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NEWSLETTER

THE FINANCIAL SYSTEM INQUIRY – WHERE NEXT FOR SUPERANNUATION FUNDS?

The final report of the Financial System Inquiry (FSI) was released on Sunday 7 December.

The report is critical of the superannuation industry and makes some telling recommendations for change. The government appears to be pleased with the contents of the FSI final report, but not all suggestions will receive bipartisan political support.

We discuss the likely impact on the superannuation industry and then set out the framework for superannuation funds to address the Inquiry's findings.

Smart superannuation funds and providers will not wait until the recommendations are legislated but will start preparing for change now.

Key points

Objectives

The Inquiry's review of superannuation begins with the premise that this elephantine industry has grown without an overall national objective. It suggests the primary objective for superannuation should be:

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

It provides several secondary objectives mostly related to security in receiving stable retirement income. It does overlook one key objective which is a major part of the current system, namely the provision of life insurance benefits - which are mandatory in MySuper.

Value

One of the five themes for recommendations of the final report of the Inquiry states:

Lift the value of the superannuation system and retirement incomes.

While the Report recognises that the superannuation system has strengths, it maintains the system is not operationally efficient due to the absence of any price-based competition. It is also critical of how assets are converted into retirement incomes, as well as the absence of risk pooling for retirees.

While it is too early to say whether the Stronger Super reforms will lead to major improvements in member outcomes, it is clear that the Inquiry is not satisfied with the outcome to date. The Inquiry recommends ***a formal competitive process to allocate new workforce entrants to high performing superannuation funds*** in the industry unless Stronger Super reforms become effective (by 2020).

Retirement income

As expected, the Inquiry recommends that superannuation funds set up a comprehensive income product for retirement (CIPR) as a default pension for members. The Inquiry recommends these products should have some form of protection against longevity risks by pooling. Provided the pooling is done at fair value, this should increase the retirement income received at the expense of retirees leaving bequests to their (mainly middle-aged) dependants.

The default will operate at the time the member retires. The member will advise the trustee that they want to shift to a retirement benefit and it will happen seamlessly. Alternately, they might elect to take their benefit in a different way.

In order to build awareness with members before they approach retirement, funds will need to show benefits on annual statements converted into retirement incomes rather than as a lump sum. Presumably, funds will base these projection calculations on their default pension strategy.

Governance

The Inquiry recommends that public offer superannuation funds should have a majority of independent directors and an independent Chair. These directors will have the same duties (and potential liability) as company directors.

This structure would diminish the influence of the sponsors of not-for-profit funds (who hold the shares of the trustee business beneficially for members). In the retail segment, independent directors might be concerned about the institution's profit margins; in the industry fund segment, some unions and employer associations might lose their Board positions.

We could also foresee the Boards of two funds wanting to merge against the wishes of the entities owning the shares in the funds.

We don't believe there would be much material difference in strategy over time, but the industry may struggle to find sufficient independent directors.

Prime System Objective

Most superannuation funds believe they already comply with the recommended key objective of providing members with income in retirement. In reality, most money saved though superannuation is converted to a vehicle which provides a retirement income. For most, this is placed in an account-based pension; for low-income Australians, it is placed in bank deposits (outside superannuation).

However, there are a number of activities of funds which don't directly meet this goal. Funds are subject to competitive forces and they need to demonstrate good value in a number of areas.

For example, superannuation funds provide families with significant life insurance benefits. In fact, superannuation premiums represent 45% of all life insurance in Australia. Rice Warner considers the provision of life insurance to be a valuable benefit and it is sensible to maintain death benefits within superannuation; of course, disability benefits are more contentious. Yet, premiums are a cost which detract from members' retirement benefits.

Most communication from funds to members is about building their lump sums to the point of retirement. The Inquiry should be the catalyst for funds to start communicating about the levels of retirement incomes which members can reasonably expect.

In the pension phase, most funds don't currently pool risks to protect retirees against longevity. This will be a challenge all will need to face.

Superannuation fees

Rice Warner was commissioned by the FSI to prepare two reports on superannuation fees. These were both released with the final report.[1]

Our findings show a large variation in fees within the industry. Even the commodity product for unengaged members, MySuper, has a variation in fees from 48 bps to 184 bps a year. While a relatively standardised product should have keen

[1] http://fsi.gov.au/commissioned-work/

pricing, the system has several complexities which need to be priced into products:

- MySuper membership does cover some engaged members who are content for the trustee default to guide them. Some members deliberately place their super in the default investment strategy, while others use it as a core portfolio and combine it with choice options to build their overall strategy.
- Life insurance is mandatory under MySuper – and funds encourage higher levels of cover to provide cost-effective benefits for members.
- Scalable financial advice is expensive and available to MySuper members even though the unengaged members won't use it (but might later in life).
- Choice of fund adds to distribution and marketing costs.
- The availability of Choice investment strategies within all funds.

