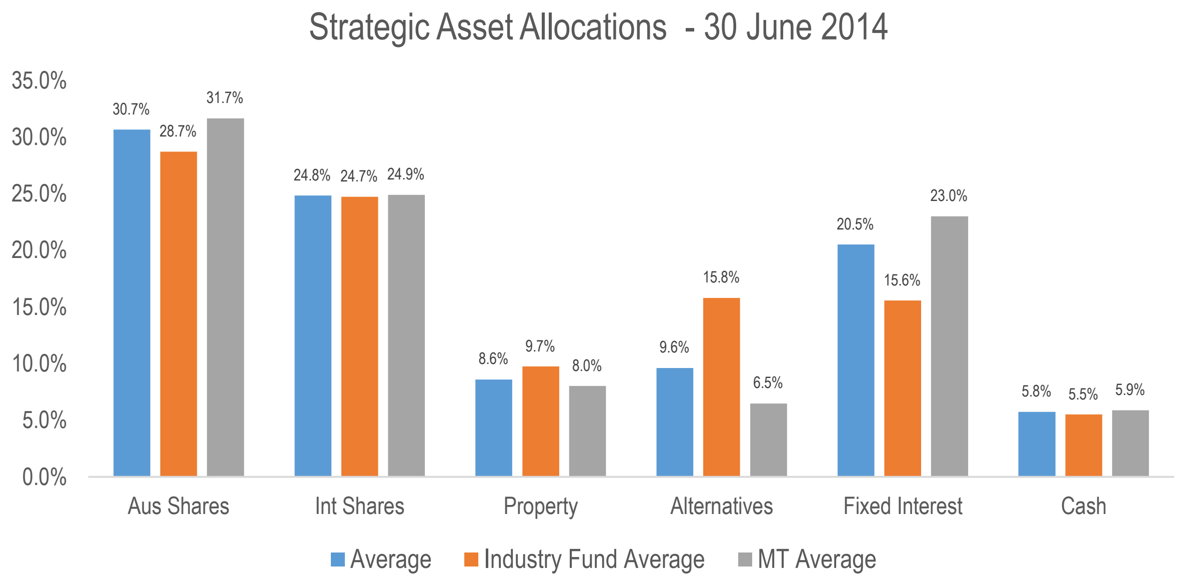
This analysis found that the median superannuation fund's fees equated to 11.0% and 15.6% of returns over 5 and 10 years respectively. However, for the top quartile of funds the average fund's fees equated to 8.8% and 12.4% of earnings over these periods. SuperRatings recognises that the 10-year performance numbers are heavily influenced by the negative returns experienced during the Global Financial Crisis and, as such, modelled this metric over a more stable investment period, being the last 5-years.

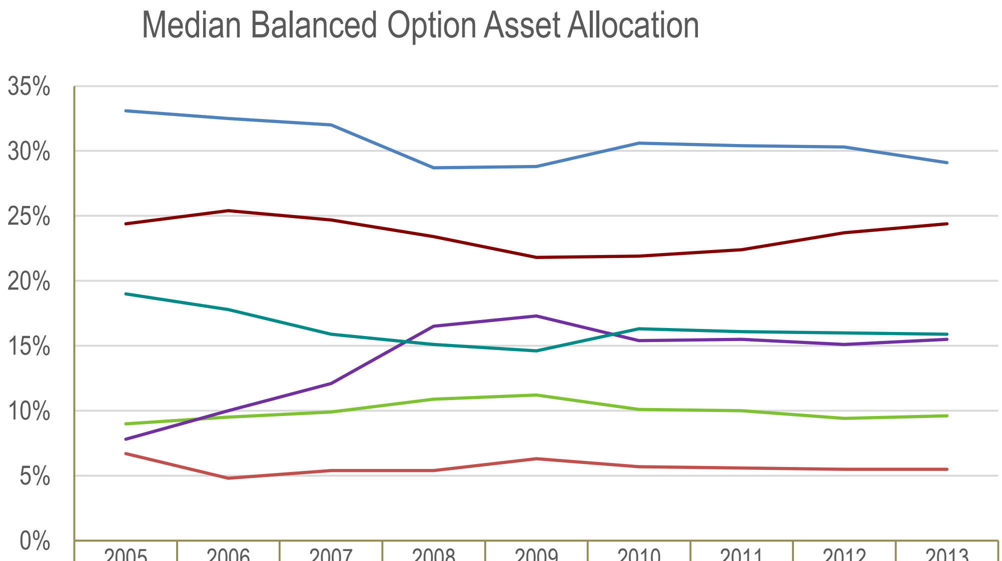
4.2. The international fee landscape

SuperRatings undertakes analysis globally through its sister-company MPF Ratings in Hong Kong and our analysis of the KiwiSaver market in New Zealand. Emanating from this, we believe that international comparisons are extremely difficult given the differences in investment structures, benefit designs and administrative requirements within each market.

Whilst we are disappointed that the Report focussed heavily on research conducted by the Grattan Institute, which we believe contains significant oversights and factual errors in respect of its conclusions on these points, we continue to take the view that the Australian market should be compared on the basis of the outcomes it provides to members, rather than fees alone.

To illustrate the difficulties in comparisons, SuperRatings provides the following table, highlighting the strategic asset allocations utilised by Australian superannuation funds at 30 June 2014:





	2005	2006	2007	2008	2009	2010	2011	2012	2013
Australian Shares	33.1%	32.5%	32.0%	28.7%	28.8%	30.6%	30.4%	30.3%	29.1%
International Shares	24.4%	25.4%	24.7%	23.4%	21.8%	21.9%	22.4%	23.7%	24.4%
Property	9.0%	9.5%	9.9%	10.9%	11.2%	10.1%	10.0%	9.4%	9.6%
Alternatives	7.8%	10.0%	12.1%	16.5%	17.3%	15.4%	15.5%	15.1%	15.5%
Fixed Int	19.0%	17.8%	15.9%	15.1%	14.6%	16.3%	16.1%	16.0%	15.9%
Cash	6.7%	4.8%	5.4%	5.4%	6.3%	5.7%	5.6%	5.5%	5.5%

As can be seen from the above tables, there is no doubt that Australian superannuation funds holds the majority of their assets in growth assets, such as domestic and international shares, property and alternatives, which are far more costly to invest in than their defensive counterparts, which include fixed interest and cash.

