

SUPER SYSTEM REVIEW FINAL REPORT

CHAPTER 1

MySuper and choice architecture

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KEY THEMES

Issue

The current superannuation system assumes that all members want to make choices about their superannuation and are interested in receiving a variety of superannuation-related services. 'Default' members are not adequately protected and can find themselves paying for services that they do not need or request and, on some occasions that they do not receive. Trustees are not always focussed on acting for the benefit of members and maximising members' retirement incomes in an efficient and cost-effective way.

Proposed solution

The Panel proposes measures, including:

- a new architecture for the superannuation industry, designed from a member — not an industry or product — perspective;
- the creation of MySuper, a simple, cost-effective product intended to better serve the interests of members who want the trustee to be responsible for making decisions about their super;
- a requirement that only MySuper is eligible to be a 'default' fund under the SG Act nominated by an employer or under Fair Work Australia awards; and
- a renewed emphasis on duties for MySuper trustees, with the trustee explicitly responsible for a single, diversified investment strategy and controlling costs.

Benefits for members

Members will benefit from the new choice architecture as:

- they would have the confidence to be engaged as much or as little with their super as they want;
- MySuper trustees would have to design and give effect to an investment strategy aimed at optimising members' financial interests; and
- the effect of commissions (and like payments) would be contained and fees would not be charged for advice that is not requested or received.

1 A NEW ARCHITECTURE FOR SUPER

Treasury projections show that the superannuation system is expected to grow to \$6.1T (in nominal dollars) by 2035.¹ The Panel believes that now is the time to position the superannuation system for the challenges of the future under an ‘architecture’ that would re-affirm the primacy of the best interests of members and the rationale of the system as optimising the contribution of superannuation to members’ retirement income.

1.1 A member-focussed ‘choice architecture’

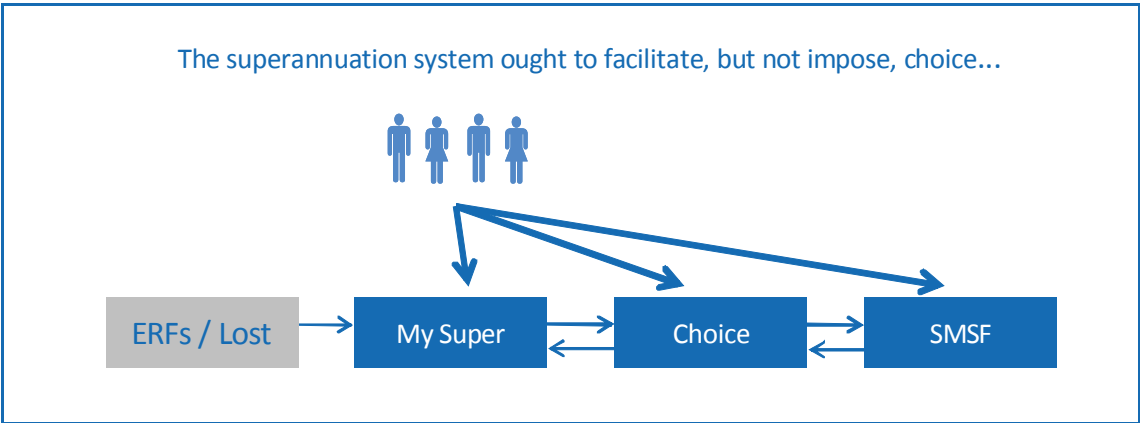
The current regulatory infrastructure supporting the superannuation industry distinguishes between different types of fund to some extent. At the margin, there are different rules applied to public offer funds as opposed to standard-employer-sponsored funds, to defined benefit plans and to SMSFs. For the most part, though, the SIS Act assumes that there can be a single model of superannuation fund governance.

The Panel believes that industry developments since the enactment of the SIS Act make this approach inadequate. More importantly, although the one-size-fits-all approach appears equitable, in practice it can result in the illusion of protection or the primacy of member interests in certain situations and in unnecessary complexity and cost in others.

The Panel believes that there has to be room in a system, where there are compulsory contributions, for a governance model that addresses not only the disengaged member, but also the member who exercises choice about the fund (or investment option in the fund) to which they belong. There also needs to be more clarity for members about the differences between the various models and what those differences mean regarding the trustee’s duties to the member.

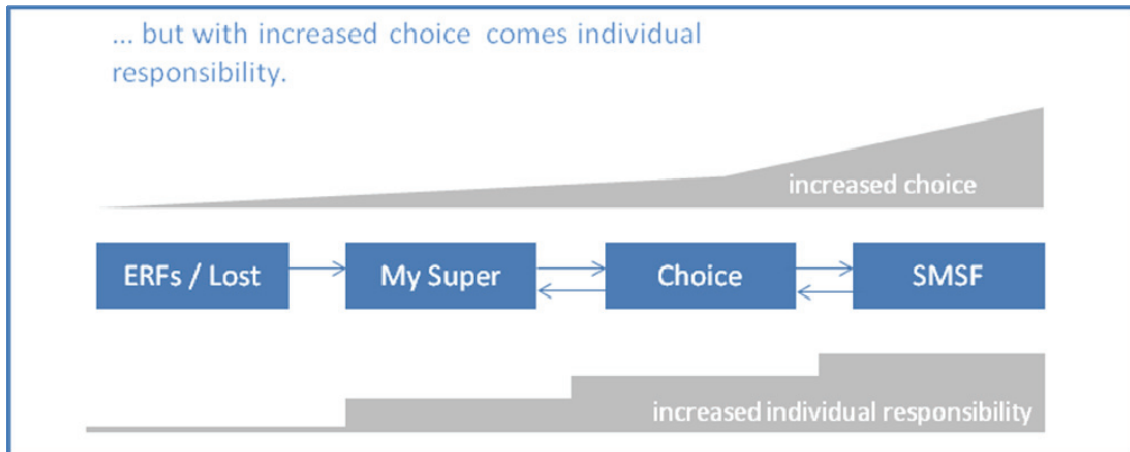
Figure 1.1 below sets out an approach which starts from a member, rather than a product or industry sector, perspective. In behavioural economics terms, this is a ‘choice architecture’ model.²

Figure 1.1: A choice architecture model for Australia’s superannuation system



The model classifies members into three main types — MySuper, choice and SMSFs — on the basis of whether or not they have made a choice about their superannuation and the nature of the choice made. A number of submissions indicated a desire to see differentiation along these lines.³

Figure 1.2: Increased choice, increased member responsibility



Those who do not make an express choice would be in MySuper. This recognises that direct engagement in superannuation decision-making is not currently a priority for a large portion of the population (and leaves open the question whether it could or should be).

However, the model also recognises the value of choice, with the greater responsibility that choice entails for the member. MySuper would be available to those who actively choose to be there and the choice sector caters for those who wish to tailor their super. SMSFs recognise that some people have the desire and capacity to manage their own retirement savings and choose to assume full responsibility and control.

The ERF/lost member sector recognises the practical reality that some people are currently disconnected from some or all of their superannuation. If a member loses connection with their account, that account would be transferred to an eligible rollover fund (ERF). The SuperStream recommendations in chapter 9 seek to address the factors contributing to this disconnection. The Panel would not expect the ERF/lost member sector to continue as a material part of the system following the implementation of SuperStream, although the existing stock of lost members would remain large for some time.

Members who want to exercise choice outside MySuper would be able to have their contributions made into non-MySuper products through an active 'opt-in' decision. Employers and others would not be permitted to 'opt-in' on behalf of their employees or clients, as applicable. People could have interests in both MySuper and choice products at the same time, though this would be by active choice, and not by poor record-keeping or because they were unable to consolidate multiple superannuation accounts.

1.2 Implications of the choice architecture model

There are several important implications for the industry arising from the choice architecture model, including:

First, the model orients attention towards members and away from 'products' and industry sectors.

Second, the model uses the conscious choices and choice-related outcomes of individuals to calibrate the levels of governance, regulation and member protection applicable. Accordingly:

- ERF members, disconnected from their super, would receive a high level of protection while they remain in the super system. There would be minimal information or disclosure, but importantly also a low cost facility to aid member identification so as to expedite consolidation of any lost amounts and, ultimately, transfer from the ERF to other sectors. ERFs are discussed further in chapter 10;
- MySuper members would receive the protection afforded by the duties imposed on a traditional trustee who is a fiduciary acting single-mindedly in the best financial interests of members. They would be in a product with a single, diversified investment strategy, insurance would be offered, but few other product features. There would be a limited role for external advice because intra-fund advice would be ‘embedded’ in the product and there would be limited choices to be made by the member;
- choice members would bear substantial responsibility for the investment choices or fund choices that they made. They would be in a product with potentially an unlimited menu of investment options, but with trustee responsibility for reasonable due diligence on investment options offered, with some limitation of liability for investment choices made by individual members. Effective disclosure would therefore be of paramount importance. Members would be likely to rely on advice or disclosure and other information about their options; and
- SMSF members would, subject to conformity with certain minimum standards, be self-reliant.

