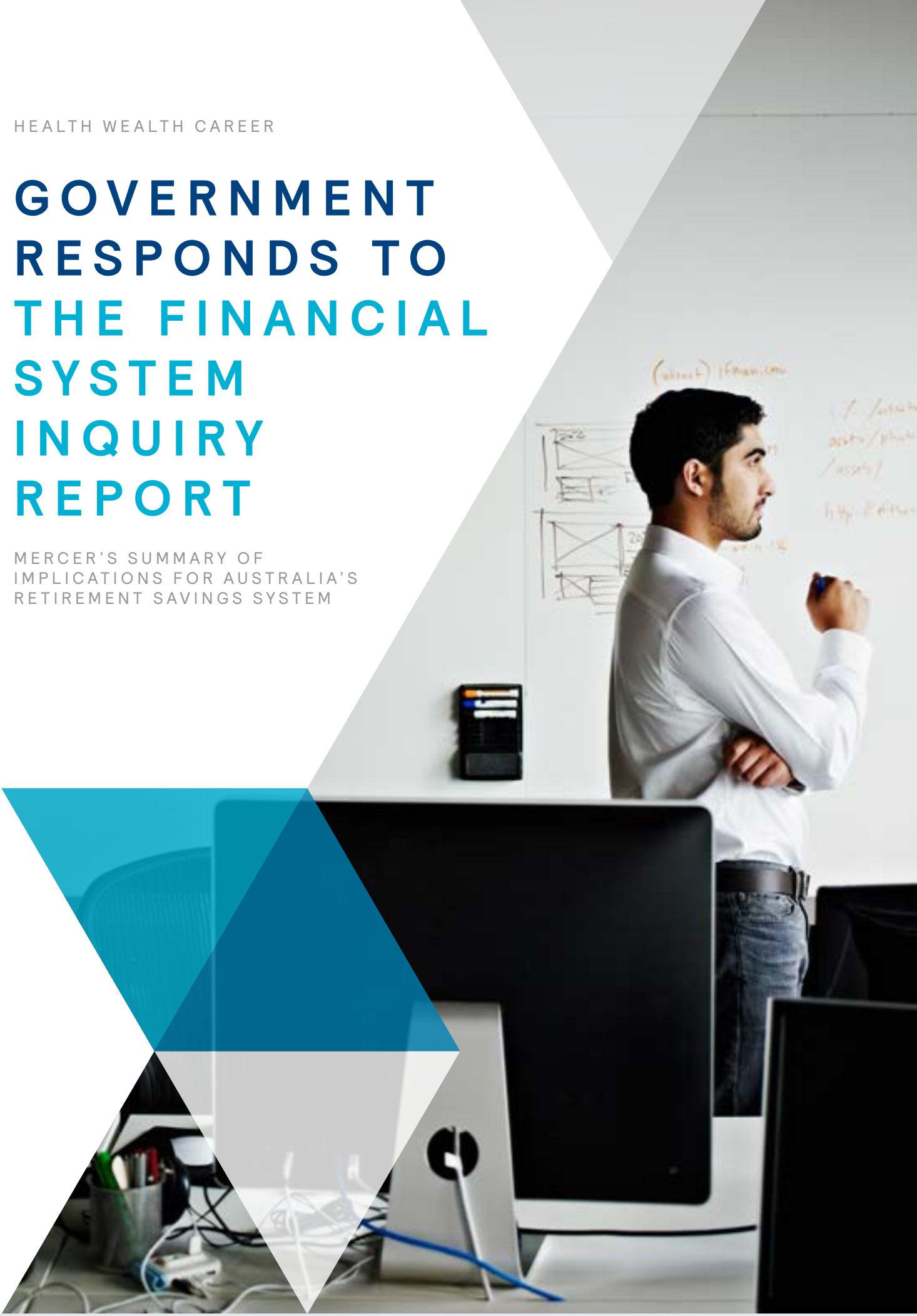
HEALTH WEALTH CAREER

GOVERNMENT RESPONDS TO THE FINANCIAL SYSTEM INQUIRY REPORT

MERCER'S SUMMARY OF IMPLICATIONS FOR AUSTRALIA'S RETIREMENT SAVINGS SYSTEM



MAKE TOMORROW, TODAY MERCER

Following much anticipation from Australia's financial services industry, on 20 October 2015 the federal government released its response to the Financial System Inquiry (FSI) report, which was publicly released on 7 December 2014.