We recognise that pension funds within the UK and many Scandinavian countries invest mostly in defensive assets and are able to charge members a far lower investment fee than their Australian counterparts and hence, a comparison of fees between these is cannot be statistically relevant.

Further to this, SuperRatings also recognises that the benefits offered by Australian superannuation funds and the administrative complexities associated with the Australian system also results in international fee comparisons being extremely difficult. For example, when comparing against the New Zealand market, SuperRatings notes that KiwiSaver products do not offer any form of life insurance or income protection as part of the benefit design. Additionally, all employer contributions and many personal contributions made to a KiwiSaver must be paid directly through the New Zealand equivalent of the Australian Taxation Office, the Inland Revenue Department.

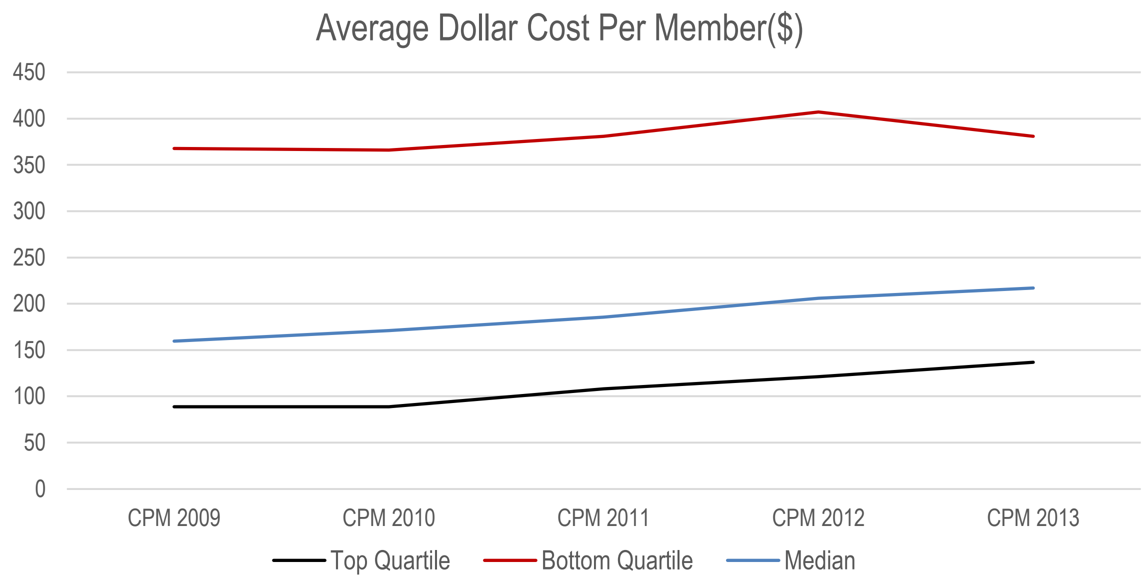
The administrative efficiencies for providers associated with these contribution arrangements and no requirement for insurance are substantial and enable KiwiSavers to operate at a far lower cost than Australian superannuation funds.

4.3. The Australian operational cost landscape

SuperRatings considers numerous operational efficiency measures within its ratings process in relation to Australian superannuation funds. Key to our assessment are two quantitative metrics:

- ***Average Dollar Cost Per Member:*** *Operating Expenses / Average Membership*
- ***Non-Investment Management Expense Ratio:*** *Operating Expenses / Average Net Assets*

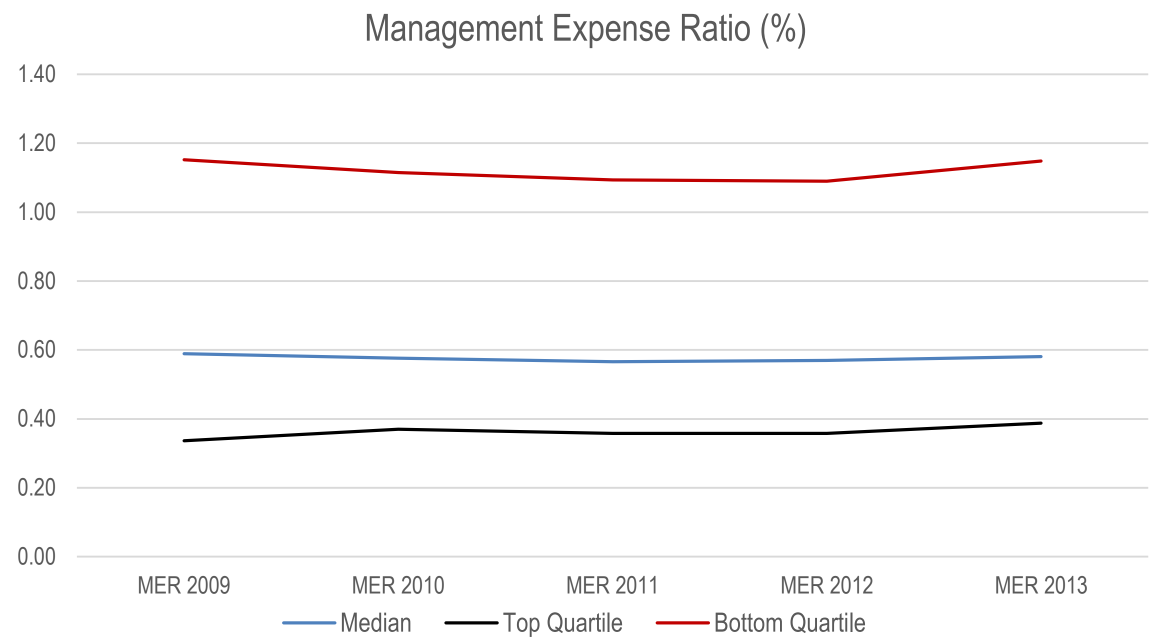
The Average Dollar Cost Per Member ("CPM") shows the operational costs (which include all non-investment related costs) of a superannuation fund on a per member basis. The following graph illustrates SuperRatings' findings in relation to CPM over the last 5-years based upon superannuation fund financial statements:



The graph shows that the operational costs per account are rising strongly across both median and top quartile funds. As at 30 June 2013, the average CPM sat at $217. This increased from $178 in 2012 and $129 in 2009 indicating that the superannuation industry continues to be challenged by increasing operating costs, driven by compliance and regulatory changes in recent years.