The Inquiry appears to take the view that unengaged members should not pay for these complexities but they should be housed in a low cost structure. Some of the complexity can potentially be avoided, but not all. The Inquiry itself, for instance, wants superannuation benefits to be portable and attached to members by default which implies a continuation of the choice of fund requirements.

Stronger Super

The Inquiry suggests that Stronger Super be given until 2020 to demonstrate its value or else it be dismantled.

We believe that Stronger Super will eventually lead to lower costs and therefore lower fees. However, its introduction has been turbulent and expensive for the industry. SuperStream has become a labyrinth which was unnecessary and should have been avoided. The weakness in contribution collection has always been through poor processes by employers. All that was needed for compliance was a ruling that employers would not receive their tax deduction for SG contributions unless they paid the money to the nominated fund electronically accompanied by data in a prescribed format.

The alternative proposal put forward by the Inquiry is to provide price-competitive pressure via a formal tendering process for eligibility for default fund status. The Inquiry's intention appears to be that this process will still see multiple funds available to default members and their employers, but that their eligibility will depend on a tendering process that includes a focus on fees rather than a decision under an award negotiation process.

A formal, transparent, public process does have the potential to drive prices down, but there are obviously a lot of details that will need to be determined before the process has credibility. The Inquiry did not recommend the actual tendering process but has referred it to the Productivity Commission. This would make for interesting times over the next few years as the market sought to agree a mechanism that can select those funds that have the best value for money combination of:

- Fees
- Investments
- Customer service levels
- Insurance (benefit design, price and claims handling philosophy).

The recommendation that superannuation benefits should by default be attached to members will reduce duplication of accounts and unnecessary costs within the system, but it will require a number of operational changes especially for employers. The question of how unengaged members would select a fund would need to be addressed. The approach also raises questions about the long term viability of corporate superannuation funds.

Curtailing costs while remaining competitive

The FSI has highlighted what it sees as a failure of the superannuation system to deliver a reduction in fees commensurate with the increase in scale that has occurred over recent years. It comments that price reductions have been largely offset due

to higher costs elsewhere in the system. This latter point is not explored in any detail, but is actually quite important.

There have been a number of significant costs associated with the introduction of Stronger Super that have been passed through the system. These should dissipate over time and the Inquiry has sensibly indicated that the Stronger Super system should be given time to become properly established before final judgements are made.

An element that does not appear to have been considered is that ageing membership bases and growing balances have brought higher levels of desire for engagement. This demand from members has put considerable stress onto the servicing structures of superannuation funds (and their administrators) and has required an increase in resources.

Member servicing, because of its requirement for interactions with members, is not particularly scalable and must be met by increased staffing and resourcing. This increase in demand is likely to continue for some time and will put upward pressure on costs which can at best be only partly met from scale benefits. We expect innovation to come from administration systems as we move from paper-based systems to electronic commerce in super.

Retirement incomes

Recommendations around retirement incomes are long overdue. The population bubble of retirees from the baby-boomer generation means that a well-defined framework around retirement incomes is critical.

We welcome the Inquiry recommendation that funds provide a much greater focus on pooling for retirement benefits so that long-living members benefit from profits from those who die early (which is the essence of any annuity product). This will allow development of many pooled products to cater for longevity risk.

In fact, it is proposed that any CIPR would be obliged to cater for longevity risk (and this is not a feature of current default pension structures other than the new Mercer product which has allowance for group self-annuitisation). The submission from the Actuaries Institute[2] states

"…a portfolio approach is likely to be more suitable than a single default product. A sensible product might include an account-based product and another product with longevity risk protection"

The challenge will be in designing products that provide this pooling efficiently and cost effectively. Failure to do this could lead to funds incurring high costs on products that achieve limited traction.

The vehicles will need to provide a much greater emphasis on asset value growth than is currently evident in the market. Non-insured mortality pooling should deliver a better result than fully insured annuities because of the removal of extremely costly hard guarantees and their associated capital costs. They must, however, do much more than that. Current annuities, and even recently launched mortality pooling products, have very defensive asset allocations which are unlikely to deliver adequate returns to support incomes that maintain living standards over the increasingly long periods in retirement.

We need mechanisms that allow members to grow their incomes in real terms while benefiting from mortality pooling.

The CIPR examples in the report[3] suggest that a useful separation of assets at retirement would be to earmark a portion as longevity protection to provide income from (say) 20 years after retirement. The balance of the benefit would then be used to provide a pension for a fixed period of 20 years.