The Government's **response** to the FSI report, which outlined 44 key recommendations to improve Australia's financial system, is understandably very high level. The detail will be critical and we hope the Government undertakes industry consultation in developing detailed policy. However, Mercer welcomes the response and we are pleased to have the overall direction which has been lacking during this year.

Mercer has consistently advocated for a superannuation system that provides certainty, efficiency and innovative solutions so Australians can confidently generate sufficient wealth whilst working, to give them financial security in retirement. Contributing ideas and insights to the industries we serve is an important part of our DNA. We help advance the health, wealth and careers of more than 100 million people globally. In Australia, our breadth and depth of expertise and solutions for the superannuation industry is unmatched.

This report outlines the Government's response to the FSI's recommendations that directly impact the superannuation and financial advice industry. We have also provided our commentary on the Government's response and what it means for Australia's retirement savings system.

Some changes may be implemented quickly and some will be longer-term. We believe it's important for super funds and employers to prepare now to be ready for another round of reform and innovation and we've outlined how Mercer can help you do this.

OBJECTIVE OF THE SUPERANNUATION SYSTEM

The government has agreed with the FSI's recommendation to enshrine the objective of the superannuation system in legislation. It intends to do this by the end of 2016. The objective will serve as a guide to policy-makers, regulators, industry and the community about superannuation's fundamental purpose.

Mercer comment:

At Mercer, we believe the fundamental purpose of superannuation is to provide an income for life to Australians and relieve pressure on the government age pension. We fully support the recommendation for clearer objectives and a more consistent legislative environment for superannuation.

The superannuation goal posts need to stop shifting. Enshrining a clear objective of superannuation into legislation should ensure new measures will be held up to scrutiny and hopefully reduce the level of tinkering with the superannuation system.

We believe it is important that the objective should be set in the context of Australia's overall retirement income system, and provide clarity around the purpose of each pillar: the age pension, compulsory super and voluntary super.

The FSI's proposed primary objective for superannuation "To provide income in retirement to substitute or supplement the Age Pension" is a sound starting point with its emphasis on "income". However we would like to see an explicit reference to the need for the income to last for the whole of retirement i.e. the retiree's lifetime.

RETIREMENT PHASE OF SUPERANNUATION

The FSI recommended super trustees be required to pre-select a comprehensive income product for retirement (CIPR) for members. The product would commence on the member's instruction, or the member may choose to take their benefits in another way.

The Government has agreed to support the development of CIPRs and will facilitate trustees pre-selecting these products for members. It will continue to work to remove impediments to retirement income product development. It considers further consultation is required (to occur during 2016) to develop a principles based framework for pre-selection of a CIPR. The framework will be developed with regard to the outcomes of the Retirement Income Streams Review (which is likely to be released later this year) and the Tax White Paper process.

Mercer comment:

The primary objective of superannuation should be to provide lifetime incomes during retirement. Requiring a portion of retirement benefits to be taken as an income stream is critical to improving retirement incomes for Australians.

For too long there has been an undue emphasis on the accumulation phase as opposed to the retirement phase, and the superannuation industry has grappled with how to offer members simple, affordable and flexible longevity risk protection. According to our **research**, on average, one in four Australians will outlive their retirement savings by more than 10 years. A simple and cost efficient way of matching retirement incomes to longevity is to use some form of pooling so that those who live a bit longer receive lifetime benefits. In October 2014, Mercer launched **Mercer LifetimePlus®**, a world-first longevity pooled investment fund within an account based pension, which is now being offered to super fund clients. Superannuation funds offering Mercer LifetimePlus, as part of a well constructed account based pension, are already providing the first CIPR products on the market.

The Government's support for the CIPR recommendation is encouraging. The trustee's selected CIPR should provide members with a trusted benchmark against which other retirement income options can be measured. While the Government has not committed to a full implementation timeline, a lot of the groundwork has already been done via the FSI and will be further covered by the Retirement Income Streams Review and the Tax White Paper process. With this in mind we believe two years is an achievable time frame to establish the legislative and industry framework to implement this important proposal.

