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Mr David Murray AO
Chairman
Financial System Inquiry
GPO Box 89
Sydney NSW 2001

Dear Mr Murray

Financial System Inquiry (FSI)

QSuper welcomes the opportunity to comment on specific aspects of the FSI Interim Report. As one of the country's largest funds, QSuper has provided input to ASFA's submission to the Inquiry and is broadly supportive of the matters raised.

However, there are a number of important aspects of the Inquiry's Interim Report which we feel warrant additional commentary as they touch on matters of great importance to the Fund and, it is submitted, to public policy generally. In particular, the attached submission comments on the matters raised for discussion regarding investment and sequencing risk, longevity risk and the measurement of fund performance.

As set out in the attached submission, QSuper has a strong conviction that, as the membership profiles of superannuation funds are not homogenous, the default investment strategy should not be set on a "one size fits all basis". This, in tandem with a focus on short-term investment returns is counter-productive to members' long term interests to maximise stable retirement outcomes. As a result, it is crucial that policy and product settings evolve to facilitate members achieving retirement outcomes that meet their individual needs and the broader public policy intent of superannuation.

Please do not hesitate to contact myself (07 3239 1693) or Chief Strategy Officer, Michael Pennisi (07 3239 1512) to discuss any aspect of this submission.

Yours sincerely

Rosemary Vilgan
Chief Executive Officer
QSuper Limited

1. Introduction

QSuper welcomes the opportunity to provide a submission regarding the *Financial System Inquiry Interim Report, July 2014.* The Inquiry provides a platform to further focus the system and ensure that the industry is best positioned to deliver for members. QSuper has contributed to the development of the ASFA submission to the Inquiry and is supportive of the general issues raised. After reviewing the specific issues raised by the Inquiry's first report though, QSuper would like to highlight specific elements to the Inquiry, particularly around the true purpose of superannuation and the industry's focus on short-term outcomes.

2. QSuper Background

QSuper is the default fund for Queensland's public sector employees and has around 540,000 members made up of current and former public sector employees and their spouses. QSuper has more than $50 billion directly under management and $80 billion in total accounts, making it one of the largest superannuation schemes in Australia.

QSuper is an APRA regulated non-public offer fund and is authorised to offer a MySuper lifecycle investment option (QSuper Lifetime) to its members. In addition to its Commonwealth regulatory obligations, QSuper is also governed by Queensland legislation.

QSuper Lifetime presently has eight member investment cohorts each tailored according to member characteristics such as age and fund balance. In addition to QSuper Lifetime, the Fund caters for the more engaged members and offers nine choice options including the soon to be launched QSuper Self Invest option which provides interested members with the opportunity to directly invest in ASX300 shares, a diverse range of ETFs and term deposits.

The Fund's entire offering is supported by advice services provided by QInvest, an advice firm wholly owned by the Fund. QSuper is also one of the largest pension income account providers in the country with over 29,000 members choosing to move their lump sum benefit into a regular income payments structure, with this amounting to over $10.7bn in FUM. Since 2013, QSuper has also offered members the option of purchasing a term annuity through a preferred pricing arrangement with Challenger Life.

QSuper has provided retirement benefits to Queensland's public sector employees for over 100 years. Its rich history includes many industry innovations, including its offer of financial planning services to members in 1994, which continues today.

QSuper has a 'member for life' philosophy and is committed to continually improving its products and services for members, from their commencement in the Fund through to retirement. This philosophy has seen the Fund extend its investment options and services to members who leave the public sector to work in the private sector.

Given our origins, a great many of our members (particularly career public sector employees) have a retirement benefit which would provide an adequate retirement income. Our average balance is very high (near $150,000) and this, together with our history, promotes a strong focus on retirement outcomes.

Consequently, this submission outlines QSuper's thoughts on the two biggest risks faced by members:

- investment risk (sequencing of returns); and
- longevity risk.

In addition, the submission addresses the important issues of how fund performance should be measured.

3. Investment and sequencing risk

The Inquiry's Interim Report raises issues regarding the tailoring of asset allocations for members and the effect 'short termism' may have on member outcomes. QSuper's views on these issues are set out below.

QSuper has a very strong belief that the purpose of the superannuation system is to provide an adequate income in retirement for members. The Fund's strategy and policy settings, within the current regulatory framework are set solely to improve retirement outcomes for members. This has been implemented through product changes (QSuper Lifetime, Income accounts and the Challenger annuity arrangement) and direct changes to the way in which investment strategy is determined.

