Alternative Default Models: Comments on the Productivity Commission's Issues Paper

Submission by UniSuper

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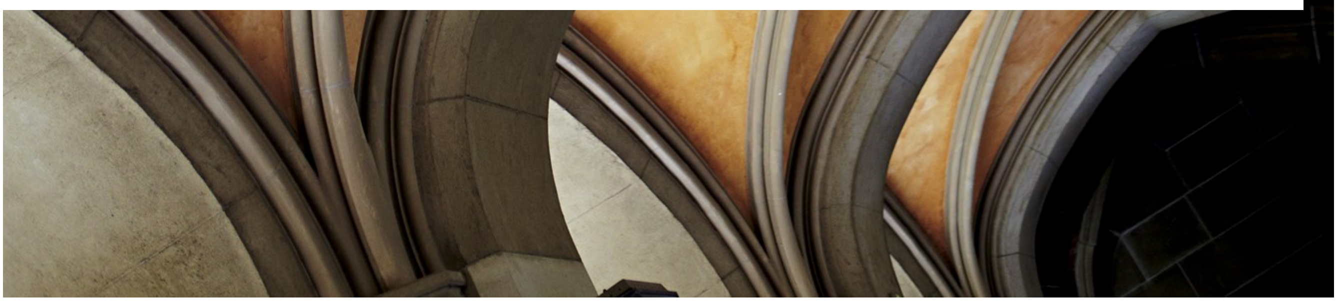

About UniSuper

UniSuper[1] is the superannuation fund dedicated to people working in Australia's higher education and research sector. With approximately 400,000 members and $55 billion in assets under management as at 30 June 2016, UniSuper is one of Australia's largest superannuation funds and has one of the very few open defined benefit schemes.

UniSuper, established in 1983 as a defined benefit (DB) scheme, was modelled broadly on then contemporary DB schemes in the Australian public sector and overseas peer funds. The benefit design from its outset offered full portability of benefits across all participating employers and coverage of all permanent employees in the sector, including general, academic and professional staff.

The multi-employer nature of UniSuper led to some important distinguishing features from its commencement, in particular:

- a fixed contribution rate of 14% of salary p.a. for employers and 7% of salary p.a. for contributing members;
- by covering the whole university sector, members can maintain defined benefit membership when transferring between employers within the sector;
- members can defer their benefits (so maintain membership) through periods when not employed in the university sector;
- a formula-based benefit related to member's salary, tenure and employment experience.

Over its foundation years, UniSuper succeeded in obtaining broad coverage of permanent employees in the Australian university sector and "folded in" a large number of legacy DB superannuation and pension schemes from individual institutions on a successor fund and/or optional transfer basis.

Today, 37 universities and roughly 200 related bodies are participating employers.
The Defined Benefit Division (DBD) remains funded by a 14% employer contribution and 7% default member contribution (which members can reduce with appropriate benefit adjustments). Many members also receive an additional 3% "award" contribution paid into an associated accumulation account, making a total employer contribution of 17%.

We also manage two defined contribution, accumulation-style accounts. Accumulation 1, is for members who are not entitled to DBD membership and Accumulation 2 is based on the same 14%/17% employer contributions paid by participating employers for those who exercise a form of choice and opt out of DBD membership.

[1] This submission has been prepared by UniSuper Management Pty Ltd (ABN 91 006 961 799), which acts as the administrator of the Trustee, UniSuper Limited (ABN 54 006 027 121).

UniSuper is proud to be recognised as one of Australia's most awarded super funds. Over the years we have received a string of awards and high ratings from independent ratings and research agencies. We strive to offer our members the best from customer service through to online experience and of course a competitive product suite. We have been recognised by SuperRatings, an independent superannuation research company, as a 'value for money' fund for ten consecutive years (2006 - 2016). We were named 'Super Fund of the Year' in both 2015 and 2016 by Chant West and received 5 apples ratings for our Accumulation 1 and Accumulation 2 products. Our Accumulation products were also awarded a 10-year Platinum Performance rating by SuperRatings. These awards reflect our ongoing commitment to providing members with the highest quality products and services, along with our competitive investment returns.