Third, different governance (and regulatory) models would be appropriate for the different types of members. Prudential regulation would be more relevant to the MySuper and choice sectors than the SMSF sector. Likewise, a traditional trustee role is more relevant to the MySuper sector than the choice sector.

Fourth, the model facilitates more precise allocation of costs to members. The costs of the compendious disclosure documents, advertising and transactional infrastructure required to facilitate member investment choices in the choice sector would be borne only by those members in the choice sector.

Fifth, the model accommodates movement of members between the sectors, albeit with some regulation. The potential for moral hazard and the removal of layers of protection mean that movement towards sectors offering increasing choice (that is, to the right in the choice architecture model in Figure 1.2) cannot be allowed to be inadvertent. Participants moving in that direction must signal their intention expressly and unambiguously. Having done so, they should be allowed to move with minimal friction and cost. On the other hand, no special restrictions need to be placed on member movement in the other direction (for example, a move from an SMSF to MySuper).

Lastly, one segment of the industry is not specifically captured in this model: defined benefit plans. These plans remain an important, but declining, part of the industry. More importantly, the allocation of investment and other risks in defined benefit plans are quite different from those in accumulation plans, which have implications for the governance and administration challenges they face. The Panel believes these plans should be subject to a regulatory environment tailored to their unique requirements. Defined benefit plans are discussed in chapter 6.

The choice architecture model does not represent a complete break from the current structure of the industry by any means. The ERF/lost member and SMSF sectors essentially exist today. The Panel discusses ERFs in chapter 10 and SMSFs in chapter 8. Similarly, there are today both MySuper and choice products available in the market; they might have different names and details, but they are essentially recognisable.

This chapter outlines the MySuper component of the choice architecture model in more detail.

Recommendation 1.1

The ‘choice architecture model’ should be adopted as the structure for Australia’s superannuation industry.

2 PURPOSE OF MYSUPER

2.1 A product for a core demographic

The MySuper component of the choice architecture model is predicated on providing a simple, cost-effective product with a diversified portfolio of investments for the vast majority of Australian workers who are invested in the default option of their current fund.⁴ A significant portion of those members have not exercised choice to be where they are, but there are some members who have actively chosen the default investment option.

MySuper does not just cater for disengaged members — it is also designed for members who choose actively to participate in this product.

Recent data show that the average member account balance across a wide range of super funds is below \$25,000.⁵ In fact, APRA data show that retail and industry fund accounts had average balances of \$18,400 and \$16,600, respectively, at 30 June 2009. Rice Warner estimate the June 2008 average balance per member (not per account) at \$32,895 for industry funds, \$46,710 for retail, \$100,302 for public sector and \$133,492 for corporate funds.⁶ Roughly 80 per cent of members are in the default strategy.⁷

These figures illustrate a core member demographic for which the Australian superannuation system should be able to cater simply and efficiently. It is particularly at these member account sizes that the Panel finds MySuper compelling; account sizes where costs and inefficiencies can make a real impact on whether a member has a comfortable retirement. But even as the system matures, and account balances grow, the Australian superannuation system should be able to ensure that there is a value for money, simple and effective product for members to rely on — whether that reliance is preferred by the member or is due to an inability or disinclination to choose.

2.2 Leveraging off a well-known existing product

Generally speaking, existing default investment options have delivered good outcomes for members. The Panel sees the MySuper proposal as based in and around the existing widely offered and well-understood default investment options. Indeed, MySuper has been designed to sit within the

existing structures currently offered by many superannuation funds. However, MySuper also aims to focus trustees' attention more sharply on the types of member advantages afforded by those default options.

Also, as noted, MySuper is not just for people who are disengaged. With the lower costs and traditional trustee obligations, the Panel believes that many engaged investors will actively choose to have their superannuation in MySuper. MySuper includes a range of additional regulatory requirements which are designed to ensure that the trustee is truly accountable to members, that the trustee is unfettered in its pursuit of the best interests of members and that the costs of delivering MySuper are contained. Together, these safeguards are designed to emphasise the true fiduciary oversight — 'trusteeship' — that MySuper members ought to expect from their product providers. They also ensure that members do not inadvertently pay for services they do not need and sometimes do not receive.

The MySuper product is intended to provide a simple superannuation option for members. It will be treated, for some purposes, as separate from other types of superannuation products, and operated so that member interests are transparently paramount and there will be an enhanced focus on optimising net investment returns and reducing overall costs. The Panel believes that by imposing some degree of homogeneity on the product, price competition might reasonably be expected to produce more positive outcomes for members and to help trustees contain costs. It would also be easier for engaged members and their advisers to make comparisons between MySuper products offered by different funds. Regulatory changes will put pressure on MySuper (and choice) trustees to be more transparent and accountable about their investment objectives, efficiency and member outcomes. This is discussed in chapter 4.

2.3 MySuper as the new 'default'

2.3.1 Superannuation Guarantee

Only MySuper products should be able to be nominated by an employer as a 'default'.

However, MySuper is also for members who choose to rely on an investment strategy developed, in their interests, by a fund trustee. Employees would therefore also be able to select MySuper products as a 'choice of fund' for SG Act purposes.

Recommendation 1.2

The SG Act should be amended so only a MySuper product is eligible to be a 'default' fund nominated by an employer.

2.3.2 The award system

The Panel also believes that only a MySuper product should be a 'default fund' for the purposes of awards and other industrial instruments. Currently, modern awards nominate a number of funds to which an employer must pay superannuation contributions on behalf of employees who do not actively choose their superannuation fund. Some submissions to the Review argued that this system is uncompetitive because employers are unable to select their preferred superannuation fund as a default if it is not nominated in the award. For example:

- IFSA maintained that competition drives improvements in superannuation fund offerings as well as efficiency and puts downward pressure on fees.⁸
- Mercer's submission noted that awards do not have the capacity to monitor the ongoing performance of funds. As a result, underperforming funds can continue to be the default fund for award-respondent employers. Employers who have actively chosen a fund, on the other hand, are able to change their default fund if circumstances require. Mercer also pointed out that the wording of modern awards with respect to the nominated default fund can prevent employers from contributing to an award-nominated fund if it ceases to exist due to a successor fund transfer or merger with another fund.⁹

Other submissions endorsed the modern award approach:

- The Australian Industry Group (**AIG**) supported the process on the basis that it is simple and reduces costs and complexity that employers would have to bear in selecting default funds. The AIG submissions said, in response to the concern that the award process lacks transparency and a competitive element, that this could equally be the case for employer-nominated default funds.¹⁰
- Generally, the ACTU agreed with AIG's views, but also supported the idea that award-nominated funds should satisfy certain governance, cost and performance criteria to be eligible for nomination as a default fund.¹¹ The Panel believes that its MySuper proposal addresses those issues.

Naming a particular fund in an award when there has been no transparent, formal selection process would appear to inhibit competition and delivers a significant advantage to the fund named. However, one cannot overlook the fact that the selection of the fund named in modern awards has been the subject of negotiation between employee and employer representatives.¹² Also, the selection of default funds by employers outside the industrial relations system is not perfectly competitive and transparent either.

As it is logical that there be a reasonable transition period before MySuper would apply generally, there seems to be no reason why the default funds in modern awards should not continue for the time being. They are due for comprehensive review in 2014. In order to prepare for the 2014 review, the Panel considers that, in 2012, the Productivity Commission should examine the way default (MySuper) funds are nominated under the awards system, with a focus on whether the procedures are the most open, transparent and competitive means by which members are given access to the most favourable default (MySuper) offerings.

Recommendation 1.3

The relevant legislation should be amended so:

- (a) only MySuper products are eligible to be nominated; and**
 - (b) all MySuper products are able to be nominated,**
- for 'default fund' purposes in awards approved by Fair Work Australia.**

Recommendation 1.4

In 2012, the Productivity Commission should conduct a review of the processes by which default funds are nominated in awards to assess whether the processes are sufficiently open and competitive.