Our product and service suite is driven by a philosophical view on the key purpose of superannuation and is further informed by the market disruption of the global financial crisis including:

- *Members close to retirement who were invested in traditional default arrangements were significantly impacted by the high allocations to equity markets.*
- *It was very clear that the membership makeup of funds is far from homogenous and markets have large cyclical fluctuations. 'A one size fits all' investment strategy for default members is inadequate.*
- *Different members have different needs and expectations with respect to risk appetites.*
- *QSuper could do better for its members via a mass-personalised approach to tailoring asset allocations for different member cohorts.*
- *Managing assets to liabilities would provide better retirement outcomes for members.*

Whilst many funds talk about long term returns, it has become evident through recent years that funds have not taken into account the sequence of investment returns.

Members do not actually experience an "average" return.

Their benefits are a product of the investment climate they <u>individually</u> experience through their lifetime, and this is especially critical during their peak balance years (eg 55-70). In addition, a means tested age pension dramatically impacts the investment risk faced by effectively providing a put option.

QSuper has a strong view that what a fund offers for 'default' members is critical, as they represent the vast majority of superannuation fund members. For most of their time as members of the fund they rely on the fund Trustees to invest on their behalf and to work to achieve the best possible retirement income for them.

In most other industries, the traditional ways of thinking have been challenged by society and technology.

In the not too distant past, ordinary Australians changed the oil in their cars. In today's world, cars are designed to run reliably and without the owner ever needing to open the bonnet. Servicing is performed by professionals with the aid of computers.

If we consider this in a superannuation context, should we expect our members to be trained mechanics tinkering under the hood? Rather, QSuper contends that the industry should focus on delivering reliability of outcomes in much the same way.

In light of the above, the Trustees of QSuper embarked on developing QSuper Lifetime and it takes into account sequencing risk and behavioural finance learnings in understanding the challenges facing members and the industry and for setting strategy. There are 447,500 members in QSuper Lifetime representing 87.7% of all accumulation members.

Defaults are important and work as evidenced by:

- *in over a year since the commencement of its phased implementation, less than 1% of members have elected to opt out of Lifetime and into more "conventional QSuper products"*
- *less than 5% of members contribute at rates different from the default member contribution rate*
- *for default insurance arrangements, in the last financial year only 2% of members opted out of default insurance.*

This underpins the responsibility Trustees have to get the strategy right for default members.

A key feature of QSuper Lifetime is its tailored asset allocations for eight member cohorts representing members with different attributes including age and account balance. The Fund intends to add further cohorts and other differentiating member factors as the strategy matures and strongly believes that tailoring for smaller and smaller groups of members is the industry direction. Age pension entitlements, contribution rates and gender will be incorporated over time.

Currently, the customisation spectrum ranges from funds that have adopted lifecycling (first iteration) to individualised portfolios via financial planners or SMSFs.

It should be stated that if a member is in a quality fund, even with a single default option, this is a good outcome.

However, given a fund knows much about members' personal characteristics and has a view on the economic cycle, an even better solution is to tailor a solution through mass customisation.

Quality personalised financial planning is best but not all members will be able to access this, or even want to.

Good	*A quality single default option*
Better	*A quality tailored default option*
Best	*A quality individual financial plan*

QSuper is conscious that superannuation's objectives are not served by 'short termism' driven by a media and an industry focus on default option returns over ever decreasing time periods. QSuper's submits that a fund's default strategy and trustee thinking should be solely focused on achieving an adequate retirement outcome for members, preferably for life.

4. Longevity risk

The Inquiry's Interim Report devoted a chapter to retirement income which, inter alia, focused on the use and acceptance of annuities and annuity products in Australia. The Report also discussed the key reasons why annuities have not been popular with retiring members and the prevalence of members taking lump sums when they retire. Two key reasons for member rejection of annuities are the 'loss of control' of member funds and the loss of ability for estate planning in the case of life annuities.

QSuper notes that concurrent with the Finance Sector Inquiry, the Commonwealth Treasury has released a discussion paper, *Review of retirement income stream regulation, July 2014*. The discussion paper also addresses barriers to innovation in annuity products and some comments below are directed to questions posed in the Treasury paper.

Evidence indicates that whilst it would be ideal for all to embrace an annuitised retirement income mindset, the facts are that this is not widely accepted for a range of reasons.

Even with QSuper members having substantial balances, preferential annuity pricing and access to affordable financial advice, the take-up of long term annuities is minimal.

Whilst this is the case, there is strong evidence that QSuper members do not "waste" their lump sums and QSuper has one of the largest account based pension products in the market. Feedback from financial advisers indicates that members are quite frugal in retirement and focussed on ensuring that their QSuper benefit will last their lifetime.

This was highlighted following the Global Financial Crisis, where members expressed significant concern about making their money last for their life expectancy. Many, as evidenced by them taking up the reduced draw down rates during the GFC, accepted a lower income when allowed to do so by the Federal Government.

Individual members managing their longevity risk is inefficient.

If members were to set aside a portion of their retirement account as their personal reserve to manage this risk, it reduces their retirement income and inflates the amount available on death - this is not the purpose of the superannuation tax concessions. Added to this is the issue that personal longevity reserves may not be sufficient or well invested, compounded by the fact that the investment capability of people of advanced age may also be an issue.

