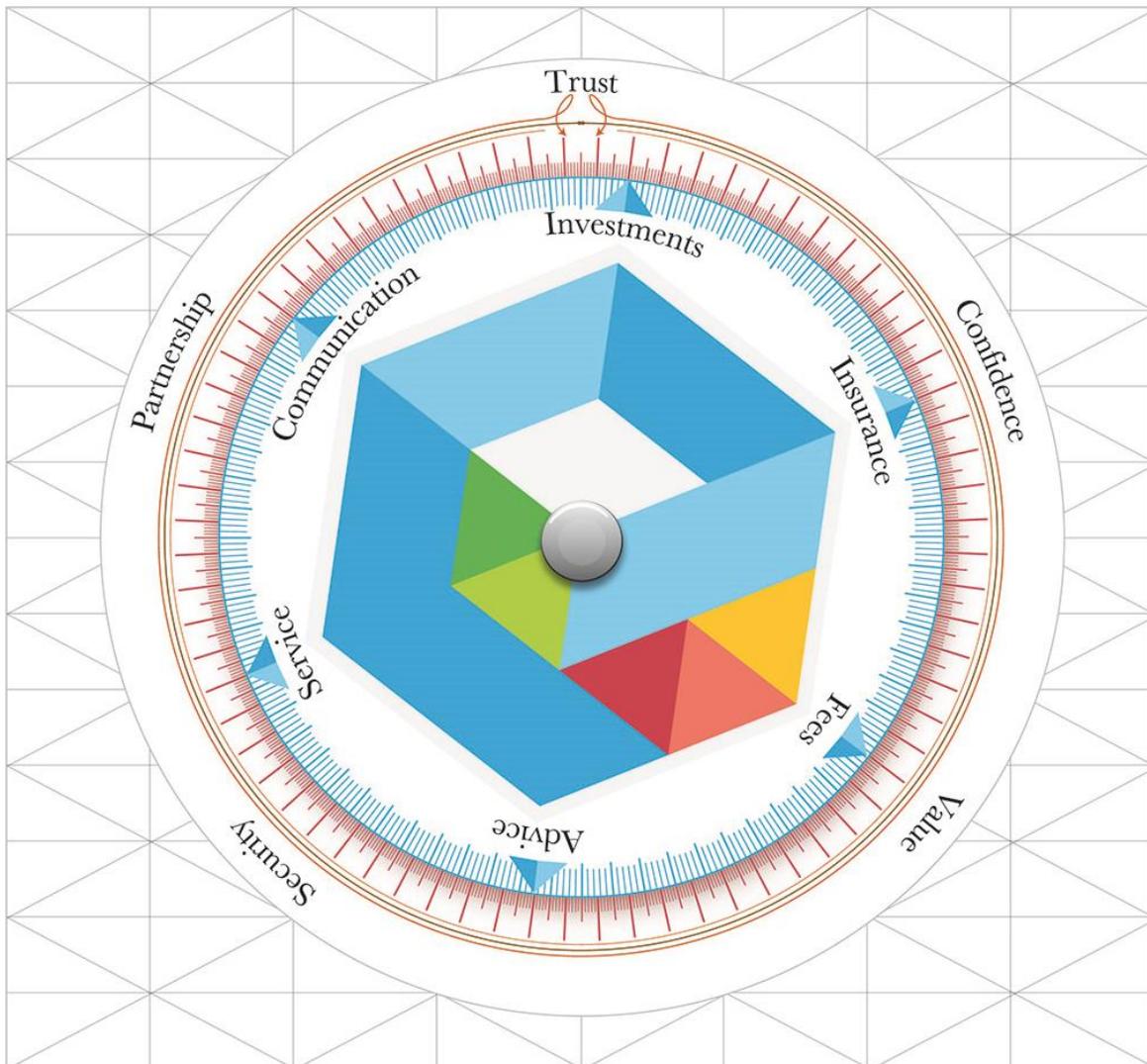


Financial System Inquiry

Submission in Response to Interim Report



August 2014

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About Equip

Equip is a multi-sector superannuation fund that has delivered confidence and financial security in retirement to members for over 80 years. The fund's members and employers are drawn from a cross-section of Australian commercial sectors. We manage \$6.5 billion in assets on behalf of about 50,000 members and provide financial planning services to a growing proportion of them.

As a public offer fund, Equip membership is available to any Australian over working age and we welcome nomination as the default fund for any workplace.

We have proven expertise as trustee for both accumulation and defined benefit superannuation plans. Over 80 corporate employers and thousands of smaller enterprises Australia-wide entrust management of their employee superannuation to Equip. Of those, over 40 have defined benefit plans, and over 1,000 members receive an income stream from the Fund. Equip is thus one of the largest 'hybrid' funds in Australia, and consequently brings to this submission views borne of operational expertise in the management of both forms of superannuation plans, as well as being a leading pension provider.

Preliminary Remarks

Equip welcomes the opportunity to contribute to the finalisation of the Financial System Inquiry (FSI) report, chaired by David Murray (Murray Inquiry), via this submission in response to the FSI interim report.

Equip is cognisant that it has been almost two decades since the release of the final report of The Financial System Inquiry 1996 (Wallis Inquiry). In the intervening time the Australian financial system has grown in terms of asset size relative to Australia's Gross Domestic Product (GDP) and in the nature and complexity of interactions between various actors in the system. Of particular relevance to Equip, and as the Murray FSI interim report details, superannuation has been one of the financial system's fastest growing sectors, with total assets increasing from \$300 billion at the time of the Wallis Inquiry to \$1.85 trillion as at 30 June 2014¹.