UniSuper Management Pty Ltd would welcome the opportunity to discuss the submission further and to provide additional information in respect of the comments made in this submission. Should you have further queries, please contact Benedict Davies

Issues paper: Alternative default models

In the Issues paper, the Commission states that its preferred, objective baseline for this inquiry is to have no defaults, and for any alternative models of default to be assessed against this baseline. That approach puts consumer sovereignty and decision-making at the heart of the system.

While consumer sovereignty is important as an aspirational objective in any market-based economy, and is a useful starting point for evaluating the markets for most goods and services, it seems a less realistic baseline assumption given the history of mandated retirement savings in Australia.

Superannuation, as we know it today, originated from a number of different but related traditions: employer paternalism, industrial agreements and government compulsion. Each of these traditions has one thing in common: compulsion.

It is, therefore, more appropriate to recognise this compulsory participation under which defaults predominate across the sector. Under this approach, a cost-benefit analysis would then compare the benefits of our current system with the *potential* gains from alternative default arrangements. We agree with the Commission that the starting point in any evaluation does matter, but we think this starting point should be anchored in the superannuation system model as it actually exists, not in a hypothetical model which ignores the realities of the system as it has evolved in Australia.[2]

The Commission has flagged downsides of defaults

In the Issues paper, the Commission argues that:

- where default products are largely homogenous, they might not meet the needs of members who have diverse characteristics and needs; and
- defaults may diminish active participation by members, making them less responsive to price signals and other elements of fund performance. This could lead to the persistence of high fees, low quality products, and the subsequent erosion of member balances over time (p. 5)

We accept that the Commission would be right to be concerned if default products were homogenous and diminished active participation by members, however, in our experience, this is not the case.

[2] See Orszag & Stiglitz, *Rethinking pension reform: Ten myths about social security systems* (1999) on inherent features versus imperfect implementation. Orszag & Stiglitz argue that "[Say], we observe that system Z is not working properly. Should we propose a switch to system Y, or instead work on improving system Z? Surely, comparing an idealized version of Y to an as-implemented version of Z is not likely to prove insightful."

A well-considered default will not be homogenous

UniSuper is the default superannuation fund in numerous enterprise agreements across the higher education sector.[3] In our case, there are two defaults: most full-time employees in the sector are defaulted into the Defined Benefit Division, while casual and contract employees are defaulted into our MySuper product unless they make an alternative decision.

The designs of both of our default products have been based on a strong understanding of the particular needs of employees in the higher education and research sector. Further, the design of our main default product – the Defined Benefit Division – was the culmination of many years of negotiations between universities and their stakeholders to bring about a multi-employer, portable default arrangement.

Our DB scheme has been in operation for over 30 years. Under current default arrangements, we have been able to establish a successful, well-funded, innovative and *open* DB scheme – a rarity when compared to many other schemes around the world. In contrast to accumulation products (which are directly exposed to investment volatility), DB schemes aim to deliver a more predictable formula-based benefit. The DB structure offers members far greater certainty in planning for their retirement, achieving this through pooling members' assets to smooth investment experience, ultimately providing a stable (formula-based) benefit that is not directly exposed to the volatility of investment markets. Over three decades, and many economic cycles, no UniSuper DB member has had any reduction to their accrued defined benefit. Even after the Global Financial Crisis (GFC), defined benefits accrued by members were not affected. Many Australians have not been so fortunate.

We also have a default MySuper product for accumulation members, typically casual and contract employees in the higher education sector. In developing our accumulation MySuper offering, we undertook extensive modelling of the level of retirement benefit required to ensure that members have adequate replacement income. The objectives of our MySuper investment strategy are formulated on the outcome of that modelling.

We are proud that our default products are anything but homogenous and are based on an intimate knowledge of our members and the employment patterns, salaries and circumstances particular to the higher education sector.

Active participation by members can work hand-in-hand with a default

The Commission also highlights concerns that defaults may diminish active participation by members. In our case, we think this concern can be addressed by giving members a real voice, which we do through our Consultative Committee.

[3] UniSuper is named in the two higher education awards and in a third award on post-secondary education. Despite having default status in awards and EBAs, many new employees can still "opt out" of being a member of UniSuper. We have established rules, supported by enterprise agreements, that allow new employees the choice to join another fund and not UniSuper, particularly where an employee is already a member of another similar defined benefit scheme, such as the CSS or PSS, or is a visiting academic from overseas. These rules were also established to prevent members having duplicate superannuation accounts.