We provided a detailed view on the key considerations of implementing a CIPR framework in our response to the FSI report, we believe the superannuation industry stands ready with the expertise and products to provide Australians more affordable, flexible and sustainable solutions to protect against longevity risk.

> "Longevity risk is a problem in Australia that demands urgent action. We believe we've changed the game for the better with Mercer LifetimePlus."

Dr David Knox, Senior Partner at Mercer

ALLOCATION OF NEW DEFAULT MEMBERS AND IMPROVING EFFICIENCY

The FSI recommended the introduction of a formal competitive process to allocate new default employees to MySuper products unless a review by 2020 concludes the Stronger Super reforms have been effective in significantly improving competition and efficiency in the super system.

The government has agreed to task the Productivity Commission (by the end of 2015) to immediately:

- Develop and release criteria to assess the efficiency and competitiveness of the super system; and
- Develop alternative models for a formal competitive process for allocating default fund members to products

After the criteria has been developed and the MySuper reforms have been fully implemented, the Productivity Commission will be asked to review the efficiency and competitiveness of the super system.

The Government will also explore additional measures to improve efficiency and competitiveness in super with more needing to be done to reduce fees and improve after-fee returns for members.

Mercer comment:

Mercer agrees the existing system is not as efficient as it could be. Opportunities exist to improve both the efficiency of the system and the level of competition within the system.

A more competitive retirement savings system will lead to better outcomes for Australians in retirement and ultimately reduce pressure on future tax payers to fund the costs of the Government age pension. However, increasing competition and efficiencies should deliver more value than just reducing fees.

Scrutiny on fees is justified, as the costs associated with superannuation ultimately impact the retirement benefits of millions of Australians.

However, lower costs do not automatically lead to improved outcomes and it's important the debate about increasing efficiency is transparent and complete. We believe the focus needs to be on net returns and long-term outcomes with product providers competing on an equal footing.

Fees for default members have generally come down since the introduction of MySuper products, despite the huge costs of implementing ongoing legislative change including the major investment in SuperStream. It is important to note it will take some years for the cost savings from SuperStream to fully flow through. However, there is scope for further significant reductions by improving the efficiency of the system. For example, recent changes by the Regulator to disclosure requirements will enable significant cost savings because trustees have been given greater scope to provide disclosure material electronically rather than by mail out of paper documents.

continued

IMPROVING EFFICIENCY CONTINUED

There is also scope for increased competition. The existing system restricts competition by limiting default funds (for employees covered by a Modern Award or under some Enterprise Agreements) to the small number of funds listed in the Award/Agreement. Such provisions should be removed to enable greater competition to occur. A more competitive system is also likely to result in a reduction in fees.

However, the desirability of a formal competitive process for allocating default fund members to products will need to be thoughtfully evaluated, as it would itself add costs to the system and restrict competition in some ways e.g. employers may not be able to negotiate the best default arrangements for their employees. There are many examples of positive outcomes to employees as a result of the involvement of employers in the selection of default funds for their employees.

Formal tender processes have been implemented in some other countries, however the approaches adopted have been developed to suit the specific circumstances of those markets and their suitability and likely impact if adopted in Australia would need to be very carefully evaluated in the context of our own marketplace.

We intend to contribute to the Productivity Commission processes and will use our global reach to analyse, assess and gain insights into the merits of formal tender systems used internationally.

> "It is in injecting more competition and better governance into the compulsory superannuation system that Murray will likely carve out its own era."
>
> Australian Financial Review Editorial, 21 October, 2015

GOVERNANCE

The FSI recommended mandating a majority of independent directors (including an independent chair) on the board of corporate trustees of public offer super funds. The Government has already tabled legislation to require at least one-third independent directors (including an independent chair) for both public offer and non-public offer super funds.

Mercer comment:

We support the Government proposal in principle. Superannuation funds are increasingly becoming large financial entities and should be subject to similar director standards to those that apply to other large financial corporations. We believe the proposed reform is a way of bringing broader skills and experience and greater diversity to trustee boards.

The proposal to allow trustees to choose whether to comply with the one-third minimum or to have a majority of independent directors, provides them with the ability to determine their own size and composition based on the skills and competencies required for their individual fund.

While strengthening the independence of superannuation boards is important, we believe the collective skillset, objective judgment and dynamics of a board are just as important to effective decision-making.