Shift in Understanding of Behavioural Drivers

One of the fundamental developments in policy formulation since the Wallis Inquiry is the acknowledgement of the importance of behavioural drivers in how individuals interact with the financial system. The lessons of behavioural economics and behavioural finance have moved from the fringes of academia and policy making at the time of the Wallis Inquiry to be prominent in the current Murray Inquiry. Commenting on the impact of the Global Financial Crisis (GFC) the FSI interim report notes:

*"Since the crisis, the emerging theory of behavioural economics has recognised that most individuals do not always act in an economically rational way. Behavioural biases can reduce the effectiveness of many traditional consumer protection approaches, which rely on the assumption that consumers will seek out and understand all relevant information before purchasing a financial product."*²

This shift is relevant insofar as much of the policy landscape and regulatory framework that developed after the Wallis Inquiry was predicated on the assumption that individuals, if availed of all relevant information via an appropriately rigorous disclosure regime, would be both *willing* and *able* to make optimal decisions as to their current and expected future welfare (the 'rational decision maker' policy approach). Examples of policy that developed under this approach include:

- The *Super for all: Security and flexibility in retirement policy* (1996) which increased the ability of employees to choose the superannuation fund into which their mandatory contributions would be made (broadly supported by the Wallis Inquiry);
- The finalisation in 2004 of regulations allowing the portability of benefits between different superannuation accounts;
- The full implementation in 2005 of choice of superannuation fund (Super Choice) legislation allowing new employees to nominate their preferred superannuation fund into which to receive super guarantee contributions;
- Various superannuation and taxation measures that have been broadly supportive of Self-Managed Superannuation Funds (SMSFs).

These and other relevant policy changes have resulted in a significant increase in consumer choice within the superannuation sector. Many superannuation providers, particularly in the retail space, have responded by increasing the menu of investment options available, surmising that if some choice is better than none, a great

¹ APRA, Quarterly Superannuation Performance, June 2014 interim edition.

² The Australian Government, *Financial System Inquiry – Interim Report*, July 2014 at 1-20

deal of choice must be better than a little. And yet eight years after Super Choice came into full effect, 69³ per cent of members are still in a 'default' fund, many of these in the default investment option within that fund.

Classical economics assumes that people are made better off when offered more choices, as long as they can always choose what they had before. Behavioural finance now gives us a richer understanding of the 'paradox of choice'. When people do not have the knowledge to make choices that are in their own best interests, increasing the number of choices does not necessarily make them better off. This is the dilemma that confronts the superannuation sector some two decades on from the Wallis Inquiry.

Scope of Equip's Submission

This submission will focus on two areas outlined in the FSI Interim Report, these being Superannuation (Section 4) and Retirement Income (Section 8).

In relation to Superannuation, Equip will focus comments, insights and suggestions to the following observation made within the FSI Interim Report [at 2-95]:

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

In relation to Retirement Income, Equip will focus comments, insights and suggestions to the following observations made within the FSI Interim Report:

"The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees." [4-8]

"There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees." [4-25]

³ Investment Trends 2013, *Member Sentiment and Communications Report*, June.

Superannuation (Section 4)

General Comments

The FSI interim report takes the view that Australia's superannuation sector has not achieved operational efficiency gains in line with its growth since the Wallis Inquiry. The interim report appears to place a significant reliance on recent work produced by the Grattan Institute⁴ to support its position. By way of example Chart 4.1 [at 2-100] depicts an international comparison of superannuation fund expenses, with Australia's fees being significantly higher than those of the two other systems with net assets in excess of (USD) \$1 trillion. Similarly, data provided in Chart 4.2 [at 2-102] suggests that whilst the average APRA-regulated fund has increased in size from less than \$500 million in 2002 to over \$3 billion in 2013, average fees have failed to benefit from economies of scale, falling only around 25 basis points during that time.

As a profit-for-member fund Equip is highly cognisant of the impact that fees can have on member benefits over the course of a working life (and thereafter in retirement). Equip is therefore broadly supportive of the general proposition that lowering fees would deliver tangible benefits to members whilst they interact with the superannuation system.

The comparison of fees involves significant complexity. Many of these complexities appear to have been overlooked by the FSI interim report. Equip proffers the following as reasons why a comparison of fees, both intra-system and internationally, needs to be undertaken in the context of the structure of Australia's superannuation system, policy settings and member behavioural drivers:

Dominance of Defined Contribution in Plan Design

Of the four largest pension systems in the world, Australia is the only one that is dominated by defined contribution (DC or accumulation) plans. According to Treasury data⁵, during the 1982-83 year 81.8 per cent of participants were members of a defined benefit (DB) plans, with only 18.2 per cent in DC plans. By 1999-2000 the ratios had effectively reversed, with only 13.9 per cent in DB plans and 86.1 per cent in DC plans. Defined contribution funds now account for over 90 per cent of total system assets.

The reasons for the relative demise of DB plans are well documented. The provision of universal superannuation coverage via first the broadening of award super and then the commencement of the *Superannuation Guarantee* legislation was the key catalyst for the move from DB to DC plans. This trend was given further impetus by the desire of many traditional DB plan providers (corporates) to reduce the balance sheet and operational risks associated with providing employees with DB superannuation arrangements.

Outside of the corporate funds, Equip is one of only a few superannuation funds that has a history of managing member benefits under both DB and DC arrangements. As a hybrid fund it is Equip's contention that, if the same scale is applied across both DB and DC, the operational costs of providing services to DC members in a choice environment is higher than for equivalent DB members and, scaled up over the entire super system, results in Australia's fee structure being significantly higher than equivalently sized international systems

⁴ Minifie, J Cameron, T and Savage, J 2014, *Super sting: how to stop Australian's paying too much for superannuation*, Grattan Institute, Victoria

⁵ The Treasury, *Towards higher retirement incomes for Australians: a history of the Australian income system since Federation*, 2001, Commonwealth of Australia

where DB funds dominate. Importantly, the cost of DB in the current system is driven by the declining scale as opposed to the operational cost of delivery.