Recommendation 1.5

Any fund that is a ‘successor fund’ (as defined in the SIS Act) to a fund currently nominated as a default fund under an award should, where the successor fund is a MySuper product, be accepted automatically as a default fund under the award, so that there is no impediment to consolidation for those funds that wish to do so.

Following the implementation of these measures, the Panel intends that MySuper would replace the current concept of ‘defaults’ and that the regulatory structure and industry cease referring the term ‘default’.

2.4 Open to all providers

There is no reason why any industry sector should be excluded from offering a MySuper product, and so be considered for nomination as a modern award default fund. It is not intended that only not-for-profit entities should be able to participate in the MySuper category, nor that only retail financial institutions should be able to participate in the choice category. The Panel’s view is that greater competition should result in due course.

The Panel believes that members of current default funds or default investment options that a trustee flags for conversion into a MySuper product will not need to move out of these funds because of this transformation. Funds would be able to offer either MySuper or choice products (or both) but the requirements pertinent to each of the types of product would need to be met.

3 QUALIFYING AS A MYSUPER PRODUCT

A MySuper product would be formally established by demonstrating compliance with objective criteria to which any trustee would have to conform in order to qualify as a MySuper product. There would also be principles-based duties in relation to MySuper products that trustees would be legally obliged to meet, addressing financial performance, reporting and disclosure. APRA would be empowered to work with the trustee to resolve any non-conformity with the principles depending on the circumstances.

3.1 Principles-based trustee duties

The Panel considers that MySuper trustees should operate under new high level, principles-based, duties that could not be diluted in a fund’s governing rules. These are set out below. The overall duties of MySuper trustees would also include the types of governance duties discussed in chapter 2.

However, for the purposes of articulating MySuper as a stand-alone concept, the Panel has kept the two discussions (that is, MySuper in chapter 1 and trustee governance in chapter 2) separate.

3.1.1 Optimising investment performance and overall cost to members

The trustee would have to formulate and give effect to a single, diversified investment strategy at an overall cost aimed at optimising fund members' financial best interests, as reflected in the net investment return over the longer term. This does not mean that a trustee would have to provide the lowest possible cost investment strategy. While there is an emphasis on low costs, this would not be at the expense of investment returns. The Panel recognises the importance of asset allocation and that some investment strategies would be more costly to provide than others.

Although there would not be an overall fee cap or other regulation of the cost of a MySuper product, a MySuper trustee would be required to operate with a clear and transparent justification for the investment strategy it formulates and the overall cost and net return to members.

3.1.2 MySuper trustees and investments

A touchstone of MySuper is that its members would defer to the trustee generally in relation to all aspects of their superannuation. The Panel believes that offering investment choices in MySuper would, in essence, be delegating what some regard as the most important activity of the trustee to members who are generally not well-equipped to perform that activity or who have specifically chosen to minimise their own decision-making by adopting the MySuper product. The Panel therefore believes that decisions about investment strategy in a MySuper product would be the sole responsibility of the trustee.

There is a clear consensus that people should ideally have a suitably diversified investment strategy. This is common practice within default investment options of funds at present. The Panel has also recommended a mandatory system for explaining investment aims, volatility and costs, which is discussed further in chapter 4.

It should also be stressed that while MySuper must have a single investment strategy from the perspective of the member (that is, no choices) it is very much open to the trustee to change the investment profile over time to reflect certain characteristics of members, including movement according to defined age bands and/or proximity to a target retirement date.

3.1.3 Scale

Scale is central to a trustee optimising operating costs in the best interest of fund members. A report prepared for the Review by independent consultant, Deloitte Actuaries & Consultants Limited, describes the power of economies of scale in reducing per member investment, advice and operating costs, and so the scope to reduce total member fees.¹³ A copy of the Deloitte report, dated 19 April 2010, is appendix D to Part 1 of this report.

As part of the grant of a MySuper registrable superannuation entity (**RSE**) licence, a MySuper trustee would have to demonstrate to APRA that the product had sufficient scale or, if a new entrant, there was a credible path to building the necessary scale. Also, on an annual basis, a trustee would have to ask itself and determine whether it would continue to have sufficient scale in relation to its MySuper product (with respect to both assets and number of members) to deliver optimal benefits to members.

Further, scale would be part of APRA's ongoing review of MySuper products. The way the scale concept is administered would, of course, need to deal with a fund's individual circumstances, features particular to certain occupations and to allowing competition from new entrants to the market. The interaction between the trustee's duty and APRA's regulatory role in relation to scale is discussed further in chapter 10.

Recommendation 1.6

The SIS Act should be amended to apply statutory duties to MySuper trustees to:

- (a) formulate and give effect to a single, diversified investment strategy at an overall cost aimed at optimising fund members' financial best interests, as reflected in the net investment return over the longer term; and**
- (b) actively examine and conclude whether, on an annual basis, its MySuper product has sufficient scale on its own (with respect to both assets and number of members) to continue providing optimal benefits to members.**

3.2 Objective criteria for MySuper products

Set out below are some of the criteria with which trustees offering MySuper products would have to comply and the features which a MySuper product would have to contain.

APRA licensing

A trustee who wants to offer a MySuper product would be required to hold a 'MySuper' class of RSE licence granted by APRA. This would most likely be through a variation to an existing licence.

Contributions

The trustee would have to accept all types of contributions (except where prevented by law).

Single investment strategy/diversified asset allocation

The trustee must formulate and give effect to a single, diversified investment strategy for the MySuper product.

No costs cross-subsidisation

The Panel recognises that there is always some degree of cost cross-subsidisation between members in any pooled investment. However, it would be a clear feature of MySuper that there should be no direct or indirect cross-subsidisation of costs between MySuper products and other products offered by a fund trustee, whether within the same RSE or not. The outcomes reporting standard to be developed by APRA in consultation with ASIC and the industry, as discussed in chapter 4, would cover cost cross-subsidisation issues in MySuper products.

Buy and sell spreads

Buy and sell spreads could be charged to MySuper members so long as the charge is closely linked to demonstrable costs incurred by the fund (that is, actual transaction costs in investing contributions and paying benefits) and provided that the charges are paid to the fund and not to the trustee in its personal capacity or to any other party.

Switching fees

Fees payable on switching into or out of a MySuper product, whether chargeable on the first switch in any given period or only after a certain limit has been reached, would be able to be charged in MySuper provided that those fees are paid to the fund (as in the case of the buy and sell spread) and not the trustee in its personal capacity or to any other party.

Fee schedules and discounts

All fee schedules and discounts (if any) for MySuper products are to be explicit and not subject to negotiation or rebates.

Performance-based investment management fees

No performance-based investment management fees could be paid to or by a MySuper trustee unless they comply with the performance fee standard, discussed in chapter 3.

E-super disclosures

Because of the simplicity of a MySuper product and the central role of the trustee in overseeing the product, there would be reduced member disclosure obligations to assist with cost reduction. Entry to a MySuper product would not depend on notions of informed choice reliant on trustee disclosures and trustees would not be required to provide disclosure to members in the form of Product Disclosure Statements. Joining a MySuper product would generally occur online. People choosing to enter a MySuper product would not be treated differently from those entering through 'default' processes. Comprehensive information, at a variety of levels of detail, would be made generally available by the trustee online, and any person without internet access would be able get hard copy information on request. Member benefit statements would continue to be sent out as they currently are, including by email, because this is one of a fund's primary forms of engagement with members. However, the legislation would make it clear that MySuper members could elect to have member account information available to them online instead of in hard copy.

Retirement product

MySuper would not just cover accumulation to retirement, but ultimately must also offer a retirement income stream product, either on its own or in conjunction with another provider. The Panel views MySuper, in its fully-developed form, as a 'whole of life' product. This would need extensive consultation and development with industry, but is a key part of the MySuper concept. Options include a range of account-based pension products, annuity products and other longevity risk hedging products. This is discussed in more detail in chapter 7.

Entry and exit fees

There would be no entry (contribution) fees charged for a MySuper product, including on rollovers. Exit fees could only be charged on a cost recovery basis.

Benchmarking

To drive the advantages of MySuper, the Panel believes that MySuper products should be regularly benchmarked against each other according to a transparent methodology, approved by APRA and applied on a consistent and objective basis. This is discussed further in chapter 4.

