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Australia's Productivity Commission and Royal Commission Release Final Reports Suggesting Improvements to Regulation of Retirement System and Financial Services Sector

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March 15, 2019 TO: ICI Members
ICI Global Members
ICI Global Pacific Chapter
ICI Global Regulated Funds Committee
ICI Global Retirement Savings Committee
Pension Committee
Pension Operations Advisory Committee SUBJECTS: International/Global
Pension RE: Australia's Productivity Commission and Royal Commission Release Final Reports Suggesting Improvements to Regulation of Retirement System and Financial Services Sector

Two significant government reports were recently released in Australia relating to Australia's financial services sector and the regulation of Australia's retirement system (superannuation or super system).

Australia's Productivity Commission[1] released a report assessing the efficiency and competitiveness of Australia's superannuation system and whether the system needs better ways to allocate savers to default investments.[2] The 700-page report makes 31 recommendations that address a range of concerns. The report is quite critical regarding a number of aspects of the system, from superannuation fund performance to failures of the regulators.

Separately, Australia's Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry[3] released its final report, outlining the results of its sweeping inquiry into potential misconduct in the financial services industry following the global financial crisis.[4] The 500-page report makes 76 policy recommendations on different areas of the financial services industry, including banking, financial advice, superannuation, and insurance. The report's recommendations are expected to have considerable impact on wholesale distribution and superannuation, with a largely indirect impact on asset managers.

We provide below a brief background of the Australian superannuation system, followed by a description of the two reports and their findings and recommendations that are most relevant for regulated funds and their managers.

Brief Background on Superannuation System and Default Fund Selection

Australia has a mandatory, employer-based defined contribution system, known as the Superannuation Guarantee. Employees are required to contribute a percentage of their salaries (currently 9.5 percent, but scheduled to increase).[5] Employers are responsible for selecting a default fund, designated as a "MySuper" product, for those employees who fail to make an investment choice. MySuper products must be simple and low cost and must have a diversified portfolio suitable for use as a default investment.[6] In addition to the MySuper products, employees can select from a range of "choice" super funds or can invest in a self-managed super fund (SMSF). Trustees oversee the super funds and they owe a fiduciary duty to investors in the funds.

With respect to investment options, two regulators play a role—the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investment Commission (ASIC).[7]APRA oversees funds' governance and investment management and is responsible for authorizing super funds. ASIC oversees consumer protection aspects of the system, including provision of financial advice.

Overview of Report

After a thorough assessment of the system, the Productivity Commission developed a series of findings, organized under the following topics:

- Investment performance,
- Fees and costs,
- Members' needs,
- Member engagement,
- Erosion of member balances,
- Market structure, contestability and behavior,
- Insurance,
- Fund governance,
- System governance,
- Overall assessment, and
- Competing for default members.

The report then describes 31 recommendations to address the Productivity Commission's various concerns. Following are highlights of the Productivity Commission's findings and recommendations that we found most relevant to ICI members.

Create "best in show" shortlist for MySuper.[8] The Productivity Commission found that employers sometimes do not make the best choices in selecting MySuper funds, employees often cannot or will not make choices, and many savers are not in the best performing superannuation funds.

To address these concerns, the Productivity Commission recommends removing the employer from the decision-making process by creating a "best in show" shortlist of up to

10 superannuation products. The shortlist would be presented to each individual who is new to the workforce or does not already have a superannuation account (although individuals would not be prevented from selecting an option that is not on the shortlist). Any person who does not have an existing account and who fails to make an investment decision would be defaulted to a product on the shortlist, selected via sequential allocation. To develop this shortlist, the government would establish an independent expert panel. The panel will establish a clear set of criteria,[9] and funds would submit for consideration products meeting the criteria.

Reduce number of accounts. The Productivity Commission found that individuals have too many accounts, due to job changes, which has the effect of eroding balances from unnecessary fees and insurance.[10] The report estimates that a third of accounts are "unintended multiple accounts."