Equip is in broad agreement with the FSI interim report finding that members have yet to fully benefit from economies of scale given the reduction in APRA-regulated funds (4,700 in June 1997 to 299 in March 2014). Equip contends however that part of the reason for this fee intransigence is the inherent design of DC plans, where members have choice in relation to investment options, switching between options and the ability to move accrued benefits to another DC fund (portability). Referencing the Preliminary Remarks earlier, the trade-off for greater individual choice is a more fragmented super system, with this fragmentation countering in part the benefits to be had from economies of scale.

Fee efficiency also differs markedly across the various superannuation segments in Australia. The Grattan Institute report, on cursory examination, paints the entire super system with the same 'high fee' brush. A more detailed review of its key findings however suggests a material difference in the fee structure across public sector, corporate, industry (profit-for-member) and retail (for-profit) superannuation funds. For instance Grattan notes that in a distribution of funds by type, only retail funds have fee structures in excess of 1.6 per cent on a \$50,000 balance.

Analysis by Grattan also demonstrates that whilst industry (profit-for-member) funds have listed fees that generally match expenses as reported to APRA, retail (for-profit) funds appear to have fee structures higher than expenses reported to APRA, in some cases significantly so. In aggregate this behaviour is to be expected, given the need for retail funds to remunerate advisors who recommend their products and deliver a return on equity to shareholders in addition to providing benefits and services to fund members.

Policy Effects

The FSI interim report correctly, in Equip's view, points to policy setting instability as a possible explanation for the lack of operational efficiency. This is aptly summarised in Figure 4.2 [at 2-119] that chronicles the major policy changes that have occurred since 1992. As the total superannuation system has grown and matured, its size and importance, both to individual retirement outcomes and to the tax/transfer system, has necessitated occasional policy adjustments.

Equip is supportive of government policy designed to increase member equity, reduce opacity, improve governance and reduce systemic risks within the superannuation sector. It is Equip's view that the *Super System Review* (Cooper Review) of 2010 dealt adequately with these issues, and that the policy and regulatory measures introduced as a result will benefit all Australians in due course.

Equip believes that a period of consolidation is now needed to bed in the legislative and regulatory changes brought about by the Stronger Super changes. MySuper and other changes such as SuperStream, product dashboards, aligned member/APRA reporting and portfolio holdings disclosure all have a place to play in making the superannuation system more robust. However, these changes have come at a significant cost. It is estimated that for Equip, the introduction of MySuper alone cost the fund in excess of \$1.5 million.

We would encourage Government to allow the current raft of changes to bed down before adding more costs to the system through additional change. Additional policy adjustments may at this stage impinge on the efficacy of the Cooper Review changes in delivering their full measure of benefit.

Member Behavioural Effects

As alluded to in the Preliminary Remarks section above, recent insights gained from behavioural economics and behavioural finance now poses a challenge to the notion of individuals as conforming to the rational decision making models of neo-classical economics. Rather than being able to meet theoretical constructs in relation to decision making under conditions of uncertainty (the essence of investing for the future) human beings appear instead to use mental shortcuts (heuristics) when making decisions for which they have insufficient knowledge of the choices before them.

Behavioural biases that come to the fore in the context of retirement planning include dynamically inconsistent preferences (hyperbolic discounting), loss aversion, framing effects and overconfidence. All these behavioural biases often act at odds with policy settings that assume optimal individual decision making under all conditions, provided sufficient information, disclosure and choice is available.

Does, or will, MySuper provide sufficient competitive pressures to ensure future economies of scale will be reflected in higher after-fee returns? What are the costs and benefits of auctioning the management rights to default funds principally on the basis of fees for a given asset mix? Are there alternative options?

Whilst Equip supports the principle of simple, low cost superannuation products that cater to the needs of the majority of members (particularly those disengaged from the system), it is too early to determine whether MySuper will deliver sufficient competitive pressure to keep fees in check, or to reduce them materially *in aggregate* across the system. There is however some preliminary data, contained within the Grattan Institute findings, that suggests that the differing segments may be responding to the MySuper changes differently.

The Grattan Institute report provided data⁶ indicating that both public-sector and corporate funds appear not to have made any noticeable reduction in fees following their implementation of MySuper products. Industry (profit-for-member) funds by comparison appeared to have made inroads into lowering fees since the introduction of MySuper. Retail (for-profit) funds were absent from this particular analysis.

It is also important to note that account consolidation, which ultimately benefits the consumer, is likely to result in per member costs increasing, all other things being equal. If the number of accounts decline, the cost per account will rise, reflecting the largely fixed nature of many system costs.

In light of the above, Equip considers it premature for the Murray Inquiry to crystallise a system-wide view that changes brought about by MySuper are insufficient to lower fees. Equip would instead welcome further research on the matter in line with the methodology adopted by the Grattan Institute above, but incorporating both a longitudinal study and the inclusion of retail (for-profit) funds.

Equip considers the option of auctioning the management rights to default funds (the Chilean approach) to be problematic for a number of reasons. It would increase the concentration risk and manager risk of one large investment pool under one authority. In addition, investment behavioural drivers might shift toward shorter-term performance, in order to maximise the probability of winning/retaining the management mandate. Such behaviours might be at odds with the longer term interests of members.

⁶ Minifie, J. et al, *Super sting: how to stop Australian's paying too much for superannuation*, 2014 Figure 13 at page 22, Grattan Institute, Victoria.

Equip therefore does not consider any alternative options to be viable or worthy of further investigation at this time. Reiterating a need for a period of consolidation, we believe that this issue might best be addressed via a post-implementation review of MySuper once it has been fully operational for at least five years.