Intra-fund advice

Trustees offering MySuper products would be required to maintain a facility for providing ‘intra-fund’ advice to members. Under current ASIC arrangements, the trustee of a superannuation fund that holds an Australian financial services licence to provide personal financial product advice is able to give advice to fund members about certain aspects of their existing interest in the fund, with the level of inquiry and consideration in relation to that advice set by the trustee’s fiduciary duty to members, rather than the Corporations Act. ASIC has also provided guidance in relation to giving personal advice to fund members only in relation to specific fund features under the generic standards in the Corporations Act.¹⁴ The Panel notes the Government’s announcement in the Future of Financial Advice reform package to expand the current intra-fund advice regime to new topics, and considers this will be particularly appropriate for MySuper.¹⁵

The cost of intra-fund advice to fund members could either be shared across the MySuper membership (like an administration expense) or charged to those who use the service. Any payment for superannuation advice from a member’s superannuation account must comply with the ‘sole purpose test’ in the SIS Act and payment for advice about superannuation has been accepted as meeting this test. The ‘price point’ at which intra-fund advice must be charged to the member, rather than shared across the fund, is a matter to be determined under the trustee’s optimisation duties.

As well as making intra-fund advice available to members, the Panel also sees a role for a pro-active offering of the trustee’s intra-fund advice service in relation to specific member needs or life stages. This could be in relation to the role and value of death and total and permanent disability (TPD) insurance, especially to members with families and mortgages, and this is discussed further in chapter 5. A pro-active approach to the offering of intra-fund advice services would also be appropriate as members approach retirement and during retirement, and this is discussed further in chapter 7.

The Panel also notes that, in providing intra-fund advice, the trustee would be required to act in the best interest of members. This will be important in relation to any potential for trustee advice to be used to direct MySuper members into choice products. The Panel envisages monitoring by the regulators to ensure appropriate advice is given consistent with the trustee’s fiduciary duty. In addition, the Panel envisages that such monitoring will include ensuring that expensive and non-transparent advice arrangements are not reintroduced with the expansion of the intra-fund advice arrangements.

Payment for external or non-intra-fund advice is discussed in section 4.3 below.

Other criteria

Other objective criteria for MySuper products are also part of the specific detailed sections later in this chapter in relation to advice, insurance, member movement and engagement in MySuper products. Other aspects of MySuper products are also covered in later chapters of this report.

Recommendation 1.7

The SIS Act should be amended to require trustees of MySuper products to satisfy objective criteria relating to:

- (a) APRA licensing;
- (b) Acceptance of contributions;
- (c) Single, diversified investment strategy;
- (d) Absence of costs cross-subsidisation;
- (e) Buy and sell spreads;
- (f) Switching fees;
- (g) Fee discounts;
- (h) Performance-based investment management fees;
- (i) E-super disclosures;
- (j) Retirement income stream product;
- (k) Entry and exit fees;
- (l) Benchmarking;
- (m) Intra-fund advice;
- (n) Insurance;
- (o) Absence of commissions and like payments; and
- (p) Member engagement.

3.3 MySuper structures

3.3.1 Legal

The integrity of the MySuper concept requires that trustees would generally not be able to present a prospective member with choice between different MySuper products. Choices can be made outside the MySuper environment. Generally, there would be only one MySuper product in each RSE.

However, the Panel recognises that there would be situations where a trustee would have multiple distinctly-branded products within a single RSE legal structure. In those circumstances, one MySuper would be permitted under each brand name.

The Panel also recognises that there might be situations where a master trust could have multiple MySuper sub-funds to reflect the fact that it is serving a range of different employers. An employee

of any particular employer could, however, only be offered the one MySuper product and not a range of them. Similarly, an employee could only be defaulted into a single MySuper product. In some structures, the same MySuper product could be offered at different price points reflecting differences in the scale of employer participation. The over-arching principle is that a member is only presented with, or defaulted into, the one MySuper product.

3.3.2 Operational

The Panel does not seek a complete separation of a MySuper product from other aspects of a fund's operations (for example, any other superannuation products and any investment options). The Panel would not envisage that a trustee would be required to undertake separate mandates for MySuper investments as opposed to investments for choice products. The Panel wants trustees to keep the synergies available from treating MySuper and choice members as a single pool for administration and investment purposes, where appropriate. This would allow trustees to get the benefits of economies of scale and bulk purchasing power. It would also not prevent trustees from using pooled vehicles. Of course, a trustee would be free to operate MySuper as a separate, stand-alone asset pool if it chose, subject to being able to obtain the scale required to deliver a cost-effective product. All these matters would be for trustees to assess under their optimisation duty.

3.3.3 MySuper separately audited accounts

In its second Phase One Preliminary Report on MySuper, the Panel articulated a view that MySuper would require separate audited financial statements. The Panel's concluded view is that the outcomes reporting standards (as discussed in chapter 4) could produce a better outcome for all stakeholders, but that a level of assurance by way of audit would still be required. The mechanism by which this would occur should be specifically addressed in the outcomes reporting standard which will follow extensive industry consultation.

3.3.4 Unit prices and crediting rates

The Panel has decided not to intervene in the debate about whether unit pricing or crediting rates is a superior method of crediting and valuing interests in a super fund. The Panel does not see that MySuper necessarily calls for one approach or the other. Both methods seek to serve the same purpose. This is more of an operational issue better left to the trustees under the existing regulatory framework.

4 ADVICE

4.1 Concerns with current arrangements

The Panel is fundamentally opposed to the 'bundling' of advice with superannuation products, other than intra-fund advice. By bundling the cost of advice into the price of the product, and by having that cost incurred on an ongoing basis, members do not appreciate the true cost of the advice and may pay much more for the advice than it is worth. Also, members' choices in this regard are limited; they generally cannot opt-out.

Conceptually, given that there are relatively low barriers to entry in the advice market, any excessive advice fees should be driven down through competition. However, there are concerns that the

advice market is imperfect such that this does not occur. This is most pronounced where a component of a member's fees may be distributed to a financial adviser even though the member has not met the adviser or received any advice.

Further, the adviser has an incentive to recommend products that pay commissions, or pay higher commissions, rather than products that do not. Some advisers also receive other incentive payments based on the volume of products they recommend to clients. This is often compounded in the sense that members might not be aware of the relationship between their adviser and the product provider. Many of the larger corporate groups use various 'brands' to target different market segments or adviser types. While large financial institutions have both product-making and distribution by financial advisers in the single corporate group, the financial adviser group often has a different branding from the institution itself. Consequently, these interrelationships, and the associated potential for conflicts of interest, are often not readily apparent to members. This makes it difficult for members to assess the impact of these conflicts on the advice they receive.

The Panel is also concerned where members receive information and advice in a collective fashion, rather than individually.¹⁶ As an example, fund members might be invited to attend a workplace seminar. In these circumstances, members might pay for the cost of this information and advice, whether or not they want it and whether or not they attend.

Lastly, there are circumstances where advisers help employers choose a default fund or default insurance settings and the like. These services and their cost is typically bundled into the overall fee a member pays, raising concerns over whether the benefits the members receive from these services exceed the costs. There is also a more fundamental problem being that members should not pay for services provided to an employer (as opposed to the trustee) under any circumstances. Such arrangements need to dissect more transparently what costs are properly payable by the employer and which ones are payable by the trustee, and then ultimately by the members through administration fees.

4.2 No 'bundled' advice

Reflecting these concerns, the following aspects concerning advice would be objective criteria for a MySuper product.

MySuper trustees would have a duty to optimise overall costs to members. Accountability and transparency in costs would therefore be paramount. Accordingly, advice (other than intra-fund advice) should not be bundled with MySuper products. The costs of providing superannuation advice services (and other services) provided to employers also should not be bundled into member charges or paid from member accounts in MySuper products under any circumstances. An employer should pay for advice services provided to it (which would be tax deductible as a business expense), rather than the fund members. Services provided to the trustee can, of course, be passed on to members as part of explicit fees such as the administration fee.

This is also an area in which the Panel is concerned not to create regulatory imbalances or opportunities for arbitrage between MySuper and choice products, including SMSFs. The Panel therefore considers that there should also be no bundling of advice in relation to any choice sector products and including products offered to SMSFs. The Panel notes that removal of the capacity to bundle advice services with superannuation products will not affect a fund trustee's intra-fund advice facility.

Outside the intra-fund advice model, it should be up to members to ask for advice. Employers would still be able to arrange for advice services to be offered to members, but members would have to opt-in to this arrangement. For advice about superannuation, the member would have to agree in writing for any fee to be deducted from their account and the payment would have to relate solely to advice about superannuation.

Recommendation 1.8

Neither advice to members (other than intra-fund advice), nor advice to employers should be 'bundled' with MySuper products.

Recommendation 1.9

Advice to members of a MySuper product (other than intra-fund advice) should only be provided on request and trustees should only be able to deduct the costs of advice about superannuation from a member's account with the member's written agreement.