The issue facing the industry is how to invest the longevity bucket.

According to the Inquiry, ***Many people will live for several decades after retirement. CIPRs should therefore provide exposure to growth assets to increase retirement income. Rice Warner[4] advises that "…any investment period of 20 or more years***

[2] Financial System Inquiry Final Report p127
[3] Financial System Inquiry Final Report – Table 5, p128
[4] Our second round submission on Retirement Incomes Solutions p14

requires a significant proportion of growth assets." Using CIPRs will allow superannuation funds to take a longer-term investment perspective and reduce the need for retirees to worry about sequencing risk."

Our modelling suggests that an optimum investment strategy for such a longevity product would be for members to invest about 15% to 20% of their retirement benefit into a separate longevity bucket which they would not touch for a long period (say, 20 years).

This bucket should be invested heavily in growth assets (80% to 100%) so that the amount available in 20 years is maximised. At present, members would need to allocate a separate non-pooled investment bucket for this as there are no available longevity products which are backed by growth assets.

At the expiry of this 20 year deferred period, five lifetime annuities would be bought (each with 20% of the accumulated benefit) over a five year period. Buying the annuities over time reduces the interest rate sequencing risk at the time of purchase.

This strategy is better than buying a deferred annuity, despite the mortality profits which emerge in that product during deferral. The significantly higher earnings over twenty years coupled with the better value of lifetime annuities at advanced ages is a winner. This strategy also has the benefit of providing some value for retirees who die before the expiry of the 20 year term.

In time, we expect the industry will develop pooled longevity products invested appropriately for the long term.

There were a few other interesting observations:

- A CIPR should not be enforced on an SMSF ***because the trustees are the fund's members.*** While this recognises that it is difficult to pool risks within an SMSF, it would not be difficult to set aside funds for longevity protection as we have set out above. Exempting SMSFs might lead to further arbitrage between these funds and APRA-regulated funds. There may be scope for product providers to develop pools that are available to SMSF members.
- The means test on the Age Pension ***should aim to provide neutral treatment of products with longevity risk protection***[5]. This is relevant in light of the recent DSS decision to revoke the favourable treatment of some annuities from January 2015.

Taxation

The report discusses superannuation taxation almost in passing. It notes that *taxation is one of a number of distortions that impede the efficient market allocation of financial resources.* These are listed in Appendix 2 of the report.

In our submission to the Inquiry on Retirement Incomes Solutions[6] Rice Warner made a number of suggestions for improving taxation within superannuation and integrating retirement benefits better with social security.

The Inquiry notes various problems arising from taxation of accumulation and retirement accounts not being aligned. It also notes the poor targeting of superannuation concessions generally.

Taxation matters (including our recommendations) have been referred to the Treasury group preparing the White Paper.

What about SMSFs?

Leverage

The key recommendation affecting the SMSF segment is the proposed abolition of borrowing (limited recourse borrowing arrangements, LRBA) for super funds to purchase housing or equities. This makes sense given the heavy concentration of assets for an SMSF in investing in an illiquid asset such as property. The Inquiry noted our alternate suggestion of capping the amount of the fund which could be held in an LRBA.

[5] Financial System Inquiry Final Report p 127

[6] http://www.ricewarner.com/media/101438/Rice-Warner-Submission-to-the-Financial-System-Inquiry.pdf

Dividend imputation

The Inquiry questions the value of dividend imputation. This was introduced (in 1987) to reduce the cost of capital for businesses and to avoid double taxation of company profits. As Australia now has access to global capital markets, the Inquiry claims this is no longer as important and the imputation actually steers superannuation funds towards Australian equities.

The original reason for introducing imputation should be kept in mind as a move to remove imputation would reduce members' ability to maintain their incomes in retirement since it would reduce the returns on the assets they need to provide the growth.

The reason for introducing imputation was to remove the inequity in the tax system between business interest and dividends. Interest was (and is) taxed in the hands of the recipient taxpayer and the borrower can claim it as a deduction. Business profits, however, were taxed in the hands of the company and were then taxed again in the hands of the shareholder. This biased investment and savings away from productive investments.

Imputation simply levelled the playing field ensuring that both forms of income were taxed in the same way.

Any move to remove this equity between interest and dividends should be considered very carefully in the light of the Inquiry's recommendations to strengthen the balance sheets of the banks. The removal of imputation would significantly increase the cost of capital for the banks by driving down their attraction for the shareholders who will need to supply this capital.

The Inquiry suggests lowering company tax rates which will automatically reduce the value of these tax concessions. Of course, the government could always limit the amounts super funds could claim as imputation credits (they used to be offset against any tax paid which would remove their value for pensioners). Any change to this system is likely to have major ramifications for the Australian stock market as the SMSF segment holds more than $275 billion of Australian shares (most of them listed). APRA-regulated funds hold a further $250 billion in listed Australian equities.