The Non-Investment Management Expense Ratio ("MER") shows the level of operational costs relative to the average net assets of a superannuation fund and illustrates the quantum of operating costs relative to the size of the superannuation fund.

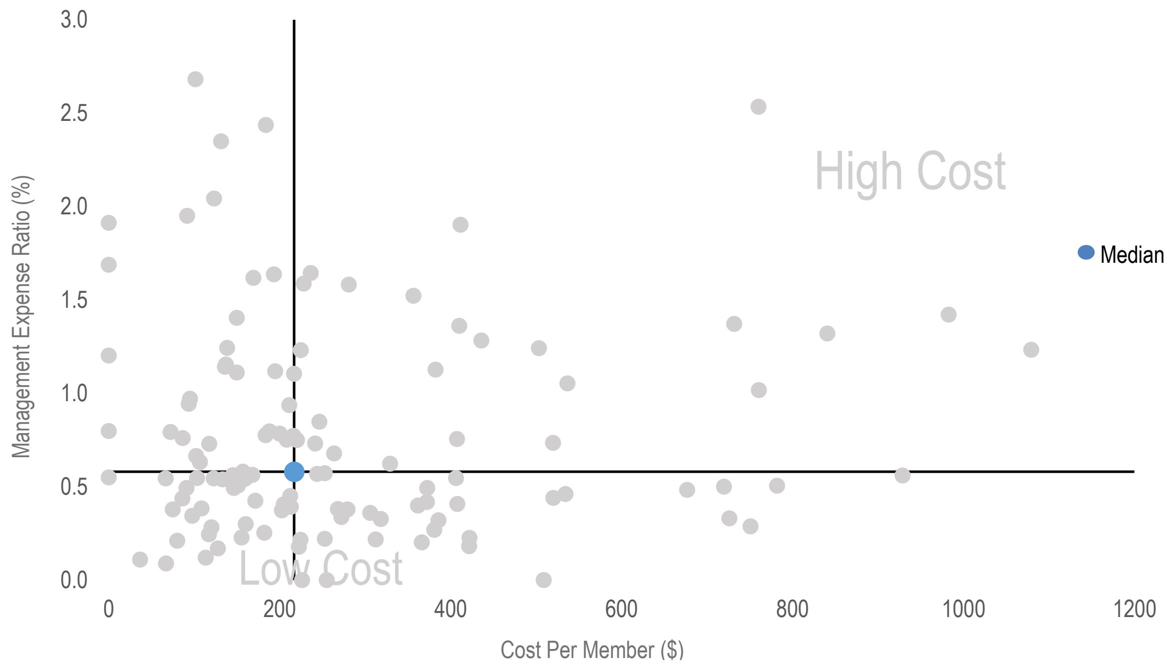
The following graph illustrates the trends noted by SuperRatings in relation to MER over the last 5-years:



Despite the growth in assets within the superannuation system, operational costs relative to fund assets has remained relatively constant in recent years. During the negative returns experienced by superannuation funds in 2009, SuperRatings noted an upward movement in the non-investment MER, but that has remained high in the strong returns since this time.

Due to the different demographics and average balances between superannuation funds, SuperRatings believe it is sub-optimal to view either the CPM or MER metric in isolation. Rather, they should be viewed together to show a superannuation fund's operational efficiency relative to the industry.

The following graph illustrates the connectivity between the CPM and MER, noting the median CPM of $217 and MER of 0.58% of assets:



5. Passive investment management may detract from member outcomes

Observation from the Report

According to the Grattan Institute, active management of superannuation increases costs but not after-fee average returns in the sector

SuperRatings believes that both active and passive asset management have a role to play in investment management. In particular, we believe that there are certain asset classes in which it is difficult for active management to enhance the overall returns achieved and hence passive management may be appropriate. SuperRatings is concerned, however, with the trend for funds to utilise passive investment management across the entire portfolio in order to reduce the fee of the product, as we believe that this will reduce the overall net benefit outcome provided to members.

We agree that it is difficult for the superannuation system as a whole to beat the market over the long run within an asset class, however, evidence does suggest that some active managers can outperform over the medium and longer term. Whilst the fees associated with active management may be higher than passive management, SuperRatings believes that the outperformance generated by these managers can outweigh the costs involved, resulting in a positive net benefit delivered to members account balances.

The below table provides a summary of SuperRatings' Fund Crediting Rate Survey, which measures the investment returns of a substantial portion of superannuation fund investment options. Specifically, the table illustrates the number of actively managed investment options in the top 20 diversified option classifications. Given that very few passively managed investment options have been in existence for more than one year, the table utilises one year returns to 30 June 2014.

SuperRatings Index (growth assets)	Proportion of top 20 funds actively managed
High Growth (91-100)	17 out of 20 (85%)
Growth (77-90)	18 out of 20 (90%)
Balanced (60-76)	20 out of 20 (100%)
Conservative Balanced (41-59)	18 out of 20 (90%)
Capital Stable (20-40)	19 out of 20 (95%)
Secure (0-19)	17 out of 20 (85%)

The above analysis indicates the value of active investment management in general, with the majority of strong performers within SuperRatings' surveys being actively managed.

Overall, our ratings methodology attempts to remain as objective as possible in the active/passive debate, with no particular bias displayed towards either style. However, we would offer the following insights:

- SuperRatings views active or semi-active investment management positively when it generates outperformance after fees over the long term;
- Passive investment management is acceptable where a product issuer believes it will deliver a higher net return to members than they could achieve through active management, or where they believe that the benefits delivered by active management will not be sufficient to outweigh the additional costs;
- Passive investment management utilised across the entire portfolio just to maintain low investment management costs and overall price competitiveness with little focus on returns is not appropriate; and
- The net investment returns, after tax, investment and product fees, should be central in informing decisions in this debate. Funds should be free to implement an investment philosophy that they feel is in their member's best interests. However, the success of this investment philosophy cannot be judged solely on costs without any regard to the benefits received. Where funds seek to pursue a higher cost strategy, their investment returns should reflect the benefits over the long term. Similarly, where funds seek to pursue a lower cost strategy, members should not be disadvantaged in respect of either investment performance or diversification benefits.