Recommendation 1.10

The cost of advice or services provided to employers should not be borne in any way, directly or indirectly, by MySuper members.

Recommendations relating to advice in the choice sector are in section 9 of this chapter.

4.3 No up-front or trailing commission or ongoing payments

Payments for advice to fund members in the form of product-based up-front or trailing commissions or other like payments raise real and potential conflicts of interest that could have no place in relation to a MySuper trustee's fully member-focussed duties. The Panel notes the Government has decided to ban commissions more widely in the *Future of Financial Advice* reform package. This package outlined the Government's decision to remove conflicted remuneration structures generally from financial services. Although those reforms would extend to superannuation, the Panel is particularly of the view that a ban on payments of these kinds would be necessary to be consistent with the duties of a MySuper trustee.

Recommendation 1.11

Trustees of MySuper products should not:

(a) pay or fund any product-based up-front or trailing commission or other similar payment;
or

(b) make or fund any payment that relates to volume,

in respect of superannuation advice or other products or services provided to members.

4.4 Annual renewal of advice contract

The ability of a fund trustee to permit the cost of superannuation advice to be paid from the member's fund account under the sole purpose test helps to ensure that advice remains accessible to those who cannot afford to pay for it from other sources.

However, the Panel believes that there should be an opt-in regime so that MySuper members are in control. Under this regime, any arrangement for superannuation advice to the member could only operate for a period of no longer than 12 months, after which time it would lapse if not expressly renewed. Anti-avoidance rules would be necessary to prevent arrangements designed to have clients committing to payments over a longer period.

Any arrangement by a member for ongoing advice about their superannuation would have to be renewed in a standard form, akin to an annual insurance renewal, with full disclosure of the estimated cost to the member of continuing the arrangement for up to another year. Where possible, the renewal notice should be provided electronically. There should always be the option of paying for the advice on a fee-for-service basis and from sources outside the member's super account, and the same renewal requirements would apply in those cases. It would not be permitted for the standard form to be incorporated with any other information.

The Panel notes the *Future of Financial Advice* reform package requires that if an adviser is to provide an ongoing service, the adviser must send an annual renewal notice to the client. Although those reforms are intended to apply in relation to any financial services, including superannuation, the Panel is particularly of the view that an annual renewal regime would be necessary in MySuper.

Recommendation 1.12

Members of MySuper products should only be provided with advice about superannuation (other than intra-fund advice) under arrangements that require the member to renew the advice service each year on a renewal notice from the adviser.

Recommendation 1.13

ASIC should, in consultation with industry, devise a standard form which requires clear identification of the advice service to be provided where a fund member renews an ongoing advice service.

5 INSURANCE

The following aspects concerning insurance would also be objective criteria for a MySuper product. A further discussion of insurance in superannuation is in chapter 5.

5.1 No up-front or trailing commission or ongoing payments

In a MySuper product, the premium paid for insured member benefits would not be allowed to include or fund up-front or trailing commissions or like payments in connection with any group

insurance arrangement. This would not prevent a trustee paying brokerage for services rendered to the trustee by a broker or agent on a fee-for-service basis.

The Panel notes that, in the *Future of Financial Advice* reform package, the Government has announced its intention to remove conflicted remuneration structures generally from financial services, including superannuation, but not, at this stage, in relation to risk insurance (including group insurance). The Government noted that policy concerns in relation to affordability of insurance and under-insurance of the population would need to be explored and further consultations undertaken.

As with commissions for financial advice, commissions on group insurance policies raise real and potential conflicts of interest that have no place in relation to a MySuper trustee's duties. The Panel, for its part, is of the view that concerns in relation to affordability and under-insurance are less relevant in the specific context of MySuper products and the duties under which MySuper trustees would be required to operate. The removal of commissions in relation to insurance is also consistent with the removal of commissions for advice in MySuper products, and forms an integrated approach to removing unwarranted costs that adversely affect the financial outcomes delivered to members. On this basis, the Panel maintains its view that in a MySuper product group risk insurance premiums should not be allowed to include or fund an up-front or trailing commission or like payment.

Recommendation 1.14

Trustees of MySuper products should not pay premiums for insured member benefits that include or fund an up-front or trailing commission or like payment.

5.2 Death and TPD insurance

Death and TPD insurance (subject to availability of cover) would have to be offered on an opt-out basis in MySuper products: that is, cover would be automatic unless the member chose to opt-out. The member could opt out at any time. Cover would also be able to be increased above the default level of cover at member election. There would not be a minimum specified level of cover; trustees would retain their traditional responsibility to set an appropriate minimum default and maximum optional level of cover to suit its member demographic and balance that against the impact of premiums on the accrual of member's final retirement benefits.

5.3 Income protection insurance

The Panel believes that MySuper trustees should have the option, but not the obligation, of offering income protection (salary continuance) insurance in support of temporary disability benefits on an opt-out or opt-in basis, if they believe that it is in their members' interests to do so.

5.4 Other types of insurance

The Panel believes that there should be limits on a MySuper trustee providing insurance that is not directly related to building retirement savings out of a member's superannuation. Therefore, a MySuper trustee should not be able to offer trauma insurance and other types of cover.

5.5 Risk pool

Consistent with the Panel's view that MySuper is aimed at transparency of outcomes and not physical barriers, it should be possible for MySuper members to be in the same pool as other members for the purposes of pricing the risk attaching to group life or other types of insurance.

5.6 Aim of uniform coverage

The Panel's aspiration is that insurance coverage in MySuper products be provided on an automatic acceptance basis. Preferably, coverage would also be generic, in that there would be no difference in coverage whether a member were to join a MySuper product through a 'default' process or by virtue of the member's own decision. However, the Panel recognises the scope for cross-subsidisation where people can benefit from there being no requirement to demonstrate health, as currently occurs in default arrangements, and that this may require further industry consultation.

6 MOVEMENT OF MYSUPER MEMBERS

The Panel expects that some MySuper members might wish to make investment choices through some level of participation in the choice sector. MySuper is not 'all or nothing'. It would be possible for a member to have part of their superannuation in a MySuper product and the rest in, for example, an international equities investment option in a choice product offered by the same trustee or in another fund altogether.

Of course, a MySuper trustee would always comply with legislative obligations to transfer a member's benefits, such as those in relation to the payment to the ATO of the benefits of certain former temporary residents and lost members. MySuper products would also operate consistently with the wider family law and super arrangements. Otherwise, the Panel believes that, in general, a member should not be moved from a MySuper product other than by way of the member's active choice. The aspects below in relation to the involuntary movement of MySuper members would also be objective criteria for a MySuper product.

6.1 Member choice

There should be very few barriers to a trustee giving effect to a member's choice to move some or their entire super out of a MySuper product, if that is what they want to do. This should be treated as just another piece of fund administration to be done efficiently. The Panel is very keen to see an end to efforts by trustees to delay (or frustrate) the wishes of members to move to another fund.

6.1.1 Recommendations by advisers and trustees

There would, however, be some important protections for members making a decision to move out of MySuper. Where a financial adviser recommends that a member switch out of a MySuper product into an alternative superannuation product, the Panel believes that requirements at least as robust as those in section 947D of the Corporations Act would be required. These would ensure the advice covers such aspects as charges the member would incur, pecuniary or other benefits the member would lose and other significant consequences. This would be required whether the alternative

product is within a suite of products offered by the same trustee under a single RSE umbrella or is a completely separate product offered by a competitor.

Switching advice requirements would also apply to a trustee's recommendation. In providing advice, the trustee would be under a range of obligations directed at the member's best financial interests in MySuper. The purpose of MySuper would be quickly defeated if trustees could induce members to switch to other choice products offered by the trustee that were either equivalent to MySuper, but carried higher fees or were inferior or unsuitable for some reason.

The Panel notes that the measures announced by the Government in the *Future of Financial Advice* reform package also move in this direction. Under those reforms, financial advisers would be under a duty to act in the best interests of their clients.

Recommendation 1.15

Legislation should apply specific and thorough conduct and enquiry duties on persons (including trustees) providing switching advice to a MySuper member built on the current requirements of section 947D of the Corporations Act.

6.1.2 Moving back to MySuper

A member might also decide to switch those benefits back to MySuper. The Panel sees this occurring in much the same way as it does now. The move back to MySuper should involve even less administration and would not call for the member being treated in any way differently from other MySuper members merely because the member had made a 'choice' to move or had made a 'choice' to return.