We also commend the flexibility in the government's proposed approach, which would allow for member representation on trustee boards to continue.

The Inquiry also recommended aligning the director penalty regime with that applicable to managed investment schemes and strengthening the conflict of interest requirements.

The Government supports introducing penalty provisions and criminal sanctions for directors who fail to execute their duty to act in the best interests of members or who use their position to further their interests or the interests of others to the detriment of members. This will be implemented after 2016.

Mercer comment:

Mercer did not support the FSI recommendation to completely align the director penalty regime to that applicable for managed investment schemes.

We believe this would have resulted in superannuation trustee directors being exposed to more liability than any other directors in Australia, with both potential liability to individual members for loss under the superannuation director covenants and potential penalties. The wording of the Government announcement supports imposing penalties for certain kinds of inappropriate trustee director behaviour but is silent about whether these penalties would be in addition to or in substitution for civil liability to members for loss under the superannuation director covenants.

GOVERNANCE CONTINUED

The Government also supports APRA requiring Board members to acknowledge when a director adds an interest to the conflicts register.

Mercer comment:

We support this action.

> "Managing the balance between engaging independent directors and retaining the natural alignment of interests inherent in the representative director model is a challenge, but not an insurmountable one."
>
> Mercer's 2014 Superannuation Governance Survey

MEMBER ENGAGEMENT

The FSI recommended:

- Publishing retirement income projections on member statements (defined contribution schemes) using ASIC regulatory guidance; and
- Facilitating access to super information held by the ATO to use with ASIC's and super funds' retirement income projection calculators

The Government agreed with the recommendation to publish retirement income projections where this is practicable and cost-effective. However, consultation on this will not occur until after 2016.

ASIC and the ATO will consider options to facilitate access to consolidated super information and APRA and ASIC will present the data they currently collect in a more consumer-friendly manner.

Mercer comment:

We support these actions although we believe they could be actioned more quickly so members can be better informed and engaged as soon as possible.

ASIC's guidance for projections will need to be kept under review as CIPRs are developed, to ensure that it allows projected income from the CIPR to be projected and illustrated in an appropriate manner.

IMPACT INVESTMENT

The government agrees that impact investing has the potential to benefit both government and taxpayers, and will:

- Develop legislative amendments to provide greater certainty for private ancillary funds wishing to invest in social impact bonds; and
- prepare a discussion paper to explore ways to facilitate development of the impact investment market in Australia and introduce legislative amendments if necessary.

This response broadly reflects the FSI recommendations. However, in regard to the recommendation to provide guidance to superannuation trustees on the appropriateness of impact investment, the Government said this was a matter for APRA to consider.

Mercer comment:

We believe it is important to facilitate the development of the impact investment market and encourage innovation, including social service and environmental solution delivery.

The first step must be to define and reach a consensus on what the term "impact investment" actually means to key stakeholders who participate in markets and communities. This is a critical step as the term is open to a wide variety of interpretations.

Secondly, we believe it is important to identify key stakeholders and create an Impact Investment 'platform' or centralised 'hub', under the auspices of an **industry leadership body** that includes community sector representation.

Finally, the development of impact investment should be supported via data collection, establishment of data registries and case studies showcasing good practice both locally and globally.

On the issue of potential guidance to superannuation trustees, in our view impact investment should be an integral aspect of a super fund's Environmental, Social and Governance (ESG) policy. As such, trustees should be guided by their ESG framework.

FINANCIAL ADVICE

The government will introduce legislation by mid-2016 to raise the professional, ethical and educational standards of financial advisers. Advisers will be required to hold a degree, pass an exam, undertake continuous professional development, subscribe to a code of ethics and undertake a professional year. The detail of the new standards will be set by a new independent, industry funded body recognised in the legislation.

The government will consult on appropriate transitional arrangements for existing advisers.

The recently established register of financial advisers will be amended to clearly identify whether individuals meet the new standards and whether there are relevant bans, disqualifications or code breaches applicable to that individual.

The government will also legislate to:

- restrict the terms 'financial adviser' and 'financial planner' to those listed on the register
- re-name 'general advice' to improve consumer understanding. The new term will be finalised after consultation and consumer testing
- ensure that financial advisers and mortgage brokers adequately disclose their relationships with associated entities
- give ASIC the power to ban individuals from managing financial firms.