To stop the proliferation of accounts, the Productivity Commission recommends that new default accounts should only be created for members who are new to the workforce or do not already have a superannuation account. When an employee changes jobs, absent any affirmative choice, the employee would continue contributing to his most recently active existing account (a centralized, online service will facilitate this process), linking the default system to the individual rather than his or her job.

To address the multiple accounts already in existence, the report recommends automatic consolidation of accounts with balances under $6,000 and 13 or more months of inactivity.

Limit fees. The Productivity Commission determined that fees in the super system are higher than they should be (particularly for choice products, since MySuper products have stricter limits on fees). Although the superannuation system has realized significant economies of scale over the prior 13 years, the report expresses the belief that cost savings have not sufficiently been passed to investors in the form of lower fees. Further, although commissions were banned in 2013 for new accounts, trailing commissions in many grandfathered arrangements are still in place.

To address these findings and reduce fees, the Productivity Commission recommends that the government (1) limit the fees charged by APRA-regulated superannuation funds, prohibiting funds from charging fees that exceed their cost recovery levels and (2) completely ban trailing financial adviser commissions in superannuation.

Require annual outcomes testing. The Productivity Commission found a vast difference in investment performance; while many superannuation products perform well, many significantly underperform. To weed out persistent underperforming products, the Productivity Commission suggests that all superannuation products should "earn the right to remain" in the system.

The report recommends the government accomplish this by requiring that all APRA-regulated superannuation funds undertake annual outcomes tests for their MySuper and choice offerings. Every investment option would be compared with a benchmark portfolio tailored to its asset allocation. If an investment option's performance is, on average, more than 0.5 percentage points below the benchmark over a rolling eight-year period, the investment option will be subject to a 12-month remediation period or withdrawn from the market (and members would be transferred to a better performing option). Every three years, the fund would need to obtain independent verification (an audit-level standard) of the outcomes testing.

The report recommends that APRA be given greater authority, allowing it to (1) prevent a fund from launching new investment options or accepting new members into existing investment options until a remediation is complete, and (2) when remediation is unsuccessful, to revoke a fund's MySuper authorization or require the fund to withdraw the choice option.

Reassess retirement income covenant. The report highlights concerns regarding the decumulation phase of retirement. The Productivity Commission found that there are a range of retirement income products currently available. Its concern is that, due to the broad diversity of pre-retirees' needs and preferences, it is difficult for individuals to pick the product that is best for them. The government's not-yet-implemented Retirement Income Covenant will require funds to offer a risk-pooled product to members when they retire.[11]

The report recommends that the government reassess the costs and benefits of the Retirement Income Covenant and only introduce it if the design flaws can be sufficiently remediated. To help pre-retirees with decisions regarding retirement income, the report recommends that the government consider providing retirees with access to a one-time impartial information session and/or investing in technology to assist retiree's decision-making. To immediately improve access to useful information, the government should prompt each individual reaching age 55 to visit applicable government websites.[12]

Improve disclosure. The Productivity Commission found that individuals need simpler, more meaningful disclosure (i.e., better, not more, information) in order to increase engagement and improve decision-making. Simple, single-page disclosures with information on performance and cost—in the form of "dashboards"—exist for MySuper products. Dashboards are scheduled to be required for choice products; however, these requirements have been continually delayed.

The report recommends that dashboards be required of all super investment options, and that implementation for choice product dashboards be completed by the end of 2019.

Overview of Royal Commission Report

The final report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry sets out the Royal Commission's final findings and recommendations under the following broad categories:

- Banking,
- Financial Advice,
- Superannuation,
- Insurance,
- Culture, governance, and remuneration, and
- Regulators.

The report includes 76 recommendations to address the Royal Commission's various concerns. Following are highlights of the Royal Commission's findings and recommendations on financial advice and superannuation that we found most relevant to ICI members.

Royal Commission's Recommendations: Financial Advice

The Royal Commission's goal is to complete what it characterizes as the transition of the financial advice industry "from an industry dedicated to the sale of financial products to a profession concerned with the provision of financial advice."[13] The report describes obstacles to this transition and makes the following recommendations to address these obstacles.