6.2 Transfer to an ERF

A MySuper trustee would be able to transfer members to an ERF without the members' active choice. This is consistent with current provisions in the SIS Act in relation to all super funds.¹⁷ All ERFs would be required to operate under standards very similar to those proposed for MySuper. ERFs are discussed further in chapter 10.

6.3 Flipping

'Fund flipping' describes the practice of a member being automatically moved from one division of a fund to another (generally to a 'personal' division or plan) on cessation by the member of the particular employment to which the original fund division related. Generally, the personal division will have higher fees and may involve a decrease in insurance cover or an increase in the premium charged.

Fees in a corporate division can often be lower than in a personal division in the same fund because the employer usually subsidises costs for its active employees and, when in a retail fund, the employer can use its purchasing power to negotiate discounted fees for its employees. On ceasing employment, the member no longer enjoys those benefits and is 'flipped'.

Some unsatisfactory practices have arisen from flipping. Members often have no 'grace period' after termination of employment in which to provide the trustee with instructions concerning transfer of their benefit and thereby avoid the higher fee. Also, disclosure about this practice is often inadequate and members do not know it will happen or has happened.

However, the Panel recognises there would be scope for flipping in MySuper products in master trusts. The Panel believes that a member could be moved from a MySuper product without the member's active choice where the member is flipped to another MySuper product in the personal division of the corporate master trust.

The inbuilt criteria of a MySuper product, at both ends of this member movement, would remove many of the concerns identified with flipping. The Panel believes that this would be a matter for the trustee whether a MySuper corporate master trust product engages in such flipping; the trustee could decide to retain the member and accumulated balance in the original MySuper corporate master fund product.

6.4 SuperStream auto-consolidation

Arrangements for the auto-consolidation of accounts within the same fund, without prior reference to the member, are recommended in chapter 9. To the extent multiple accounts for the same member are found in a MySuper product, such auto-consolidation would be highly appropriate. Chapter 9 also canvasses arrangements for account consolidation, on an opt-out or opt-in basis, across all large APRA funds to the fund with the latest contribution. These arrangements would ensure any member could keep their MySuper membership if they were to move part of their balance into the choice sector and, if desired, retain a previous MySuper membership after a change of employment and a decision to enter a choice sector product.

The Panel does not see much potential for the misuse of auto-consolidation in advice to MySuper members (that is, the possibility that an adviser recommends the creation of a new account without regard to other accounts, knowing that auto-consolidation will sweep them up), particularly if an opt-out model is ultimately adopted. The advice could not properly ignore the possibility of the client having existing super accounts. In the *Future of Financial Advice* reform package, the Government has announced that financial advisers would come under a duty to act in the best interests of clients, and chapter 9 recommends that the ATO develop a mechanism to display all funds of which a person is a member. The Panel therefore believes that these regulatory settings should provide sufficient protection.

Recommendation 1.16

Members should only be able to be moved involuntarily out of a MySuper product if they are:

- (a) transferred to an ERF;**
- (b) flipped from a MySuper product in a master trust to another MySuper product in another division of that trust; or**
- (c) transferred under legislative requirements such as auto-consolidation of accounts or temporary resident arrangements.**

7 MEMBER ENGAGEMENT

The aspects below illustrate a feature of a MySuper trustee's duty in relation to the optimisation of costs and performance, and describe another objective criterion for a MySuper product.

7.1 Trustees' focus on engagement

Currently, there is a range of approaches to encouraging members to be more engaged with their superannuation. Some trustees offer intra-fund advice (which has only been available since mid-2009) and will now be specifically required in MySuper. Other communications by trustees to members are closer to advertising and less obviously in member interests. Some trustees engage in a substantial amount of outright advertising. The Panel believes that, in MySuper, trustees need to be more focused on the intent of engagement with members and its tangible benefit to them.

The Panel certainly does not intend to deny members access to information or to enforce a level of disengagement in an effort to reduce costs. This is not to say that the Panel is opposed to efforts to get members to take more responsibility for their retirement; far from it. The point is that these initiatives cost money and trustees need to be accountable for their effectiveness. The Panel is seeking to make trustees accountable for overall costs to members with the result that some practices carried out in the name of member engagement might be more difficult for trustees to justify.

The Panel envisages that MySuper would result in a greatly enhanced environment for those members who are engaged or want to engage with their superannuation, arising from a combination of the following:

- (a) the e-super disclosure measures mentioned above would make comprehensive information about the MySuper product readily available;
- (b) the MySuper trustee's intra-fund advice facility, as expanded by the *Future of Financial Advice* package, would mean that all MySuper members would have access to information and advice direct from their trustee, and the Panel envisages this being offered pro-actively in some cases;
- (c) the mandatory provision of forecasts about likely retirement benefits, discussed in section 7.2 below; and
- (d) greater transparency imposed on all funds by other measures recommended by the Panel in chapter 4, including performance measurement and information about the wider fund, including the fund's trustee.

These measures would reduce the need for other, less relevant, engagement with a corresponding reduction in costs to members.

7.2 Forecasts of retirement benefits

The Panel believes that possibly the biggest engagement hurdle is getting members to understand whether their current contribution strategy is likely to provide them with an adequate income in retirement. This involves the multi-tiered challenges of focusing them on future events, current

savings habits and the conversion of their lump-sum thinking into ‘replacement rate’ thinking; what proportion of their current income will they need to live on in retirement?

Forecasts of retirement benefits (also variously described as ‘end benefit projections’, ‘retirement projections’ or ‘superannuation forecasts’) aim to provide super fund members with an indication of the value of their ultimate retirement benefits. The Panel agrees with widely held sentiments in the industry that these projections can help educate fund members about the adequacy of their current super savings and can help members make choices that will help them achieve financial security in retirement.¹⁸ However, forecasts of retirement benefits are not about comparing the potential performance of different funds and should not be structured to suggest this. Comparing funds is a separate endeavour and is discussed in chapter 4.

The Panel considers that the relative simplicity of a MySuper product would support a single standardised system for retirement projections for use by all MySuper trustees. A forecast of retirement benefits would also have a natural synergy with the intra-fund advice facility. There would also be clear value in a forecast being actively presented to members, as a routine part of a MySuper members’ annual statement. This is a key member communication and the important purpose and message of these forecasts would be far less likely to be achieved through indirect means, such as a link to a calculator. For this reason, in chapter 7, the Panel also recommends that a MySuper trustee must pro-actively offer intra-fund advice to members when they get close to retirement and at intervals in retirement.

Many features appropriate for MySuper forecasts of retirement benefits have been identified in ASIC’s consultations in respect of benefit projections.¹⁹ The Panel is aware of submissions to ASIC from sections of the industry critical of some of these aspects. However, the Panel firmly believes standardised retirement projections are the best way to seek to raise members’ awareness of their likely financial position at retirement and prompt them to seek out other information, consider their options and make informed choices about their contribution rate and length of time in employment. On this basis, a MySuper retirement projection would:

- be provided in relation to a member’s account balance and a set uniform retirement date;
- not consider any entitlement to the age pension or any other superannuation account;
- assume no change to current salary for SG contributions outside set assumptions for inflation, and assume no change to current personal contribution levels;
- assume current taxation and other legal conditions remain unchanged;
- utilise a single set of annual assumptions for investment earnings, insurance premiums, fees and costs across all MySuper funds, developed by government in consultation with the industry and the actuarial profession;
- be accompanied by suitable standard warnings and disclosures including, for example, in relation to how the age pension and other assets also determine final retirement income; and
- present the projection as an amount in current-day dollars.

Retirement projection would also be best presented in the form of both a final account balance and an annual income stream, to assist members to understand their superannuation savings in terms of

the 'replacement rate' in relation to current employment income. However, this would need to be developed further in conjunction with the development of the MySuper retirement product.

Recommendation 1.17

The presentation of retirement forecasts should be mandatory for MySuper products, and should be developed in consultation with industry in accordance with the approach identified by the Panel.

8 IMPLEMENTATION

The Panel expects many existing funds would wish to offer MySuper products to continue to participate in the SG and award 'default' framework. The kinds of issues that arise in the transition to the new choice architecture model and, in particular, in relation to the implementation of MySuper will inevitably give rise to a number of issues arising from individual circumstances. While the Panel acknowledges this is ultimately a matter for Government and further consultation, in this section the Panel outlines its thinking on some of those issues.

8.1 Some key implementation issues

8.1.1 Conversion

It is a core aim of the MySuper proposal to ensure that an existing default fund or default investment option can be modified to conform with MySuper product requirements with minimal disruption and transition cost.²⁰ It is therefore not the Panel's intention that MySuper could be achieved only through setting up a new MySuper RSE.