SuperRatings' believes that superannuation funds must be able to justify their investment fees through long-term net investment returns. This would allow for objective analysis of superannuation funds by members to show whether the fund has been able to generate strong member outcomes, regardless of type of investment management utilised. Where possible, this comparison should be done on a like for like basis, to ensure that any differences due solely to asset allocation are excluded.

An undue focus on costs would also dissuade some superannuation funds from taking advantage of the benefits available through investing in certain alternative asset classes. Investors in asset classes such as infrastructure, private equity, hedge funds and commodities can take advantage of additional risk factors not generally available to investors in equities and bonds. Alternative asset classes also provide significant diversification advantages, the benefits of which may not be obvious in times of positive market performance.

6. Lack of policy stability evident

Observation from the Report

Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system.

SuperRatings agrees with the Inquiry in relation to the lack of policy stability with respect to superannuation. Without doubt, continual changes to the superannuation landscape add substantial costs to the system whilst also undermining the trust of members on the outcomes they may generate from their superannuation investment.

SuperRatings also believes that the MySuper changes have not had sufficient time to make an impact on the industry and as such, recommends that the Inquiry allow greater opportunity for these to take effect before any further changes are made.

7. Developments in retirement products and income disclosure needed

Observation from the Report

There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.

Industry practitioners continue to look for a single product to meet all of the requirements of a members retirement needs, when it is becoming increasingly obvious that no one offering is likely to meet the needs of every individual. Whilst products have been developed recently that attempt to offer members account-based pension style income with underlying lifetime annuity guarantees, the complexity of these products and the high fee structures have seen many investors turn away and opt for a simple account-based pension product. Similarly, the offering of lifetime annuity products has also seen reasonably low uptake due to the current low yield environment and a general reluctance for members to pay the large lump sum required to purchase a guaranteed income stream for life.

With this in mind, SuperRatings believes that a new way of considering an individual's retirement needs is appropriate, utilising a range of products, with differing features and objectives focussed on a variety of specific outcomes.

Whilst longevity risk appears to be the "buzz" word within the industry currently, SuperRatings believes that the existing style of pension products available within the market are unlikely to be able to meet all of the needs of investors in their retirement, particularly where individuals are seeking a reasonable income replacement in retirement but are also wishing to protect capital at the same time.

On this basis, we believe that funds could consider utilising a range of products in order to meet the various needs of investors as follows:

— An account-based pension – to provide reasonable income for a specific period of time (such as until the age of 85);

— A lifetime annuity to provide a risk-free guaranteed income for the remainder of an individual's life;

— A deferred annuity style product – to provide a guaranteed income for the remainder of an individual's life, to supplement the income from the account-based pension, once it has been exhausted; and

— An investment bond or fixed term product – to provide a lump sum payment at a certain age to facilitate any large health related expenses or to provide a bequest for future generations.

Where individuals consider this type of retirement strategy and superannuation funds are able to develop products to support these initiatives, it becomes evident that the underlying investment strategies for each are very different, but will complement each other if structured correctly.

With such a retirement structure, members will be able to separate investment decisions for the three types of investments (excluding the lifetime annuity). For example, given members will have the back-up of the deferred annuity at a later age to provide a guaranteed income, investment decisions in respect of the account-based pension could be more aggressive in order to maximise returns and provide a reasonable income during the formative years of retirement.

With regard to the deferred annuity product, this will provide an income for the remainder of the individual's life once it has commenced at say age 85. Combined with the aged pension, lifetime annuity and remnants of the allocated pension product utilised within the early stages of retirement, this will provide a regular amount of guaranteed income throughout the individual's retirement to ensure regular living expenses can continue to be met.

A third investment bucket could include an investment bond, fixed or long term style product that could be locked away for a fixed timeframe and be available at a certain point later in life. This could be aggressively invested (and given it is for a fixed term should yield a higher return) in order to maximise a lump sum payment at maturity, which may be used to fund large one-off payments such as a retirement home bond, health expenses or a bequest to relatives upon death.

SuperRatings also believes there is opportunity for greater product development within the existing menu of retirement products. Currently, the majority of funds offer the same investment option menus across their accumulation and retirement offerings. SuperRatings believes that the investment objectives of accumulation and retiree members are different but that the majority of product providers do not sufficiently plan for this. Whilst members at varying stages of accumulation may be concerned with growing their account balances in the most effective manner, retirees face a number of competing objectives, including the need for income, capital preservation in real dollar terms for longevity protection, and downside risk protection. Furthermore, the differing tax environment in the accumulation and pension phases adds to the need to develop tailored investment portfolios, at least between the accumulation and pension phase. We note that legislation now requires fund trustees to have regard for the after-tax outcomes delivered to members and this requirement should drive increased awareness and development in this respect.

To help members understand the impact of their accumulated savings over the long term, SuperRatings agrees that retirement income projections should be included on member statements. The key purpose of this change should be to assist members in better understanding how their superannuation benefit can be altered to improve the alignment between members' expectations upon retirement.

Given the sensitivity of inputs into long term projections, SuperRatings believes that any assumptions or input estimates required in developing retirement income projections should be standardised. This would reduce instances of funds attempting to improve member outcomes by incorporating more aggressive forecasts relative to peers.

Similarly, as members nearing the retirement phase are more sensitive to the impact of volatility on their investment portfolios, probabilities or ranges should also be disclosed to better inform likely retirement outcomes. Again, we believe that any assumptions required in the calculation of confidence intervals around these retirement projections should be standardised across the industry.