UniSuper

UniSuper's founding governance arrangements include a framework for the active participation of members. The Committee is an integral part of the Fund's governance and decision-making process. The Committee is not simply a "sounding board" but has real authority; no changes can be made to UniSuper's Trust Deed without the Committee's approval. That is, the UniSuper Board cannot approve Deed changes on its own authority.

The Committee comprises four representatives from each participating employer (University), of whom two represent employees (one each from academic and general staff) and two represent employers. Assuming a full complement (i.e. no vacancies), the Committee has 136 members who are selected through a variety of institution specific election / nomination processes and generally serve for terms of four years.

The Committee also functions as an "electoral college" with authority to elect from its ranks four of the eight representative trustee directors on the Board of UniSuper Limited. The other four representative positions are nominated by the peak bodies for each constituency viz: the Vice Chancellors of Australia's universities on the employer side and the National Tertiary Education Union (NTEU) and Community and Public Sector Union (CPSU) on the member side. In turn, those eight representative directors decide whom to appoint as the three independent directors (including the independent Chair) on the Board.

This combination of measures means that UniSuper has genuine participation in its governance framework of each of its key stakeholder groups, and a significant additional layer of accountability for its Board and Management. While this model might not work for all funds, it does bring an even stronger "member voice" to the decision-making process for UniSuper.

Employees eligible to become members of a defined benefit scheme raise special issues

In the Issues paper, consideration is given to different allocative *models* for different groups of new default members, but rejects this as an unnecessary complication. The Issues paper does, however, highlight a case for exempting some new employees from the alternative default models, in particular, employees eligible to become members of a defined benefit scheme (p. 10).

We strongly agree with this point.

Policy makers have long recognised that DB schemes require special consideration. Parallels can be drawn with the existing Choice legislation that includes a specific exemption from Choice for *existing* defined benefit members. If that exemption were removed there would be significant consequences for remaining members.

There are a number of important differences between DB schemes and Defined Contribution (DC) schemes. Probably the most important difference is that with DB schemes the actions of a few members can have consequences for the many.

Thus if existing DB members were able to exercise a choice to redirect their employer contributions or, in the inter-related case, those eligible to become defined benefit members were no longer eligible, there is a real potential to put pressure on the viability of a DB scheme because there could be:

- Material numbers of exits of DB members who choose to leave the DB and crystallise their defined benefits, which could lead to significant funding, asset valuation and liquidity issues

- A fundamental shift in the remaining membership profile, creating future funding concerns

- Increased anti-selection risk, exacerbated by a lower proportion of members remaining within the scheme

The occurrence of one or all of the above would, in all likelihood, prompt an actuarial review of funding and potentially require appropriate actions to ensure the ongoing viability of the scheme. In UniSuper's case, possible reductions in member benefits could be required because the fund has neither a government (or employer) guarantee nor recourse to additional employer contributions.

We believe there continue to be very strong reasons why DB schemes need special consideration in developing alternative default models. Our preference would be for an exemption that would allow multi-employer DB arrangements – such as ours – to be exempted from any new default requirements i.e. employers and employee representatives continue to be able to choose or enter into industrial agreements that include a defined benefit scheme as a default.

Even with default arrangements, members receive many choices and sometimes greater choices

We accept that defaults can, in certain circumstances, lead to a lack of choice and flexibility. From our experience, this is not the base case. We think it is important to highlight the amount of choice and flexibility our members already enjoy.

Under current default arrangements, full time employees in the higher education sector are defaulted into our DBD but have up to 24 months to choose between the DBD and our accumulation option. If a member chooses the accumulation option, there are fund rules in place which allow members at most universities to have an amount equivalent to the SG contributions paid to a fund of their choice, with the difference (making up the balance of the mandated 17%) paid to UniSuper.

The outcome of these arrangements is that our members have a number of choices. Not only is there a choice to cease being a defined benefit member within 24 months of joining, there is also a positive choice to *remain* a defined benefit member. We believe that this choice would be put at risk if default arrangements did not exclude employees eligible to become defined benefit members.

Collectively-pooled arrangements, such as DB schemes are not an historical oddity. In fact, future directions for product development across the superannuation industry suggest a return to many of the principles of collective-risk sharing which are central to DB schemes.