A statutory review in 2019 will consider whether the new regulatory framework has raised the professional standards of financial advisers and whether further changes are required.

The above responses are broadly consistent with the FSI's recommendations.

In relation to adviser and licensee remuneration relating to retail life insurance, the government confirmed that it supported the industry's proposed reforms as announced by the then Assistant Treasurer on 25 June 2015, rather than the level commission structure recommended by the FSI.

The government will consider the extent to which legislation and/or action by ASIC may be necessary to implement the industry agreement.

A government review in 2018 will consider whether the new industry arrangements for life insurance advice have better aligned the interests of firms and consumers. If the review suggests further reform, consideration would be given to the FSI's recommended commission structure or further extending the existing Future of Financial Advice provisions on conflicted remuneration to life insurance advice.

Mercer comment:

Mercer supports the view that the entry requirements for providers of financial advice are too low across the industry. Higher education and professional standards are integral to gaining the trust of consumers and increasing the usage of quality advice and we therefore welcome the Government's proposals.

Mercer's Financial Advice business had previously implemented a minimum degree qualification for all new and existing advisers. We require our strategic advisers to have a CFP designation or Masters or be working towards these designations. We have a minimum of 40 hours ongoing CPD for advisers, which is higher than the professional association requirements for CFPs. Our existing standards are much higher than those proposed by the Government and the PJC.

We also support the proposed restrictions on the use of the terms 'financial adviser' and 'financial planner' and agree that 'general advice' should be re-named to try to avoid misleading consumers who don't differentiate between general and personal advice.

CONSIDERATIONS FOR SUPERANNUATION TRUSTEES & EMPLOYERS

FSI RECOMMENDATION

Comprehensive Income Products for Retirement (CIPRs)

The Government agrees to support the development of comprehensive income products for retirement and will facilitate trustees pre-selecting these products for members. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.

TRUSTEE

Key considerations

- *Can you offer your members/employees a selection of retirement income solutions (CIPRs) and ensure their super savings will last for the rest of their lives?*
- *Can you, and have you, tested your retirement strategies against your members' income expectations and needs, not just returns?*

How Mercer can help

Mercer can help in the following ways:

1. Delivery of Mercer LifetimePlus
2. Design and delivery of bespoke CIPRs
3. Development of retirement income based objectives for a fund and testing of investment strategies to meet these objectives

There are already compelling demographic, fiduciary and commercial arguments for why super funds need to develop more innovative post-retirement solutions. Soon, there will also be legislative requirements to do so.

Traditionally, post-retirement solutions have existed along a spectrum from pure investment based products through to guarantee based products such as annuities. However, more recent post-retirement innovation has focussed on solutions that sit somewhere in the middle of this spectrum, offering a hybrid of the traditional investment and guarantee based approaches.

The design of an appropriate CIPR for a fund will require careful consideration of member circumstances and needs, as well as available product features across aspects including investment strategy and risk, income design, longevity protection, cost and flexibility.

We don't believe there is a single solution for all funds and members and it will be important for funds to consider more than one CIPR to cater for membership groups with different characteristics, particularly the size of the account balance.

Funds that make an early start on considering their CIPR design will have a much better chance of achieving the optimal design for their members.

Super funds will need to be able to test retirement income strategies against their members' retirement income based objectives, which is a complex task.

Mercer's **Retirement Income Framework** and modelling is a significant step forward in helping super funds better understand the retirement income needs and expectations of their members, and how the likelihood of achieving that income will be impacted by adopting different retirement strategies.

> "When we look under the bonnet of what super funds are offering retirees to help them manage their super throughout their retirement we see a wider range of solutions beginning to emerge as the industry shifts its focus from accumulating wealth to providing an income throughout retirement – to the very end."

Graeme Mather, Leader of Mercer's Retirement & Investment Consulting Business, Pacific.

EMPLOYER

Key considerations

Does your superannuation fund add value in educating your employees and provide innovative solutions to help during retirement as well as leading up to it?

How Mercer can help

Our **research** reveals that around 1 in 5 Australians aged 50-80 believe they will return to work to manage the impact of longevity risk, only 6% of those already retired have returned to work. Your employees' expectations around retirement are highly likely to be disconnected to the reality of retirement.