End "fees for no service". The report outlines concerns about clients having been charged ongoing fees for services that were not provided. To address this, the report recommends increasing disclosure and scrutiny of ongoing fee arrangements such as trailing commissions.[14]

Address conflicted advice. The 2012 Future of Financial Advice (FoFA) reforms imposed a best interests obligation on financial advisers giving personal advice to retail clients, increased fee transparency, and also banned conflicted remuneration. The report expresses concern that the best interests obligation, in practice, requires the adviser to make little or no independent inquiry into, or assessment of, products. The report also highlights that financial advisers consistently recommend proprietary over third-party products. The report therefore recommends 1) requiring financial advisers to disclose lack of independence; 2) ending grandfathering of conflicted commission arrangements; 3) and reviewing the best interests duty in three years.[15]

Establish new disciplinary system. The report finds that the existing disciplinary system for financial advisers is fragmented and ineffective. The report recommends establishing a new disciplinary system for financial advisers.[16]

Scrutinize "one stop shop" model. The report raises concerns with the "one stop shop" model, where product manufacture, sale, and financial advice are vertically integrated—for example, where retail customers can receive financial advice alongside traditional banking facilities such as loan and deposit services. Although the Royal Commission does not make any recommendations at this point, the report says that the "one stop shop" model creates a bias toward promoting proprietary products, even where they may not be ideal for the consumer.

Royal Commission's Recommendations: Superannuation

The Royal Commission report makes recommendations in four core areas of superannuation, including trustees' obligations, 'selling' superannuation products, the existing framework for default accounts, and the role of regulators. There is some overlap with the Productivity Commission's recommendations.

Reduce trustees' conflicts of interest. The report expresses concern that some trustees do not adequately understand their obligation to act in the best interests of beneficiaries. The report reiterates that the best interests covenant[17] requires a trustee to prioritize the beneficiaries' interests where a conflict arises and that disclosure of conflicts of interests on its own is not enough.

The report finds that conflicts of interest arise when a trustee acts a dual-registered entity—for example, taking on the obligations of responsible entity of a managed investment scheme. To prevent these conflicts, the report recommends prohibiting a superannuation fund trustee from assuming any obligations other than those arising from or in the course of its performance of the duties of a trustee of a superannuation fund.[18] This would prevent a trustee from acting as a dual-regulated entity, as well as undertaking any obligation that does not arise out of its holding the office of trustee. It would still allow a trustee to serve as the trustee of more than one superannuation fund.

Limit fees for advice. Similar to the report's findings on financial advice, the report also expresses concern that account holders may not realize the amount of the fees that they are paying, or that they may be paying for services they are not receiving. The report recommends placing various restrictions on fees for advice, including restricting the deduction of advice fees from choice accounts.[19] Similar to the Productivity Commission, the report also recommends banning grandfathering of trailing financial adviser commissions.[20]

Prohibit unsolicited retail sales. The report recommends prohibiting the unsolicited offer or sale of superannuation products to retail clients (referred to as 'hawking'), with the exception of non-retail clients or under an eligible employee share scheme.[21] This would not prevent a trustee or related entities from advertising generally the availability of the fund.

Create single default account system. The Royal Commission report agrees with the Productivity Commission's recommendation that default superannuation accounts should only be created for new workers, or workers who do not already have a superannuation account. The report further recommends creating a framework for that single default account to then be carried over, or 'stapled', to a worker as they move jobs.[22]

Adjust role of regulators. The report recommends maintaining the existing 'twin peaks' model of regulation, with APRA continuing to act as prudential regulator and ASIC as the conduct regulator.[23] Although the report does not favor the creation of a superannuation-only regulator, it recommends various adjustments to the roles of APRA and ASIC.[24]

The report also recommends introducing a regulatory regime for superannuation funds that is similar to the Banking Executive Accountability Regime (BEAR).[25] This would subject the directors and senior executives of large superannuation funds to statutory obligations that are generally similar to those that the BEAR imposes on bank board members and executives.

Finally, the report recommends establishing a new oversight body for APRA and ASIC, to "assess the effectiveness of each regulator in discharging its functions and meeting its statutory obligations."[26] This new entity would be comprised of three part-time members, staffed by a permanent secretariat. The report also recommends requiring the oversight body to report to the Minister on each regulator at least biennially.