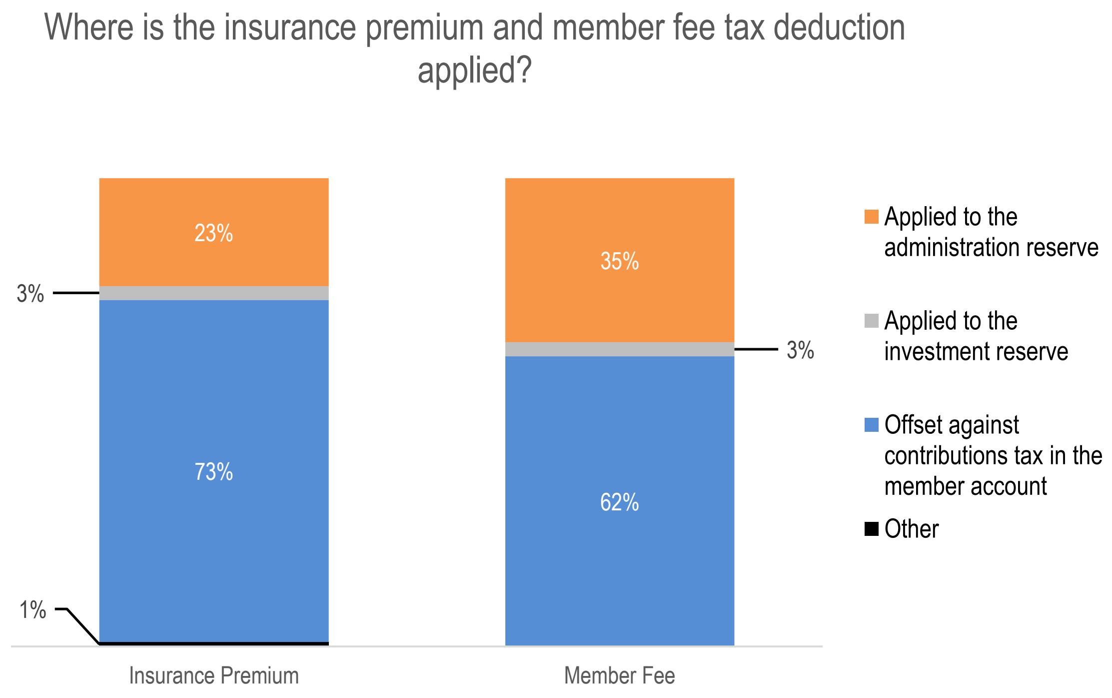
8. Improvements in fee disclosure required

In SuperRatings view, fee disclosure should allow for a meaningful comparison between funds, particularly in relation to administration and investment fees.

Subsequent to 1 July 2014 and ASIC guidance prior to this date, an emerging trend has been the bundling of administration and investment fees within product fee disclosure into a single Indirect Cost Ratio measure. This presents challenges for accurate attribution of fees into their underlying components and makes effective fee comparison extremely difficult.

A further difficulty noted by SuperRatings within fee disclosure is the indirect levying of fees through reductions in the crediting rate/unit prices given to members, rather than accurate disclosure of these amounts as specific fees. An example of this has been the creation of the Operational Risk Financial Requirement reserve, which many funds have drawn from the crediting rate/unit prices of the fund, but have not disclosed this as a discreet fee to members. This has incorrectly resulted in a number of funds appearing to maintain low fees than those that have accurately disclosed the reserve allocation as a discrete fee.

SuperRatings is pleased that the ASIC guidance has confirmed that all fees should be disclosed on a gross of tax basis, however, we recognise that varying practices exist in relation to the manner in which the tax deductions that are available for administration costs and insurance premiums are actually passed on to members. Most funds pass on the benefit of this tax deduction to members via a reduction in the rate of tax on contributions or via an increase in the crediting rate/unit prices applied to member accounts, however, a number of funds still apply this amount to the administration or investment reserve. The following table summarises SuperRatings' research in the practices adopted by funds in relation to tax deductions:



Based upon the above, SuperRatings believes that further disclosure in relation to the manner in which the tax deduction for administration fees and insurance premiums is applied is necessary to ensure transparency in treatment.

SuperRatings also recognises that further changes to disclosure will be made in the next 12 months, with full investment portfolio disclosure becoming mandatory. SuperRatings believes that whilst the intent is appropriate, full portfolio disclosure is likely to create substantial administrative burdens for superannuation funds, given the increase in investor activism and the requirements for funds to respond to these types of queries.

We also note that transparency in relation to underlying fee structures for fund of funds has been mandated and should create a more level playing field in relation to fee disclosures. The Regulator must ensure, however, that all funds are making accurate disclosures in respect of these requirements, as based upon the data collected by SuperRatings, we are aware that very few funds are provide full disclosure in relation to their underlying investments and in particular, fund of fund structures.

9. Additional items

SuperRatings also provides the following comments in relation to the issues raised within the Report for the Inquiry's consideration:

9.1. Competition in relation to choice of fund

Observation from the Report

Low rates of switching between large funds also contribute to the lack of fee competition. The Super System Review found "the model of member-driven competition through 'choice of fund' … has struggled to deliver a competitive market that reduces costs for members."

The challenges faced by members, due to ID Verification requirements, the need to download and mail in forms to superannuation funds and overly manual administration processes has made the task of switching funds overly complex.

SuperRatings notes, however, that the increasing use of TFN as a key identifier and the launch of a number of seamless online rollover tools in the market has seen transfers between funds increase resulting in greater consolidation of account balances across the industry.

We also believe that the increasing awareness of superannuation resulting from enhanced member servicing and advice structures will also help to engender this change.

9.2. Change in policy options

View sought by the Inquiry

No change to current arrangements and review the effectiveness of MySuper regime in due course.

As discussed within Section 6 of this submission, SuperRatings believes that MySuper has not had sufficient time in which to deliver the objectives expected for the superannuation industry. Furthermore, the continued tinkering to superannuation legislation and changes to the system result in a lack of understanding and engagement from members, which undermines the overall outcomes delivered.

To this end, SuperRatings recommends that no material changes are made to the MySuper requirements until sufficient time has been available to fully assess the success of these measures.

View sought by the Inquiry

Consider additional mechanisms to MySuper to achieve better results for members including auctions for default fund status.

As noted above, SuperRatings believes there has been insufficient time to appropriately assess the success of the MySuper changes and on this basis, we do not believe the Inquiry should consider additional mechanisms to better achieve outcomes.

In terms of the default suggestion contained within the Grattan Institute report, SuperRatings believes that this suggestion further demonstrates the lack of understanding of the superannuation system both within Australia and in Chile, where default fund status is auctioned every two years.