Mercer can help in the following ways:

- Assess the retirement readiness of your workforce using Mercer's Retirement Readiness Index
- Introduce Mercer LifetimePlus to your super fund to provide your employees with greater peace of mind to transition to retirement
- Provide workplace financial education for your workforce

FSI RECOMMENDATION

Governance changes

The Government agrees with the need to improve the governance of superannuation funds.

TRUSTEE

Key considerations

What is your plan to cope with added scrutiny & the proposed changes in governance requirements?

How will you ensure the most effective composition of skills and experience and attributes on your trustee board?

How will you maximise the benefits of your trustees' skills and experience?

The Bill to introduce the Government's one-third minimum independent trustee requirements has been passed in the House of Representatives and is now to be considered by the Senate, with the Senate Economics Legislation Committee inquiry into the Bill due to report by 9 November 2015.

If the Senate approves the Bill, trustee boards will have a significant amount of work to do over the next 12 months (and beyond) to ensure they comply with the new legislation and the associated changes to APRA Prudential Standards.

How Mercer can help

At Mercer, we believe good governance means having the right structure, people and frameworks in place to successfully realise your vision and achieve your goals.

We have a strong team of governance professionals with multidisciplinary backgrounds who specialise in advising the boards and management teams of superannuation funds, other financial institutions and companies on governance matters.

Mercer can help in the following ways:

- Review legal and governance structures for effectiveness. This may include drafting changes to constitutions and deeds, review and drafting of delegations to committees and management, advice on board processes and development of transition plans.
- Determine which (if any) of existing trustee directors meet the new definition for independence.
- Develop competency and skills criteria aligned to the trustee's strategy, in order for the board to deliver on its key objectives and meet regulatory obligations. Undertake a gap analysis of the board against the set criteria and assist with the design of a plan to address the gaps.
- Develop job descriptions for future independent directors to ensure their competency and skill sets will add value to board and committee governance and effectiveness.
- Advise on aligning the remuneration approach with the business strategy and developing a narrative around remuneration disclosure, which is critical to how remuneration arrangements are received, understood and accepted by the fund's stakeholders.
- Provide and advise on rigorous and continuous training programs critical to improving trustee director's skills and competencies and ultimately board performance.
- Provide independent Board Effectiveness Reviews – We believe these should be conducted at least every 2 or 3 years.

FSI RECOMMENDATION

Superannuation member engagement

The government agrees that where practicable and cost effective, retirement income projections should be published on member statements.

TRUSTEE

Key considerations

Many funds have already started to provide retirement income projections on member statements.

Have you considered doing so now in order to better engage and inform your members, rather than waiting until it is compulsory?

Are your members on track to achieve their retirement goals?

How can you identify members at risk and what are your strategies to enhance retirement readiness?

How Mercer can help

Mercer can help in the following ways:

- Create engaging member projection statements customised to a fund's requirements using our Retirement Income Projection Statements that leverage our robust Retirement Income Simulator engine
- Member filtering: Target specific statements to member segments by filtering raw input data
- Alternative scenarios: Include alternative scenarios in statements to demonstrate how members can improve their retirement income
- Custom output: Retirement Income Projection Statements can include any combination of member specific inputs and outputs from the Retirement Income Simulator engine, including charts
- Brand customisation: The positioning and style of the member-specific information can be customised to fit into a template document of your own design.

FSI RECOMMENDATION

Financial adviser arrangements

The government will introduce laws to raise professional standards of advisers by mid-2016 and in 2019 consider whether more changes are needed.

TRUSTEE

Key considerations

Do you add value for your members by supporting them with financial advice services?

Have you planned how you can ensure your advice services are ready to meet the new requirements, which seem certain to proceed, or to consider alternative arrangements such as outsourcing?

How Mercer can help

Mercer Financial Advice is extremely well placed to assist funds through the provision of quality financial planning services to their members under the new requirements. In fact, our business has been geared for it well ahead of regulation.

Mercer's Financial Advice business has already implemented a minimum degree qualification for all new and existing advisers. All our advisers are members of a professional body. Mercer is the first and the only salaried advice business in Australia where every office is accredited as a Professional Practice of the Financial Planning Association, Australia's peak professional body for financial planners. The Professional Practice designation is designed to recognise financial planning practices that are proven to provide the highest quality financial advice in their community.

IMPORTANT INFORMATION

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