Realistically, members do not like forfeiting a lump sum to fund longevity risk. It is clear that members will not do so without some incentive or soft compulsion.

Australia can of course, solely manage longevity risk through the means tested age pension. It is submitted that this may not be appropriate either for the level of benefit that an individual might desire, or fiscally affordable.

For longevity protection to be effectively implemented, behavioural finance learnings need to be taken into account, and again the default set appropriately. Ideally, we should be structuring the system so that members have a combination of their own benefit, plus longevity protection.

QSuper submits that longevity risk can be better managed and solutions via income streams can be possible without involving financial stress to members. Two examples are

A. To address the risk of members outliving their superannuation, allow deferred annuities to be purchased by trustees through contributions or premiums over time rather than a lump sum. Such premiums could be deducted by funds even during employment in a similar manner to current death and incapacity insurance. Members would then retire with both their account balance and "long life insurance", rather than having to give up some of their money to buy an annuity.

   This would help alleviate point in time interest rate risk which presently acts as potential barrier to take-up. This would act to protect members from their superannuation being exhausted and therefore being reliant solely on Centrelink entitlements. Such benefits could be structured in a pooled way, and trustees could then choose investments which may or may not involve guarantees or some proportionate return of capital for early death. Tax rules and the pension assets test currently pose barriers to this type of innovation and insurance funded in this way should not be considered as part of the means test until such time as they commence paying an income.

B. In a gradual way, introduce changes to the form in which retirement benefits are taken. For example, this could be done by applying changed conditions to new contributions, or for example, a portion of the future increases in the Superannuation Guarantee. Members are genuinely concerned that rules are not changed overnight, but experience has shown that gradual change (eg age pension to 67 over a number of years) can be acceptable to the community.

The industry is increasingly focusing on the development of retirement income products beyond the annuity spectrum of products, including for example, where risks are shared between the fund and the member in the development of income products. Regulatory flexibility will be required in some instances to support product innovation that allows for a broader range of choices for members and funds confronting the longevity risk issue. This could include a spectrum of strategies targeted at delivering stable, predictable income streams together with longevity insurance. QSuper supports open discussion between the industry and Government on the regulatory mechanisms that would facilitate innovation in this space.

5. Measuring Performance

QSuper strongly believes that as the industry evolves to more tailored solutions so too must the way we are measured.

The league tables of investment performance are often criticised, and arguably have done little to foster true innovation as funds face market risk as they deviate from peers.

A review of the asset allocations of the majority of public offer industry and public sector funds shows that default options have very similar weights to growth and defensive assets. The question is whether this is driven by a considered view of the makeup of their default membership and economic outlooks, or whether peer comparability is driving investment strategy.

When asked unprompted about their goals in retirement, QSuper pre-retirees consistently rate security, independence and certainty as key objectives.

QSuper contends that a focus on short term returns does not aide members to either achieve or understand whether they are on track for a retirement income to achieve the security and certainty they aspire to receive when they stop work.

It is submitted that a better approach would be to hold funds to account on the basis of the consistency of meeting stated investment objectives targeted towards the delivery of the primary objective of an adequate retirement outcome. This could take the form of an index where fund trustees are compared on the basis of a “confidence index’ or “reliability guide” that measures the success of a fund achieving its investment objectives.

> It is very important for trustees to be focussed on the goals they are publicly meant to be providing members.
>
> If the goal is a generic CPI+% target, how often has the fund achieved that over <u>each</u> of the last 5 or 10 years?
>
> Or if the fund has a goal of getting members towards target amounts, how successful has the fund been?
>
> So funds would be compared as being 88% reliable, or 93% reliable, or 65% reliable.

QSuper submits that a measure designed in such a fashion would target the minds of funds better to focus on the consistency of investment performance against the milestone that the member is being promised – the industry ‘end game’ should be an adequate retirement outcome for members.

This approach would negate the importance of a “headline” return number that is often used in marketing product to members.

QSuper also contends that this approach can and should be extended to financial advisors and firms. Rankings could be applied based on the quality of advice provided based on the achievement of agreed objectives with their clients. This would provide consumers with the ability to select advisors based on a reliability score. Recent ‘shadow shopping’ outcomes reported by ASIC show that such a system is warranted with wide-spread poor results being reported.

6. Conclusion

In conclusion, QSuper sees that the industry is already beginning to be structured with funds offering members more tailored goal based solutions. These should seamlessly translate across both the accumulation and decumulation phases.

Ideally, members should transition into retirement by receiving a part lump sum, part draw down account, and also have inbuilt long life insurance. If desired, Australians could gradually transition to more income streams through sensible policy changes flagged with sufficient notice.

As the industry matures, so too must the way funds are measured and reliability is of critical importance in this area.