As noted within Section 3 of our submission, the focus of any retirement system should be on member outcomes (via the net benefit to member) rather than simply fees. In this respect, many funds with far higher fees than the average fund have delivered substantially greater outcomes to members through strong investment returns. In SuperRatings' view, this further demonstrates that selecting the cheapest fund does not necessarily provide the best overall outcome for members.

In terms of the Chilean system, SuperRatings understands that the investment of monies is highly regulated and hence, there is very little difference in the investment performance of different funds. Where this is the case, a selection based purely on fees becomes more relevant, as members of these funds are unlikely to gain significant additional investment performance through the payment of additional fees. In this instance, therefore, the default fund auction system in Chile may be appropriate for their market, but cannot be easily transferred to Australia, given the differences in investment structures and performance.

9.3. Replacement of the three-day portability rule

View sought by the Inquiry

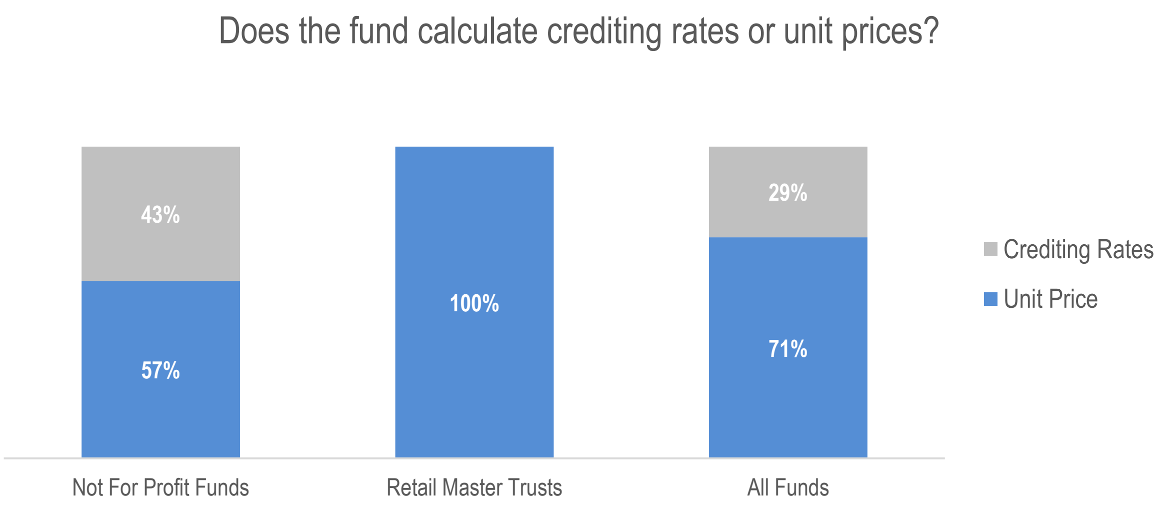
Replace the three day portability rule:

- *With a longer maximum time period or a staged transfer of members' balances between funds, including expanding the regulator's power to extend the maximum time period to the entire industry in times of stress.*

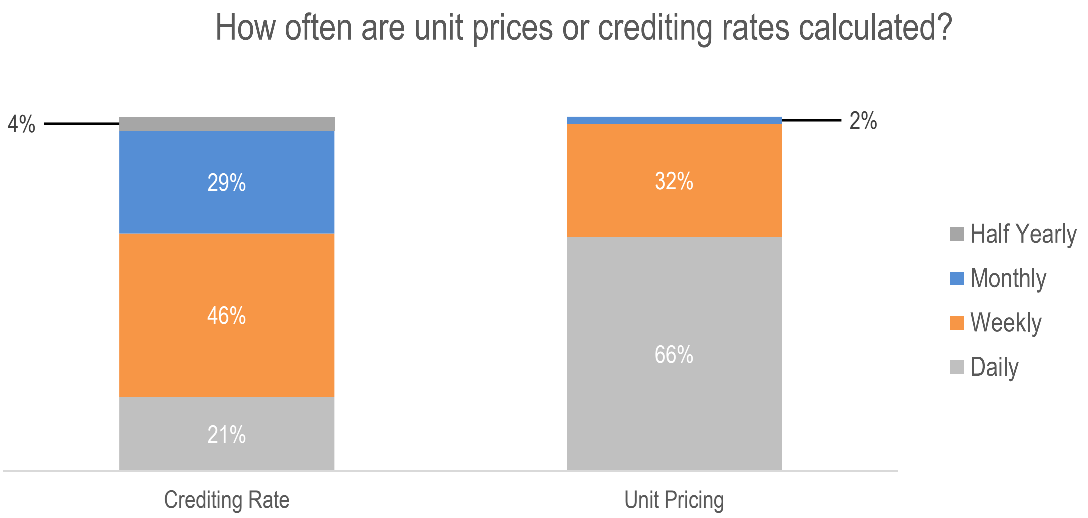
- *By moving from the current prescription-based approach for portability of superannuation benefits to a principles-based approach*

Based upon our discussions with funds and our research of investment administration, SuperRatings believe that the three-day timeframe is too tight in terms of benefit payments, due to many funds not being able to meet the requirements in accordance with best practice procedures.

To support this view, SuperRatings provides the following tables in relation to investment administration practices adopted across the industry:



The majority of funds use unit pricing, although a material proportion of the Not for Profit sector continues to apply returns to members using crediting rates.



As can be seen in the above tables, a large proportion of funds do not price their crediting rates or unit prices daily, which causes a significant challenge for funds that price weekly or less frequently to meet the three day portability requirements.

SuperRatings rate more highly those funds that utilise a forward unit-pricing methodology, however, we have recognised in our recent research that many funds have moved to historical unit pricing in order to meet the three day portability requirements. For funds that utilise a weekly crediting rate, prices used in processing rollovers may therefore be up to seven days old.

Additionally, those funds that undertake daily forward unit pricing have also indicated that, with international market closes occurring up to lunchtime of the next business day in Australia, it is also very difficult to calculate prices on a true forward basis before the 2nd or 3rd business day, leaving very little time for the fund administrator to process the payment to the member under the three-day portability requirements.

On this basis, to ensure that funds are able to maintain best practice unit pricing processes to minimise the potential for arbitrage, SuperRatings suggest that the three-day portability rule be relaxed to five-days. SuperRatings also recognises that most funds already have unit pricing policies that efficiently cope with times of stress and hence, there is no need for specific legislation or Regulator power in this regard.