The Panel does not consider that implementation should be thought of as a single 'big bang' conversion that could potentially take the fund off-line for weeks or months. There are synergies between MySuper features that mean that movement towards 'conversion' can involve several interconnected aspects at once. Similarly, systems changes that relate to MySuper would be made in conjunction with those required by the Panel's SuperStream recommendations in chapter 9.

An initial step for trustees would be whether the fund's existing default investment option could be the basis of conversion into a MySuper product. Some default investment options would not be able to convert immediately to MySuper because of existing contractual arrangements which cannot be overridden, such as commissions (whether for advice or on insurance products) and certain insurance policies. The Panel expects that funds that currently have investment options would want to retain them and the transition could involve the conversion of a fund into both MySuper and choice products.²¹ Depending on scale, the trustee may need to consider whether the MySuper product needs to merge with other funds and, if so, explore options as to how that might happen.

If a trustee decides to have MySuper and choice products in the same fund, there will be necessary alterations of the trust deed (with prospective effect) to reflect multiple products. The governing rules would need to ensure that the interests of members of one product are separately identifiable from the interests of members of the other product. While some of this might be achieved at

generic level by legislation, trustees would still determine what, if any, consequential changes might be required.

8.1.2 Initial member placement

Although new employees would be in a MySuper product unless they made an active choice in favour of a choice product, trustees would need placement strategies for existing fund members until otherwise directed by the member. These would include:

- (a) members with benefits wholly in the default investment option could be placed into the MySuper product;
- (b) members with benefits spread over a default option and other investment options could be placed in both the MySuper product and the choice product, with the trustee obliged to give effect to any existing arrangement to split future employer SG contributions between the products; and
- (c) members with no benefits in the default investment option could be placed into a choice product based on their selected investment option.

8.1.3 Timing

Implementation would involve at least a two-year transition period from passage of legislation to establish the new choice architecture. Trustees intending to offer a MySuper product would need to develop or enhance the fund's website, e-communications and intra-fund advice capabilities. APRA licensing and the finalisation of APRA prudential guidance would also be required. Time for transition should also mean that current insurance policies can expire and be re-negotiated on terms consistent with MySuper, including that a member can withdraw from cover at any time and that no commissions are involved.

Modern awards are set to be reviewed in 2014 and the date from which SG Act and award defaults funds would have to be a MySuper product could be an effective 'deadline'. This also means industry would be able to pre-position aspects of funds before the end of any formal legislative timeframe.

8.2 Supervision of implementation

The Panel also considers it would be appropriate for there to be close regulatory oversight of the transition to the new choice architecture and MySuper. It would be important to reduce the possibility of groups of members to which MySuper is directed being inadvertently overlooked. There might be potential for APRA licence conditions that aim to ensure the transition into MySuper products is as easy as possible.

The Panel also believes that ASIC should conduct an information and surveillance campaign aimed at trustee and adviser behaviour in the period leading up to the implementation of MySuper.

Recommendation 1.18

The superannuation industry should have at least two years to transition to MySuper and the new choice architecture.

Recommendation 1.19

Both APRA and ASIC should oversee the transition referred to in Recommendation 1.18.

9 CHOICE PRODUCTS

9.1 The new choice architecture

The major difference in the choice architecture model is the clear distinction to be made between MySuper and choice products, as either may be offered by large APRA funds. The Panel's broad starting point in relation to the choice architecture model is that, as far as is reasonably possible, if the trustee of a large APRA fund does not wish for a product to comply with MySuper or ERF criteria, the product should continue to operate much as it currently does.

A choice product trustee would be able to determine the extent to which it differs from a MySuper product in relation to the offer of investment choices, intra-fund advice or retirement products, among other features. This is appropriate and will allow the creation of a competitive choice sector. Of course, this must be read alongside the Panel's recommendations in this and later chapters that relate to wider systemic features that cross product sectors. Recommendations in relation to trustee governance, transparency and insurance, among other things, would also clearly affect choice products and MySuper products.

9.2 Entry and exit fees

The Panel has recommended above that, for MySuper products, there should be no entry (contribution) fees, including on rollovers, and exit fees could only be charged on a cost recovery basis. These are areas in which the Panel is concerned not to create regulatory imbalances or opportunities for arbitrage between MySuper and other products. Accordingly, the Panel also considers these should also be features of choice sector products.

Recommendation 1.20

Trustees of choice sector products should also not be able to charge entry fees and should only charge exit fees on a cost recovery basis.

9.3 Advice

The Panel's concerns with the bundling of advice apply as much to products in other sectors of the choice architecture model as to MySuper products. The Panel especially considers that in any type of product an employer should pay for advice or other services provided to it and not the member.

This is also an area in which the Panel is also concerned not to create regulatory imbalances or opportunities for arbitrage between MySuper and other products, including SMSFs. Accordingly, the Panel considers its recommendations with respect to bundling, provision of advice, up-front or trailing commission and advice service renewal should also apply to products in all sectors of the choice architecture model.

Recommendation 1.21

Neither advice to members (other than intra-fund advice), nor advice to employers should be bundled with choice products or with any other product in the choice architecture model, including products offered to SMSFs.

Recommendation 1.22

Advice to members of a choice product or of any other product in the choice architecture model (other than intra-fund advice) should only be provided on request and trustees should only be able to deduct the costs of advice about superannuation from a member's account with the members' written agreement.

Recommendation 1.23

The costs of advice to employers should not be borne in any way, directly or indirectly, by members of choice products or by members of any other products in the choice architecture model.

Recommendation 1.24

Trustees of choice products or of any other product in the choice architecture model should not:

- (a) pay or fund any product-based up-front or trailing commission or other similar payment;
or**
- (b) make or fund any payment that relates to volume,**

in respect of superannuation advice or other products or services provided to members.

Recommendation 1.25

Members of choice products or of any other product in the choice architecture model should only be provided with advice about superannuation (other than intra-fund advice) under arrangements that require the member to renew the advice service each year on a renewal notice from the adviser.

The Panel notes that the *Future of Financial Advice* reform package announced by the Government would reduce the extent of differences between MySuper and choice products in areas such as commission-based remuneration practices and advice service renewals.

9.4 Insurance

Similarly, the Panel considers that its recommendations in relation to up-front payments or trailing commissions should also apply to products in other sectors of the choice architecture model.

Recommendation 1.26

Trustees of choice products or of any other product in the choice architecture model should not pay premiums for insured member benefits that include or fund an up-front or trailing commission or like payment.

9.5 Forecasts of retirement benefits

Although recommending these forecasts be mandatory for MySuper products, in the longer term the Panel would also like to see retirement projections as a feature of choice products, and so across all large APRA funds. The introduction of retirement projections into MySuper products would be the start of this process. The Panel agrees that as account balances increase, the provision of information of this type will become increasingly important.²²

Presumably also, as some of the measures recommended in chapter 4 become well-established, there could be some scope for funds to move to projections that are specific to the investment objectives and other characteristics of individual MySuper products and choice investment options, but the Panel sees that as some way off at the moment.

9.6 Investment option duties and protections

The new duties the Panel proposes for trustees of MySuper products are explained in this chapter 1, and chapter 2 deals with trustee governance generally. This section deals with different investment governance settings proposed for trustees in the 'choice' environment where members are making decisions about where to invest their retirement savings.

Currently, trustees are required to formulate and give effect to an investment strategy that takes into account the entire circumstances of the entity, including the risk and likely investment return from investments of the fund, the diversification of those investments, liquidity requirements and the ability of the fund to discharge its liabilities. These considerations are directed at ensuring that

fund assets are not placed at excessive risk from asset concentration and that there is sufficient liquidity for outgoing funds.

While trustees are responsible for formulating an investment strategy for the fund, members can direct the trustee to follow an individual investment strategy, by selecting from one or more of the investment options made available by the trustee. This has led to some uncertainty as to whether the trustee is responsible for the appropriateness of the investment or investment mix chosen by the member. The new choice architecture model, and the very clear requirement for diversification in MySuper products, offers a new framework to consider a different scope for the role of trustees that offer investment choices.

9.6.1 Trustees and diversification

In seeking to establish suitable policy settings, three challenges exist.

First, there needs to be a balance between the ability of members to choose investments and the responsibility of trustees to ensure that investment options are appropriate for members. Secondly, for some people, maximisation of retirement income involves consideration of investments across their entire asset portfolio, rather than just across their superannuation assets alone.

Lastly, diversification needs to be defined in a way that takes risk into consideration, rather than just a mix of assets.