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

In the FSI interim report [at 2-105] it was noted that *“A trend in the wealth management sector is towards more vertical integration. Although this can provide some benefits to members of superannuation funds, the degree of cross-selling of services may reduce competitive pressures and contribute to higher costs in the sector.”*

One of the most significant trends in the financial system over the past two decades has been the integration of traditional banking services with wealth management, incorporating both superannuation and financial advice. In the main this has occurred as a consequence of the growth of the superannuation sector. As traditional deposit-taking and loan-making activities have reduced in relative importance, so Australia’s largest banks and insurance companies have sought to build significant scale and capacity in the superannuation sector.

Australia’s four largest banks, together with AMP, now dominate both the financial planning landscape and the retail superannuation segment. Large integrated financial groups such as these now account for some 40 per cent of total superannuation assets. In terms of financial advice, it is generally held that some 80 per cent of all financial advisors in Australia operate under a ‘dealer group’ whose ultimate ownership and control rests with one of the four big banks or AMP.

Ways in which vertical integration stifles competition and innovation

Equip is of the view that the current level of vertical integration is stifling competitive and innovation. This in turn contributes to higher superannuation fees. The reasons why this might be the case, Equip believes, are canvassed in Box 4.1 [at 2-105] of the FSI interim report *“Why hasn’t competition delivered optimal outcomes already?”* In particular we concur with reasons outlined in the box as follows:

- 1) ***“Complexity: Superannuation is inherently complex, and many consumers do not feel confident making decisions about it;”***

As stated earlier, behavioural insights now suggest that when people are faced with difficult tasks for which they do not believe they have sufficient knowledge or skill to make a considered choice, they are more likely to do nothing (bias to inertia). Further, the complexity of the system makes it necessary to provide advice and education services within the funds to help members who want to exercise choice and make informed decisions about their long term retirement outcomes.

- 2) ***“Agency and structural issues: There are limited opportunities for member vigilance or incentives for agency vigilance to reduce prices”.***

To overcome the complexity dilemma many Australians seek financial advice. If, however, the advice provider is part of a vertically integrated business model, agency and structural issues may hamper the freer movement of funds. Whilst the implementation of the *Future of Financial Advice (FoFA)* reforms work in part to mitigate against agency/structural issues, recent regulatory amendments to *FoFA* suggest that these agency issues may still be a barrier to enhanced competition into the future.

It is also often the case that small and mid-sized companies drive many beneficial innovations. If the superannuation sector is dominated by too few providers the impetus to innovate might be unduly muted.

Other issues with vertical integration

In addition to the issues outlined above, Equip believes that the current level of vertical integration has other deleterious effects on the superannuation sector. One such issue is that of the choice, by employers, of default funds offered to employees. Whilst section 68A of the Superannuation Industry (Supervision) Act 1993 currently prohibits the offering of inducements to employers to favour one fund over another as the default super arrangement, Equip believes that this area needs strengthening.

Equip believes that there should be an explicit legislative ban on what are commonly referred to as “third line forcing” arrangements. These arrangements occur where an employer, who is also a customer of a vertically integrated financial institution, is coerced into adopting that institution’s superannuation arrangement as a default employer super fund in order to retain the benefit of contractual arrangements with other parts of the institution.

Are there net benefits in tailoring asset allocation to members and/or projecting retirement incomes on superannuation statements?

Projecting Retirement Incomes on Superannuation Statements

As a fund with a DB heritage, Equip believes that there are positive net benefits from projecting retirement incomes on DC superannuation statements. It is observable to the Fund that the way in which member statements are prepared, and the information contained therein, makes a material difference to the level and type of engagement that members have with their superannuation.

Members in defined benefit plans that convert to a DB pension generally are less perturbed by short term market retractions, understanding that investment risk lies not with them but with the plan sponsor. This behavioural divide between DB and DC members when viewing their annual statements is eloquently stated by Nobel Laureate Professor Robert Merton thus:

“A DB scheme is designed and managed to provide members with an income in retirement. And because this motivation filters right through the scheme, members think of their benefit in terms of income. Ask DB members what their pensions are worth and they will reply with an income figure – ‘two thirds of my final salary’, for example.

DC language is different. Asset value is the metric; its growth the priority. Everything flows from this. Members are taught to understand their appetite for investment risk and to be wary of volatility in asset values rather than volatility in income. Members’ annual statements highlight their investment returns and account values.

Ask DC members what their super is worth and you are likely to hear a cash amount and perhaps a lament to the value lost to the global financial crisis⁷.”

Equip is therefore very supportive of changes to the DC system architecture that would allow for member statements to incorporate retirement income projections. We believe that such a change would shift significantly member interact with their superannuation, encouraging greater engagement at an earlier age.

Any such move toward income projections for DC members however will face two challenges. First, the not inconsequential task of revamping administration systems to allow for *meaningful* and *personalised* account balance projections, and from them retirement income estimates. This will be a costly process for most administration systems.

A second, related, challenge is the clarification of the regulatory landscape in relation to providing such estimates. Equip believes that ASIC has provided as much regulatory guidance as it can (via Consultations Paper 101 and 122 and Class Order 11/1227), however the issue of providing such estimates without these being viewed as ‘personal financial advice’ (and thus subject to the Chapter 7 (Part 7.7 and 7.7A) provisions of the Corporations Act 2001) remains broadly unresolved.

Equip therefore would welcome the Murray Inquiry’s review of this matter, with a view toward appropriate regulatory and/or legislative amendments to facilitate the provision of retirement income projections on DC superannuation statements. Equip believes that such trustee-provided estimates should be available to members across a range of technological platforms (such as member web portals) and not just on annual statements.