9.4. Vertical integration

View sought by the Inquiry

Vertical Integration – Is the recent trend of greater vertical integration in the wealth management and superannuation sectors reducing competitive pressures and contributing to higher superannuation fees? Are there mechanisms to ensure the efficiency vertical integration flow through to consumers?

As providers seek to increase scale, the strong focus on vertical integration in somewhat unsurprising, however, this must be accompanied by strong risk controls to ensure that:

1) Members are being provided competitive net investment returns.
2) Vertical integration is used to reduce costs that do not enhance member outcomes, such as administration fees.
3) The recommendation of products should be based on the member's best interests, according to the product's ability to meet the member's retirement objectives. This should require members being placed into a non-aligned product whenever it has a higher probability of meeting a member's retirement objectives.

4) The benefits for vertically integrated firms should be derived from increasing revenue from fixed dollar advice fees rather than referring members to aligned products, unless this product has the greatest probability of assisting the member to reach their retirement objectives. Where an aligned product is the most appropriate product for a member, benchmarking of why this product is most suitable for a members requirements should be explained based on a net returns and risk-adjusted basis.

Provided each of those mechanisms can be met and member outcomes delivered, SuperRatings is of the view that vertical integration can be appropriately managed in order to meet the objectives of all parties. Where parties place their own interests ahead of the interests of members, risks will arise and member outcomes may be jeopardised.

9.5. Short Termism in Returns

View sought by the Inquiry

Is there an undue focus on short-term returns by superannuation funds? If this is a significant issue, how might it be addressed?

SuperRatings' Fund Crediting Rate Survey ("FCRS") is the most widely distributed superannuation performance survey across the industry. As a market leading provider of a peer comparison returns survey, SuperRatings is cognisant of the dangers of a short term focus on investment returns. As a result, our performance surveys rank investment performance over both shorter term and longer term periods, ranging from one month to ten years.

Whilst these shorter-term figures are provided to guide funds, members, consultants and the media as to how superannuation balances are progressing, we continue to stress the importance of taking a long term view when investing for retirement. SuperRatings' views this as a valuable tool in helping drive member engagement with their superannuation by ensuring that members can see the range in long term performance across the market.

This focus on longer term performance figures is also reflected in our ratings methodology. Our quantitative assessment of investment performance uses only the longer term five, seven and ten-year performance figures to rank investment options (with a higher weighting given to the ten year performance figure, where available).

In response to industry trends, SuperRatings has also introduced two additional performance surveys. The CPI+ Objective Survey, which tracks fund performance relative to their stated investment objectives, while the Standard Risk Measure Survey tracks performance of investment options grouped by their Standard Risk Measure. These reflect an increasing focus by superannuation funds on investment portfolio risk rather than just return, which in SuperRatings' opinion is a positive development.

Whilst industry participants including superannuation funds and consultants have welcomed these additional performance measures, we feel there remains limited awareness or understanding of what risk and risk adjusted returns actually mean for members of superannuation funds. To this end, we believe additional education should be developed in this respect.

SuperRatings believes that there is not an undue focus on short-term returns and our recommendation, and the approach SuperRatings takes in its ratings methodology, is to ensure that performance is measured over the longer-term and that longer-term returns for the basis of member decisions.

9.6. Lifecycle investment and tailoring of asset allocations

View sought by the Inquiry

…to what extent more tailoring of asset allocation to members would produce net benefits for members.

SuperRatings recognises the growing trend towards lifecycle investment options across some sectors of the superannuation industry.

Based on our most recent data, approximately 25% of MySuper products incorporate some form of lifecycle investment strategy for members. This includes those funds that utilise a single dynamically managed investment option for member cohorts and those that move members through two or more options dependant on age.

Whilst any attempt to provide for better member outcomes through a more tailored approach should be welcomed, we note that there exists no one best method to tailor these investment portfolios. The current approach, implemented by the majority of the industry, involves a simple tailored cohort according to a member's age. SuperRatings notes, however, that age is only one consideration in retirement planning and that this approach does not take into account other factors including assets held (both inside and outside superannuation), salary and contribution levels and a raft of other personal factors.

Overall, SuperRatings believes that there is a benefit in tailoring investment portfolios specifically for members in each phase of their lives, but also recognises that additional tailoring requires additional operational costs for superannuation funds. These additional costs include investment in administration capabilities and data analytics to ensure that member demographics are correctly measured and that tailoring occurs successfully at an operational level and in advice offerings to ensure that members are placed in the best asset allocation for their objectives.

Whilst SuperRatings believes that some positive developments have occurred in relation to lifecycling, we also note that some weaknesses are also evident. In particular, a number of providers offer a single price point in respect of investment management costs across all member cohorts. In general, the costs of managing growth assets is higher than the costs of managing defensive assets, particularly as more conservative options have a higher allocation to fixed interest and cash investments. We believe this results in a reasonable level of cross subsidisation occurring between the investment cohorts, which is against the intent of the MySuper legislation and results in older members paying a higher fee than warranted, thus subsidising costs for younger members.

We also note that comparability between different lifecycle provides is extremely difficult given the variety of alternatives available. Some funds have utilised 5-year age cohorts, whilst the majority have opted for 10-year cohorts. Within supposedly similar age cohorts between providers, the underlying asset allocations and investment objectives are also substantially different, further reducing comparability. Finally many lifecycle providers have opted to utilise passive investment management in relation to their entire portfolio, whereas others utilise active funds management or a combination of the two.

Whilst SuperRatings is pleased to see innovation in relation to lifecycle investments, we are of the view that it is too early to judge the success of these products but look forward to continuing to track their progress and future refinements made to these offerings.