Taxation

The proposed alignment of the tax on accumulation and retirement accounts will remove some of the tax arbitrage available to SMSFs. It will simplify the system but lead to higher receipts of capital gains tax.

What should super funds do next?

Member engagement

The Inquiry recommends that members have a single high-performing account throughout their working life. This would be portable across changes in employment. Effectively, everyone would become a Choice member, though that does not necessarily mean they will become engaged!

Funds need to develop innovative member engagement strategies so that members will choose to stay in their fund if the Stronger Super system is dismantled. Against the backdrop of increasing pressure on fees, funds will need to increasingly embrace technology as a cost effective way of engaging with members.

Funds need to have a clear strategy around member engagement. It might look like this:

- Data analytics to understand its members.
- Placing members into homogenous groups.
- Campaigns to capture better data on them (industry funds don't even know their members' salaries or marital status).
- Campaigns to generate engagement (defined by activities such as making additional contributions, taking out more life insurance, changing investment strategy, rolling in from other funds).
- Campaigns to discuss retirement with older members (and stop them joining an SMSF). This includes bringing their spouse into the fund and treating the couple together for all engagement purposes.

- Changing the fund's fee structure (as all the above campaign activities are 'costs' and don't generate revenue for the fund).
- Marrying its services to homogenous groups of members:
  - New entrants need to consolidate their super.
  - Young single members need Income Protection (though this is usually better if bought outside super).
  - Life insurance for members with dependants (buy when they marry and particularly when they have kids).
  - Benefit projections and guidance for making extra contributions from an early age.
  - Advice on the right investment strategy.
  - Early advice on retirement (from age 50).
- A default retirement strategy which includes:
  - A sound investment structure for the retirement years.
  - Education on the Age Pension, expenditure patterns in retirement, rules for withdrawing money at and during retirement.
  - Building a retirement plan (including the partner for married members).
  - Financial advice and other support before, during and after retirement.

Another initiative would be to start providing retirement income projections on annual statements. Of course, there is a large variability of outcomes, and members should be provided the tools to explore different scenarios.

All funds know they need to engage more with their members. If the Inquiry's recommendations are adopted, there will be a further reduction in the role of bargaining agreements in determining how super contributions are directed – with *all* employees being able to choose a fund for themselves[7].

Fees

MySuper costs have to come down! Those funds whose costs are not in the best 50% of funds will be under pressure to improve. But all funds will be seeking cost reductions.

All funds should consider whether their pricing models are sustainable. It could be that the costs of additional insurance and Choice investment strategies need to be raised to allow a reduction in MySuper fees.

Retirement incomes

Funds need to assist their members to plan for retirement. The default solution needs to be right for *their* members. This might be best achieved by having different default settings for different segments of the membership.

The FSI final report is supportive of this, saying "CIPRs could vary with known characteristics of the member, including the size of their superannuation benefits. A trustee could decide to recommend lump sum benefits to members with balances below a certain (low) threshold[8]".

Any default structure should reflect the investment requirements of retirees, which are fundamentally different to those of people who are still working.

Funds should be proactive and should build default retirement products now. The report states "Developing CIPRs will take considerable time. This recommendation should be implemented with sufficient lead time to allow superannuation funds to design products or form partnerships with other providers." There are already innovative market developments and funds that wait risk substantial leakages of members approaching retirement.

[7] Financial System inquiry Final Report p131/132

[8] *Financial System Inquiry Final Report, page 128*

Conclusion

Superannuation has had annual legislative changes for more than 30 years and the industry is still bedding down the Stronger Super initiatives. Consequently, trustees and management will not relish further change. Nonetheless, the criticism of costs and the lack of suitable retirement solutions need to be addressed.

The Inquiry has found that the cost structure of the industry is too high and it needs to be reduced. This should be a key objective of all superannuation funds, but it will need to be managed against ongoing pressure to deliver more services to members.

Most funds are already contemplating better retirement solutions and the Inquiry's guidance will be useful. However, until there is legislation for a default retirement product, product innovation is likely to be curtailed. Consequently, funds will need to focus on providing advice to members approaching retirement. Funds which can engage members in a cost-effective manner and shift communications from lump sums at the point of retirement to a pension income through retirement, will be able to meet their core objective of delivering better outcomes for their members.

Rice Warner is a leader in providing research, advice and software development services to the Superannuation and Wealth Management industries. We have been improving our clients' business outcomes since 1987, years through the provision of unique and innovative insight, advice and associated service.

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