Tailoring Asset Allocations to Individual Members

Equip’s view is that whilst superannuation trustees should focus on optimising outcomes for member cohorts, both to and then through retirement, the ‘optimum’ asset allocation for an individual will be dependent on a myriad of factors, including many factors not known to the trustees. Therefore asset allocation ‘optimisation’ at the individual level is a task best undertaken by the member with the assistance of intra-fund or personal advice if needed.

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

Equip contends that there is an undue focus on short-term returns by DC superannuation funds. This focus is a direct consequence of a range of policy adjustments since the Wallis Inquiry that have focussed on increasing individual choice under the ‘rational decision maker’ policy assumption (see Preliminary Remarks). *Super Choice*, together with investment choice of fund options and greater portability has resulted in a greater focus on short-term investment returns.

‘Short-termism’ is explained in an individual context by the behavioural tendency to apply ‘hyperbolic discounting’, whereby short term gain tends to be more highly valued by people over potentially larger, though more distant, gains. In an institutional context however, it appears that the focus on short-term

⁷ Merton, Robert C in ‘*Next Generation Retirement Planning*’, Dimensional Managed DC publication.

returns is as much driven by external factors (consultant league tables and financial press coverage of same for example) as it is by any internal governance shortcomings.

The DC superannuation sector, now dwarfing its DB equivalent, focuses on short-term returns primarily because, as Professor Merton points out, growth is the priority and short-term returns its evidence. Failure to be in the 'top quartile' of peer group returns over periods as short as one year therefore results in heightened business risk for any DC superannuation fund, as existing employer/member goodwill is eroded and prospective employers/members less likely to cement a relationship.

The focus on DC has also, to a large extent, seen the importance of return volatility downplayed. In the longer term, volatility (risk) is as important as return to the retirement outcome of Australians due to the sequencing risk involved in superannuation (we expand this discussion in the Retirement Income section that follows).

To counter the effect of excessive "short-termism" Equip provides the following suggestions:

- 1) The adoption of retirement income projections for DC super statements, as outlined in the previous section. Such retirement income estimates should be prescribed undertaken using only an appropriate long-term return (for example a 7 or 10 year net return). Changing the frame to retirement income would lessen the tendency to focus on short-term returns.
- 2) Prescribe that all 'league tables' and related material from consultants and superannuation research firms (however republished) are required to show the longest return series first (i.e. in the first column) with the return length shortening thereafter. This in effect draws attention toward the longest returns, thus imprinting the longest return first in the observation of the reader.
- 3) Prescribe that such league tables must give prominence not just to headline return data but risk metrics as well. High returns needs to be analysed in terms of the risks that were borne in order to attain them. Metrics such as Sharpe Ratios or Information Ratios would ensure that those who prudently deliver strong risk-adjusted returns are recognised for doing so.

To what extent is there a trend away from active asset management within asset classes in superannuation funds? Is this a positive or negative development for members?

The unyielding focus on fees is resulting in funds moving away from active management toward greater indexation. This is a very natural reaction given fees are current and observable while potential out-performance is a future possibility. This, however, is a very blunt approach to the prudential management of member funds. The discussion should focus on value to members after fees and taxes. Equip as a fund has added value over the medium and long term from active management, and believes that active management has an important role to play in both risk management and after-fee return maximisation.

In an attempt to quantify the value added by active management in Equip options after fees, we compared the return of the Equip Balanced Growth portfolio (the previous default) against a hypothetical passive portfolio. The following assumptions were applied:

- Indexed asset allocations were rebalanced back to benchmark on a monthly basis for all markets except alternatives; and
- For alternatives, the Equip portfolios were used (as there is no index substitute).

The analysis is complicated by taxes. For the sake of simplicity, we have assumed the following:

- For the passive portfolio, a fee of 0.36% per annum was applied. This is the same fee applied by a large index manager on their passive balanced portfolio; and
- The tax rate was assumed to be the same as Equip. This may not be the case as trading differences in passive mandates may result in higher effective taxes actually incurred.

The results are shown in the table below. It is clear that, over time, active management has added value net of fees and taxes, although the results are not consistent from year to year.

| | Equip Gross (%) | Equip Net (%) | Passive Gross (%) | Passive Net (%) | Difference (Net) (%) |
|---------|--------------------|------------------|----------------------|--------------------|-------------------------|
| FY 2004 | 16.39 | 15.02 | 13.92 | 12.84 | 2.18 |
| FY 2005 | 13.22 | 13.29 | 12.74 | 13.10 | 0.19 |
| FY 2006 | 15.52 | 14.21 | 16.09 | 15.07 | -0.86 |
| FY 2007 | 16.03 | 14.32 | 14.87 | 13.76 | 0.56 |
| FY 2008 | -6.55 | -5.93 | -5.86 | -5.46 | -0.47 |
| FY 2009 | -8.97 | -8.30 | -6.84 | -6.94 | -1.36 |
| FY 2010 | 10.77 | 8.60 | 10.19 | 8.25 | 0.35 |
| FY 2011 | 10.71 | 10.19 | 9.99 | 9.59 | 0.60 |
| FY 2012 | 1.42 | 1.08 | 2.44 | 2.08 | -1.00 |
| FY 2013 | 17.93 | 16.02 | 16.97 | 15.30 | 0.72 |
| FY 2014 | 14.90 | 13.35 | 13.51 | 12.90 | 0.45 |

Source: Equipsuper internal analysis

Equip also contends that an industry-wide shift to passive investment would result in a range of unintended consequences. These include:

- A misallocation of capital to large, listed companies. Indexation makes little investment sense in the smaller capitalised company space, alternatives or fixed income. Equip would encourage the Murray Inquiry to consider any recommendation on passive management in conjunction with other government policy on funding infrastructure and innovation;
- Passive management leaves little opportunity for risk management. History is littered with large companies that were prominent in passive portfolios that have collapsed. If all funds were only invested in capitalisation-weighted indexed portfolios, the impact of such bankruptcies would be significantly more widespread; and
- The legislation for the SMSF sector would need to align to that of collective vehicles and disallow active management by SMSFs. This would impact the SMSF sector as choice of individual security selection is removed along with the ability to tilt portfolios toward high franked dividend paying companies.