The Panel has considered three broad options along a spectrum of weaker to stronger constraints on members making undiversified investment choices.

Option 1: Choice trustees required to offer a suite of investment options that allow members to diversify across asset classes, but members can choose to be undiversified

In formulating the fund level investment strategy, trustees would decide the type and number of options to offer to members. The range of options must be sufficient to allow members to obtain a diversified asset mix if they choose. The trustee must be satisfied that each option is 'fit for purpose', that it is suitable to be offered as part or the whole of an individual's retirement saving strategy. Members could then direct the trustee to follow any strategy selected or constructed by the member from the options offered by the trustee. The trustee would have no obligation to assess the appropriateness of the investment strategy for the member.

Having a range of investment options would allow well-advised members to optimise their portfolio across all their assets, in and outside superannuation. Members could adopt an investment strategy that changes their investments over time in line with changes in their needs and tolerance for risk over their life cycle.

However, undiversified investments are, in themselves, riskier. There is also the risk that some members might end up in the wrong investment strategy through poorly informed or advised choices.

Option 2: Choice trustees could offer undiversified investment options, however members must give written acknowledgement before investing

Members who wish to choose an undiversified investment strategy would be able to do so by giving a written acknowledgement. This would place greater emphasis on the importance of the decision and the risks involved.

This approach would not impair a member's control over their superannuation investments, while protecting those members who prefer to choose from investment options that satisfy the investment strategy requirements.

Option 3: Choice trustees and members would have to comply with mandatory diversification requirements

Under this option, choice trustees would need to ensure members' investment choices are appropriately diversified. This would reduce the risk of financial loss from poorly informed choices, but would limit the ability of members to choose how to invest their superannuation in the choice environment.

Some people would be unable to optimise their retirement income because they would have less scope to tailor their superannuation investments in light of their overall financial position (for example, substantial savings outside super). This would limit the choices available in the choice sector. It is also inconsistent with current industry practice and would therefore result in significant compliance costs.

On balance, the Panel prefers option 1 on the basis that it is appropriate to allow members of choice funds to select undiversified investment options, subject to certain safeguards that are discussed below.

9.6.2 Trustees and due diligence 'safe harbour'

Given the Panel's view above, it also considers that, generally, a choice trustee should be able to operate in an environment that gives it protection in relation to the consequences for the member of any lack of diversification in the option(s) selected by the member or in the event that the chosen option itself causes the member to suffer loss.

However, the Panel considers that such protection should only be available where the choice trustee has complied with an appropriate standard of due diligence in making investment options available for selection by fund members and in monitoring them. This duty would include aspects such as:

- a requirement for initial due diligence to understand the nature of the underlying investments involved with the option and continued monitoring of the suitability of the option. This duty is likely to be magnified where the option is a managed investment scheme or other product designed and managed by others;
- obligations in relation to the liquidity of the underlying investments and structures, including to match the liquidity/maturity terms of the underlying products with the disclosed benefit portability regime; and
- a requirement for due diligence in relation to the legal structures of underlying investments and especially foreign-domiciled entities with no legal presence in Australia.

The Panel envisages that APRA would detail the trustee's due diligence obligations through a prudential standard and/or prudential practice guide.

9.6.3 What would the safe harbour look like?

APRA and ASIC could develop, in consultation with the industry, guidance on what steps would be reasonable in the circumstances for a trustee to carry out in placing an investment option on a menu and in carrying out ongoing monitoring of the investment option. This could then be developed to form part of the new package of trustee duties recommend in chapter 2, together with an appropriate safe harbour from civil liability.

Recommendation 1.27

Choice trustees must offer a range of options sufficient to allow members to obtain a diversified asset mix if they choose, but members can choose to be undiversified and the trustee would have no obligation to assess the appropriateness of the investment strategy chosen by the member. Trustees would be subject to new express duties in selecting and monitoring options.

Recommendation 1.28

A choice trustee that discharges its duties in selecting and monitoring investment options should not be exposed to civil liability in the event that a member suffers damage by reason of illiquidity or other circumstances affecting the investment option, including diminution in value or failure.

ENDNOTES

- 1 Part 1 of this report, Overview and recommendations, explains the basis of this projection.
- 2 Thaler R and Sunstein C, (2008) *Nudge - Improving decisions about health, wealth and happiness*, Yale University Press.
- 3 For example: Australian Institute of Superannuation Trustees, Submission no. 62, pp 24-25; AMP, Submission no. 59, pp 6-7; AXA, Submission no. 34, p 13.
- 4 It has been estimated by a number of research providers, academics and industry professionals that on average 80 per cent of members are in the default option: (i) SuperRatings: “some 82% of Australians accept the default position within their funds.” SuperRatings, Submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the Structure and Operation of the Superannuation Industry, September 2006; (ii) Choice: “Nine out of 10 super fund members are invested in their fund’s ‘default’ option.” Choice, ‘Super in a volatile environment,’ 12 May 2008 <www.choice.com.au>; (iii) PricewaterhouseCoopers: “80 per cent of members are in the default investment option.” PricewaterhouseCoopers (Tubman. W), ‘The Australian Wealth Management Industry: Global gold standard, or fool’s gold?’ April 2009 ; (iv) Gallery & McDougall: “Over 80 percent of members do not exercise choice and consequently, their superannuation assets are automatically invested in their fund’s default option” Gallery G., Gallery N., McDougall L., ‘Don’t Judge a Superannuation Default Investment Option by Its Name,’ 19 April 2010;
- 5 SuperRatings 2009 SR All Fund Median average member account balance was \$24,855.
- 6 Rice Warner Actuaries, Superannuation Fees Report 2008.
- 7 Part 1 of this report, Overview and recommendations, discusses the composition of default fund membership and the level of engagement in super generally.
- 8 IFSA, Submission no. 226, p 5.
- 9 Mercer (Australia) Pty Ltd, Submission no. 296, p 106.
- 10 Australian Industry Group, Submission no. 321, p 1.
- 11 ACTU, Submission no. 218, p 4.
- 12 There are also processes if an employer, employee or organisation covered by a modern award, or that is entitled to represent one or more of the employers or employees covered by the award, wants to apply to Fair Work Australia to vary a modern award to include a different default fund.
- 13 Survey of Superannuation Costs: To understand further the impact of fund size on superannuation costs, the Review commissioned Deloitte, assisted by Chant West, to undertake an independent survey of superannuation costs. The survey was influenced by the number and representativeness of funds that responded to the survey and the difficulties in adjusting for outlying results and other factors such as asset allocation or investment style. In light of this, the Panel has decided not to rely on this analysis in forming its conclusions. That said, the results are consistent with other evidence of substantial economies of scale for fund administration. The survey showed that the smallest funds had the greatest potential economies of scale that could be experienced from increasing size. In other words, the results showed economies of scale were persistent, but at a decreasing rate. For the funds surveyed, there was no evidence of diseconomies of scale in terms of assets or members. For a member with an account balance of \$25,000, administration costs can be up to two-thirds of the fees that are paid from their account. Therefore, lower balance members are the most likely group to benefit from capturing the potential economies of scale, which would lower the cost of administration as funds become larger. Based on the average account balance size in the industry fund and retail fund sectors, the administration costs represent around half of the total cost of an account. It was not possible to adjust the results of the survey in relation to investment costs to account for different asset allocations and investment style.

- 14 See ASIC MR 09-119 Improved access to simple advice for superannuation fund members 9 July 2009 and ASIC Regulatory Guide 200 Advice to super fund members July 2009
- 15 Minister for Financial Services, Superannuation & Corporate Law & Minister for Human Services, Media Release No. 36 26 April 2010.
- 16 The provision of services in this manner is described generally the following submissions: Centric Wealth Limited, Submission no. 220; Capital Partners, Submission no. 115.
- 17 SIS Act Part 24.
- 18 For example: ASFA Submission no. 32, p 22 of Appendix 1; Institute of Actuaries of Australia, Submission no. 162, p 24; QSuper, Submission no. 86, p 7; Mercer (Australia) Pty Ltd, Submission no. 170, p 64; SPAA, Submission no. 205, p 26; ABA, Submission no. 238, p 22.
- 19 ASIC Consultation Paper 122, Superannuation forecasts, October 2009.
- 20 Funds that offer only investment choices will determine the extent to which they wish to participate in the SG and award 'default' framework.
- 21 While it is possible for a fund with investment options to convert wholly to a MySuper product, this is considered less likely.
- 22 Melbourne Centre for Financial Studies, Submission no. 169.