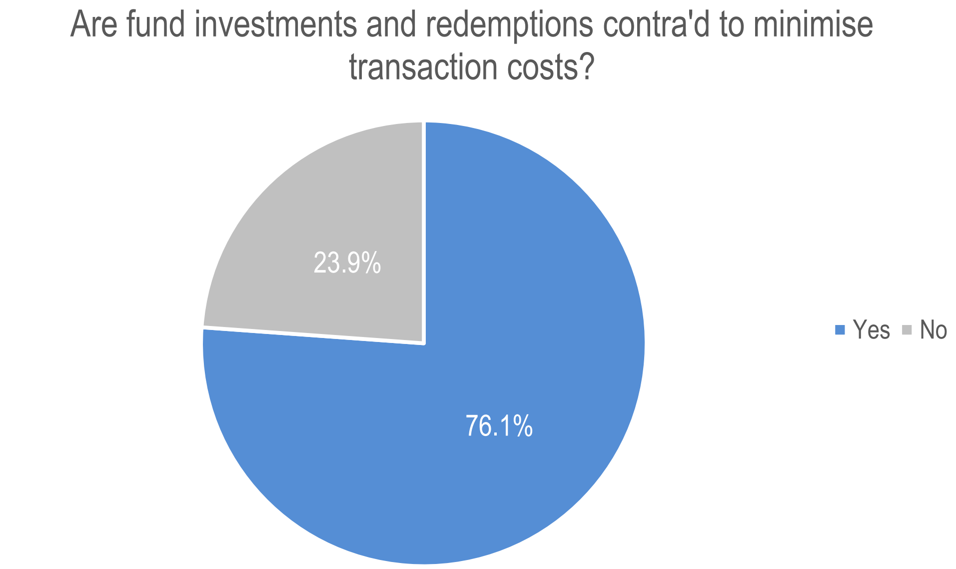
9.7. Investment switching and asset transfers

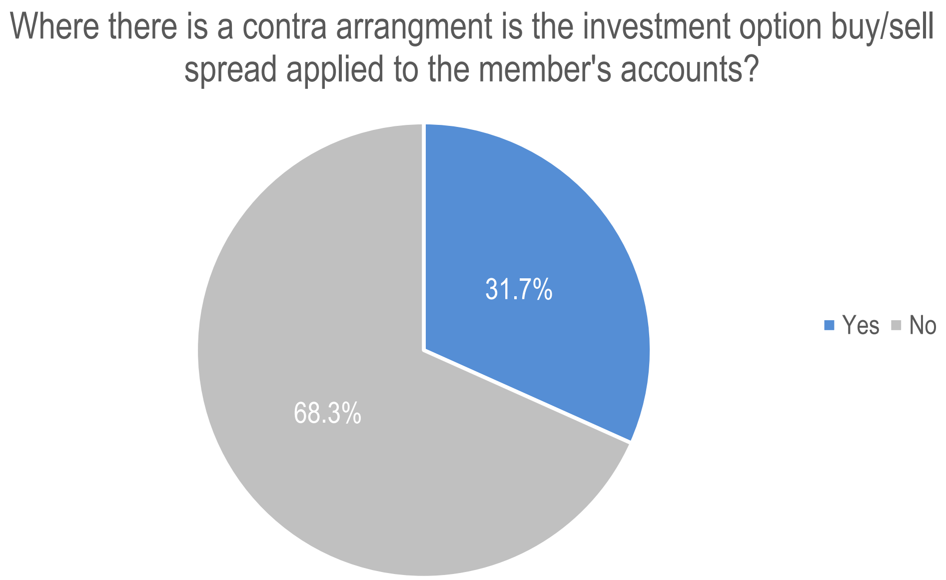
View sought by the Inquiry

How could funds price switching properly and take into account differences in liquidity between asset classes?

Could other arrangements be developed to facilitate asset transfers between funds when members switch? Do funds require additional mechanisms to manage liquidity beyond the need for liquidity for portability and member investment switching? How could funds price switching properly and take into account differences in liquidity between asset classes?

SuperRatings is of the view that the majority of superannuation funds are now large enough to manage investment switching and liquidity requirements through regular cashflow monitoring and regular stress testing. As part of SuperRatings analysis, data is collected in relation to the manner in which superannuation funds undertake investments and redemptions as a result of investment switching and general rebalancing of cashflows. The following graphs provide further detail:





As can be seen from the graphs above, the majority of funds undertake contra movements to cater for the investment of cashflows and investment switching requirements in order to minimise the underlying fund manager transactions required.

In addition to this, SuperRatings believes that the existing liquidity disclosure requirements and supporting exclusions outlined within the legislation provide adequate protection for superannuation funds in order to manage redemptions from illiquid portfolios, if required.

On this basis, SuperRatings is of the view that there is no requirement to amend the existing provisions in relation to liquidity or investment switching practices.

9.8. Trust structure for superannuation

View sought by the Inquiry

Is the trust structure best placed to meet the needs of members in a cost-effective manner?

SuperRatings is of the view that the existing trust structure governing superannuation funds has served members well historically and will continue to do so in years to come. SuperRatings does not believe it appropriate to consider other corporate-style arrangements as this would put at risk the overarching fiduciary obligation current placed upon superannuation fund trustees.

Furthermore, SuperRatings believes that a corporate structure may provide the potential to monetise the value of the trustee company, which may result in adverse outcomes for members should the trustee company be operated like a business and be focused on profits.

To this end, SuperRatings recommends that the existing trust structure be maintained going forward.

9.9. Self-Managed Superannuation Funds ("SMSFs")

Views sought by the Inquiry

To what extent should the Inquiry be concerned about the high operating expenses of many SMSFs?

Should there be any limitations on the establishment of SMSFs?

Whilst SuperRatings does not hold itself out to be experts in SMSF matters, our involvement through a range of data analysis and discussions with superannuation funds provides us with reasonable insights into the operation of these funds.

The establishment of an SMSF is a decision made by an individual, generally upon advice from a third-party, in order to maximise their retirement outcomes. Given that members are also trustees of their own funds, SuperRatings does not believe that any concern should be evident in relation to some higher operating expenses of SMSFs, nor does SuperRatings believe that there should be any limitations on the establishment of an SMSF.

Individuals and their financial advisers must maintain full responsibility for any decisions made in relation to the establishment and ongoing operation of their SMSF. SuperRatings is of the view that appropriate structures should be in place to protect individuals from advisers who have provided poor advice regarding the establishment or ongoing operation of the SMSF to ensure members are adequately compensated in respect of this.

SuperRatings also believes that a mechanism should be in place for SMSF trustees and members to easily compare the performance of their SMSF against that of the broader superannuation industry in terms of both fees and investment performance. This will enable SMSF trustees and members to assess the success of their SMSF to ensure it remains competitive.