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

Equip broadly supports the Trust structure as the most appropriate mechanism to protect the interests of all members, including disengaged beneficiaries. In particular, the fiduciary responsibility stemming from a trust arrangement provides higher levels of legal protection as opposed to contract law. Contract law assumes that all parties operate on an equal footing which, in the case of superannuation, is not a reasonable assumption.

There is no intrinsic cost from the trust structure as such. Costs relating to protection of trust beneficiaries and operating costs would equally apply to other types of legal structure. This is clearly the case for banking and insurance.

Retirement Income (Section 8)

Equip agrees with the FSI interim report observation that: *“The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.”*[4-8]. Contributory factors include the relative immaturity of the superannuation system, its DC-centric nature (a tendency to focus on the accumulation phase) and the relatively recent acceleration of the baby boomer cohort moving into retirement.

Whilst Equip is in general agreement with the FSI statement that *“the lack of effective risk management, particularly longevity risk management, is a major weakness of Australia’s retirement income system”* [4-9], it should be noted that the assertion holds true primarily for DC plans (and for DB plans that do not provide a lifetime defined benefit pension option).

Equip manages in excess of \$650 million for pension members across DB and account based pensions⁸. Unlike members in lifetime DB pensions, DC members cannot be certain as to accrued benefits at the point of retirement. They are certain neither about how much they should have accrued, nor the ‘optimum’ rate at which to consume their private pension benefits in retirement. These factors interact with the complexities of the taxation and social security systems to further compound the uncertainties associated with retirement.

In our view the spectrum of retirement risks include the following:

- **Investment risk:** The risk that investment returns will fail to meet expectations. Whilst it might reasonably be expected that growth assets will outperform defensive assets over the longer term, growth-biased portfolios may experience extended periods of low or negative returns.
- **Budgetary risk:** Expenditure patterns can vary considerably during the early (active), mid (passive) and final (frail) stages of retirement. As individuals will move through these stages differently, budgeting for varying expenditure needed across an entire retirement is a considerable challenge.
- **Sequencing risk:** A member’s account balance (both approaching and into the early years of retirement) is heavily path dependent on the sequence of annual returns whilst in the ‘Retirement Risk Zone’ (see below for explanation). Negative investment returns or market dislocations during this critical period can have an outsized effect on retirement outcomes.
- **Inflation risk:** Any increase in the retirement cost of living, if not accompanied by an equivalent increase in pension income, results in a loss of purchasing power and thus a decline in relative living standards.
- **Longevity risk:** The risk of living *beyond* one’s life expectancy, and in so doing outliving one’s financial resources. Longevity risk complicates the budgetary process, often resulting in members drawing less than an optimal amount due to the fear of prematurely exhausting their capital base.
- **Counterparty risk:** Certain retirement income products, such as lifetime annuities, have an element of counterparty risk insofar as the purchaser (retiree) must be confident that the contractual terms will be honoured by the product provider over an extended period of time. Whilst strong prudential regulation can mitigate this risk, it can never fully remove it.

⁸ Incorporated into the account-based pension data are Transition to Retirement (TTR) pensions.

- **Liquidity risk:** Retirees may need to make lump sum withdrawals (partial commutations) at short notice on occasion. Their ability to do so will be dependent on the legislative and contractual settings embedded in the retirement income products utilised.
- **Legislative risk:** It is possible that legislative and/or regulatory changes will occur during the span of a member's retirement that will impact on their financial circumstances. Whilst some disadvantageous changes may be 'grandfathered' and their impact thus mitigated, an unstable retirement policy landscape still represents a long-term risk to retirees.

Thus Equip views longevity risk as one of a number of risks borne by retirees in the current DC-dominated superannuation landscape. Equip's definition of longevity risk explicitly references the financial ramifications of living *beyond* one's life expectancy. Thus someone with a life expectancy of 84 whose private financial resources exhaust at age 82 has not experienced longevity risk but likely either investment or sequencing risk. The importance of this distinction will become apparent below.

Popularity of Account-Based Pensions

The FSI interim report correctly points out that the dominant form of retirement income stream is the account-based pension, accounting for over 94 per cent⁹ of current pension assets. Annual annuity take-up (particularly lifetime annuities) is a small fraction by comparison. As a fund that provides both lifetime DB pensions and account-based pensions, Equip is of the view that behavioural drivers play a large role in retirement product preferences.

Equip has undertaken detailed analysis to understand member preferences around the time of retirement. Our findings suggest that whilst most DC members are aware that account-based pensions are subject to market movements and may exhaust prior to life expectancy as a result, they value the redemption (partial commutation) *flexibility*, member *investment choice* and ability to *bequeath residual benefits* on death over the income *stability* and *sustainability* that lifetime annuities provide.

There appears to be a strong behavioural preference for *control of capital* (during retirement and at death) over the certainty and stability that annuities provide during retirement. Large incentives or concessions are required to overcome this preference¹⁰.

Anecdotal evidence indicates that wealthier retirees tend to commence account-based pensions (drawn typically at the minimum regulatory rate), perhaps after taking a small lump-sum amount. Low balance retirees in contrast are more likely to take their entire accrued super benefit as a lump sum, perhaps in acknowledgement that the Age Pension will provide the majority of their retirement income once qualifying conditions are met. Equip's internal research suggests that fewer than 4 per cent of our members intend to cash in their benefits as a lump-sum at retirement.