Shannon Salinas
Assistant General Counsel - Retirement Policy

Linda M. French
Assistant Chief Counsel, ICI Global

endnotes

[1] The Productivity Commission is the Australian Government's independent research and advisory body, covering a range of economic, social and environmental issues affecting the welfare of Australians. Among its core functions, it completes public inquiries and research studies requested by the Government.

[2] The Productivity Commission delivered the report (Productivity Commission, Superannuation: Assessing Efficiency and Competitiveness, Inquiry Report) to the Australian Government in December 2018 and publicly released it on 10 January 2019. The report is available at https://www.pc.gov.au/inquiries/completed/superannuation/assessment/report. The inquiry described in the report is the third stage of a larger project.

[3] The Australian government established the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry on 14 December 2017 to inquire into and report on misconduct in the financial services industry. The Royal Commission conducted seven rounds of public hearings over 68 days, called more than 130 witnesses, and reviewed over 10,000 public submissions.

[4] The Royal Commission released its final report on 4 February 2019. The report and the government's response to the report are both available at https://treasury.gov.au/publication/p2019-fsrc-final-report/. The Royal Commission also referred 24 instances of misconduct to the Australian Securities and Investments Commission and the Australian Prudential Regulation Association for prosecution.

[5] The requirement applies to all employees age 18 and older who earn at least $450 per month from an employer. Employees can contribute additional amounts, up to certain limits.

[6] Most MySuper products offer a single portfolio to be used for employees of all ages; however, approximately one-third of MySuper products offer life-cycle style portfolios (these life-cycle products generally only have two or three phases of asset allocation changes, unlike US target date funds which have a separate asset allocation for each target date fund (which are typically in 5-year segments. e.g., 2030, 2035)). In its draft report, the Productivity Commission had expressed negative views regarding life-cycle products. In the final report, while the Productivity Commission noted that current life-cycle products need improvement, it also acknowledged the value of well-designed MySuper life-cycle products and encouraged further personalization to better match them to diverse investor needs.

[7] As noted in the report, there is significant overlap between the roles of APRA and ASIC.

[8] We understand that there is widespread opposition to this recommendation, in both the government and the financial industry.

[9] The Productivity Commission lists the following guiding principles for setting the criteria and selecting products: (1) Products should be chosen based on the fund's likelihood of providing the best outcomes for members in the accumulation phase, taking account of risk; (2) Products chosen should be particularly suitable for members who have typically defaulted but should also be highly suitable products for all members; and (3) The panel should always seek to ensure a competitive dynamic exists between funds, without compromising the integrity of the 'best in show' list.

[10] The multiple account issue is magnified in the superannuation system because super products typically include insurance (life, disability, income protection), resulting in people paying duplicate premiums. A related recommendation is that individuals under age 25 should not be defaulted into such insurance, and that insurance coverage should cease for accounts in which no contributions have been made over the past 13 months.

[11] The report notes that “the exercise has been beset by design challenges and implementation has been (sensibly) delayed to 2022.”

[12] These websites include the “Retirement and superannuation” section of ASIC’s MoneySmart website and the Department of Human Services’ Financial Information Service website.

[13] Royal Commission Report, at p. 119.

[14] *See* Recommendation 2.1.

[15] *See* Recommendations 2.2 through 2.4.

[16] *See* Recommendation 2.10.

[17] *See* section 52(2)(d) of the Superannuation Industry (Supervision) Act 1993 (SIS Act).

[18] *See* Recommendation 3.1.

[19] *See* Recommendations 3.2 and 3.3.

[20] *See* Recommendation 2.4.

[21] *See* Recommendation 3.4. The report similarly recommends prohibiting ‘hawking’ of insurance products. *See* Recommendation 4.1.

[22] *See* Recommendation 3.5.

[23] *See* Recommendations 3.8 and 6.1.

[24] *See* Recommendations 3.8 and 6.3.

[25] *See* Recommendations 3.9 and 6.8.

[26] *See* Recommendation 6.14.