⁹ As provided by Financial System Inquiry interim report at [4-6].

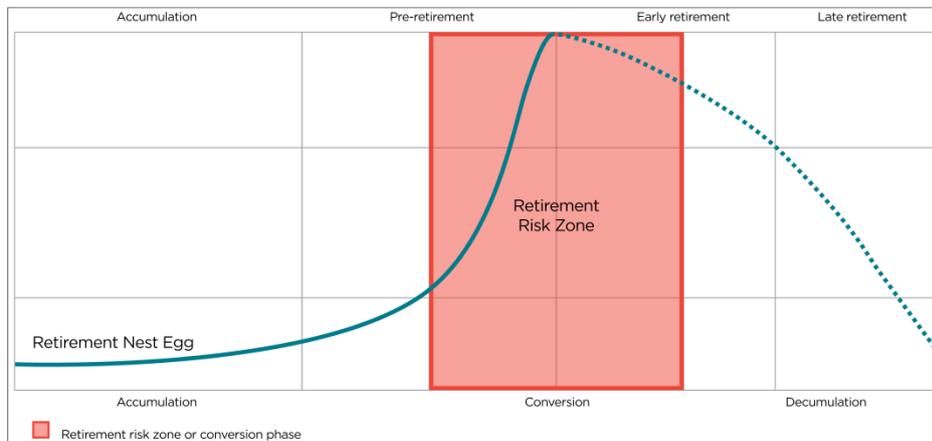
¹⁰ An example being the 100% Age Pension asset test exemption in place for certain long-term income stream products (such as lifetime annuities) that was reduced to 50% in 2004 and removed altogether in 2007.

Understanding the Retirement Risk Zone

Given a general preference for account-based pensions over annuities (and a growing proportion of DC assets relative to DB assets) Equip has sought to understand the totality of risks that magnify close to and in retirement, in order to develop a retirement income solution that provides a higher level of risk management for account holders.

The DC-centric nature of Australia's superannuation system results in members facing risks that intensify closer to, and in the early years of, retirement. The Financial Services Institute of Australasia (Finsia) has delivered significant insights in relation to this 'conversion' phase of DC superannuation. Their findings have led to acknowledgement of a 'Retirement Risk Zone' that exists broadly in the final 10 to 15 years of work and the first 10-odd years of retirement. Poor investment returns or market dislocations during this time can result in significantly lowered account balances¹¹ and by extension lower living standards in retirement.

Finsia's Retirement Risk Zone:

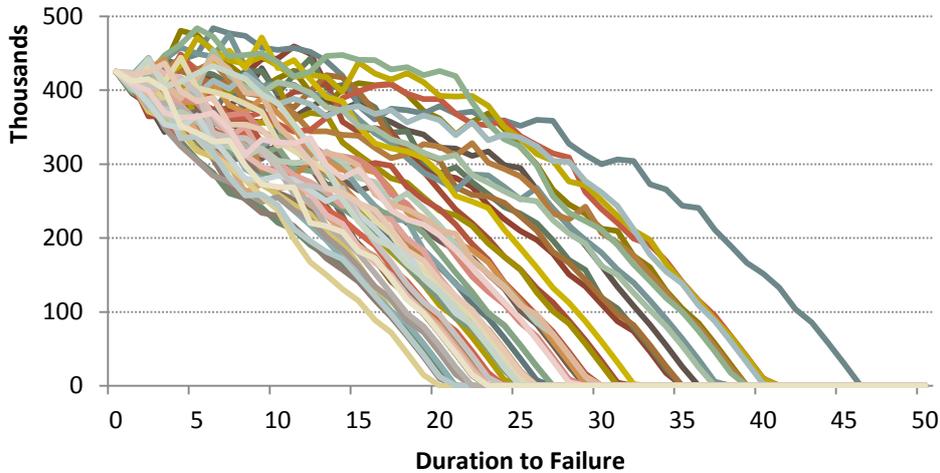


Whilst the decumulation phase (dotted line above) is depicted as a smoothly declining path, the actual path an account-based pensioner will face is *a priori* unknown, instead being determined by actual returns generated by various asset classes and each retiree's exposure to them.

The range of outcomes an individual may experience in the decumulation phase is significantly wider than is generally understood. Poor or negative returns early in retirement significantly accelerate the depletion of an account-based pension even if 'longer-term' returns normalise thereafter. Contra-wise, high early returns allow for real capital to be preserved (or enhanced), extending the time to account exhaustion well beyond life expectancy.

¹¹ An example of this occurred during the Global Financial Crisis of 2007-09 where near-retirees with high growth allocations found their super balances significantly depleted, and their retirement plans impacted as a result.

Equip modelling of the effect of sequencing risk is illustrated in the below chart, which provides the output from a stochastic simulation of possible account balance paths to exhaustion for a 60 year old member commencing a \$425,000 account-based pension with a 'Balanced' risk profile:



Source: Equipsuper internal modelling

Equip's modelling suggests that a starting account-based pension might last less than 20 years or more than 45 years, purely depending on the sequence of annual returns (the notion of sequencing risk being 'the worst returns in their worst order').

The main insights from Equip's work on post-retirement risk management are as follows:

1. a poor sequence of investment returns in an account-based pension has a more deleterious effect on the early decumulation phase than it does on the late accumulation phase (due to the cessation of contribution inflows); and
2. a dynamic tension exists in today's DC-centric decumulation environment between sequencing risk on one hand and longevity risk on the other. Sequencing risk increases with the level of growth assets held, but growth assets are necessary to mitigate both inflation and longevity risk.

Given the strong preference amongst DC members for an account-based pension over an annuity based solution, Equip has created a new product, Equip MyPension, which combines the best elements of both. Equip MyPension is an account-based pension that provides the same accessibility to capital and bequest flexibility, but takes some level of control over the investment management and pension payment process.

In managing the investment and pension drawdown process Equip provides MyPension holders with income certainty for as long as the account balance remains positive. Importantly, the trustee-managed process partly mitigates sequencing risk and thus enables members to hold a higher weighting to growth assets, which in turn assists in mitigating longevity risk.

Recommendations in Relation to Retirement Income

Equip broadly concurs with the FSI interim report that retirement risks are not well managed within the superannuation sector at present. Equip however is concerned with the view that longevity risk is the dominant risk in retirement.

Our detailed analysis of retiree preferences and retirement risks suggests that sequencing and investment risk are at least as important in a system dominated by account-based pensions that are already in existence. Equip therefore makes the following recommendations in relation to retirement incomes policy:

Offering a Default Solution to Follow MySuper

Equip concurs with the FSI view that *“Policy related to the accumulation phase is based on the premise that many people underprovision for their retirement and are prone to behavioural biases, which motivates the use of default and compulsion arrangements. The policy settings for the decumulation (or drawdown) phase generally take a more laissez-faire approach. There is an implicit assumption that individuals have the capacity and options available to them to manage their income and risks in retirement.”* [4-3].

Equip is therefore of the view that legislative impediments currently precluding super funds from defaulting MySuper members into a suitable post-retirement product should be removed. This recommendation has also been made by the highly regarded CEPAR in their FSI supplementary submission¹², with CEPAR calling for individuals to have most of their accumulated balance defaulted into an account-based pension. Were this impediment to be removed super funds would be more inclined to develop products (such as Equip MyPension) that could move members seamlessly from the accumulation phase into the decumulation phase.

Providing Late Life Longevity Protection by Default

In a similar manner to the above, the legislative framework should allow funds to default that part of a member’s retirement balance not defaulted into an account-based pension to be used to acquire a deferred lifetime annuity or a group self-annuitisation product. Such a product would only commence at life expectancy.

Combined Effect of Above Proposals

The combined effect of the two default arrangements is to ensure that members convert their accrued superannuation into two distinct pools, an account-based pension to manage the first stage of retirement (with its variable spending patterns), followed by a deferred lifetime annuity/group self-annuitisation product should the individual member experience longevity risk.

Compulsion May Result in an Inequitable Outcomes

Equip is not in favour of compulsion, either to commence an account-based pension or to acquire a lifetime annuity (deferred or immediate). Such a policy would be greatly disadvantageous to those lower balance members who might determine that taking their accrued benefits as a lump sum is the optimal strategy for their particular circumstances.

¹² ARC Centre of Excellence in Population Ageing Research, *CEPAR Supplementary Submission to the Financial System Inquiry*, University of New South Wales, June 2014.

Recommendations in Relation to Retirement Income Products

The FSI interim report correctly identifies the difficulty of retirement planning thus: *“A large body of evidence in behavioural economics - much of which has emerged since the Wallis Inquiry - demonstrates that poor outcomes can emerge from complex decision making at critical junctures, such as for retirement. Making decisions to manage income and risks in retirement is complex, even for people with specialised financial training.”* [4.3]

It is precisely because managing the myriad of retirement risks is so difficult that Equip has created MyPension, a retirement income solution that combines elements of both the account-based pension and annuities. Such innovation is therefore possible under the current prescriptive pension legislation, however for sector-wide innovation to be encouraged Equip believes that the following should be considered by the FSI:

A More Principles-Based Approach to Pension Regulation

Equip recommends that the current regulations defining what annuities and pensions are be reviewed¹³, with a view toward their replacement with a principles-based approach. This would allow for greater innovation in retirement income product design. Equip intends to submit a more detailed outline of its views in the Treasury ‘Review of Retirement Income Stream Regulation’ discussion paper (to be submitted in early September 2014).

Deferred Lifetime Annuities in Preference to Immediate Lifetime Annuities

Equip acknowledges that lifetime annuities explicitly hedge against longevity risk. We do however believe that behavioural biases lead to low levels of uptake of immediate lifetime annuities, due to these being perceived as a ‘gamble’ (i.e. the payment of a known premium for an unknown pay-off based on length of life). Equip therefore favours the deferred lifetime annuity (DLA) as a product more acceptable to retirees. Ideally DLA’s would only commence at life expectancy, with other income stream products such as account-based pensions delivering a private pension (together perhaps with some Age Pension entitlement) to the point of life expectancy. Our submission to the Treasury discussion paper will provide greater detail on this issue.

Commonwealth Government as the Ideal Provider of Longevity Risk Insurance

We agree with the findings of the Australia’s Future Tax System Review (Henry Review) that the Government is best placed to offer competitively priced longevity insurance. The Government has two key advantages as a provider of longevity insurance; lower counterparty risk than commercial providers and the ability to reduce significantly (else eliminate) adverse selection issues.

Any such provision of longevity risk by the Government should be subject to appropriate limits and might ideally be provided by way of periodic instalments (in addition to or as part of SG) that result in the provision of a DLA upon the member reaching his/her life expectancy.

Irrespective of whether the Government takes on the role of longevity risk provider or leaves it to commercial interests to do so, it is important that the Government support a deep and liquid long-duration bond market with regular issuances of 30 year (and longer) Commonwealth Government Treasury Bonds and Indexed Bonds via the Australian Office of Financial Management. Such assets will be increasingly vital for superannuation funds in matching the long-term nature of pension liabilities, and for solution providers in the management of longevity risk.

¹³ Specifically the *Superannuation Industry (Supervision) Regulations 1994* - Regulation 1.05 (Annuities) and Regulation 1.06 (Pensions).

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