Solutions to address the proposal emanating from the Financial System Inquiry (2014) for a Comprehensive Income Product for Retirement (CIPR) are likely to involve some risk-pooling to address longevity risk.

While changes to default arrangements would not necessarily preclude collective-risk pooling, it is easier and more efficient to pool risks between a well-understood and readily definable class or group of members in a particular sector. UniSuper, for example, has a long-established relationship with the higher education and research sector. This has allowed us to collect and analyse extensive data on employment patterns, resignation and retirement ages, as well as reliable mortality and life expectancy data. We use this information in developing new products to address the diverse needs for income in retirement, as well as continually assessing the suitability of existing product options.

If default arrangements were to change, large amounts of this sectoral-based expertise and knowledge could be lost which would make it harder to tailor products, insurance and lifetime income streams to a significant number of Australians.

The alternative mechanisms by which funds compete

In the Issues paper, the Commission states that a competitive process would have several components and the mechanism by which funds compete could be either:

- Administrative (such as a filter);
- Market-based (such as a tender or auction); or
- Combination.

Comments on Tender or Auction option

UniSuper is focused singularly focused on the higher education and research sector, and it is unlikely that we would bid or tender to become a national default scheme. That is because our focus remains on servicing our existing membership base in the higher education sector with a unique product offering: a multi-employer DB scheme and an award-winning MySuper product, both of which have been developed to meet the needs of the employees in that sector.

Even though we would, in all likelihood, not be involved in the process, we do, however, have some concerns if the process resulted in one or a handful of successful bidders.

There are longer-term considerations about the structure of the market after the introduction of a national tender or auction, particularly if “Round One” of such a process resulted in successful bidders growing scale rapidly as part of a “loss leader” strategy. If this were the case, this would have flow-on effects to the rest of the industry, with most other funds, particularly those without shareholder capital, struggling to market their choice products to prospective new members.

While alternative default models would likely lead to further consolidation in the industry (which is potentially desirable)[4], this would likely to come at the cost of more generic, more

[4] It is important to note that consolidation in the industry is likely to occur anyway since the introduction of the scale test as part of the Stronger Super package.

homogenous, and less tailored products. This is an inherent tension in such proposals, particularly given that the Commission has already flagged concerns about some default products not providing for the diverse characteristics and needs of all members.

Comments on the administrative filter option

Of the two broad options in the Issues paper, a quality filter raises fewer issues, but we believe it should only apply to defined contribution-style products.

We believe there are numerous potential quality filters as well as numerous potential assessors. One option, which fits into current legislation, would be for the Fair Work Commission to apply a quality filter to MySuper products as part of establishing a Default Superannuation List.

UniSuper made application for our MySuper product to be listed in, and only in, the higher education awards. We are open to that process being revisited. We are also open to alternative processes involving different assessors.

Another alternative model which has been utilised in other markets is for price (fees) alone to be used as a filter as part of a "cap and compete" policy for default funds. Such a policy has been introduced in the UK, where fees for defined contribution pension plans are capped at 75 basis points. While we make no comment on what fee level would be appropriate in an Australian context, if such a policy were to be introduced, it would need to be matched with additional integrity measures to ensure that fees were not simply traded off for lower services and lower investment returns.

Even with a quality filter – however designed and applied – we still believe that employers must continue to have a key role to play in allocating default members (particularly where employers have acted together to bring about a multi-employer superannuation scheme).

Choice of Fund and Default are closely related issues

Choice of Fund and Default superannuation are closely related issues, particularly for DB schemes. Changes to either Choice or Default rules have the potential to affect the on-going viability of collectively-pooled arrangements, such as DB schemes.

The current Choice rules (as well as recent proposed changes) recognise that DB schemes face unique issues and include an important exemption. We believe that there is strong case for exempting employees eligible to become defined benefit members from both Choice and alternative default models. We are confident that we can show from our experience that the stated concerns that the Commission has with homogenous default products and a lack of member participation are not applicable in the case of our members.

We encourage the Commission to make a recommendation to exempt both current and employees eligible to become defined benefit members from any proposed alternative default model. Such a policy would ensure that our members continue to have many choices, including a choice to *remain* a defined benefit member.

In summary, UniSuper believes that:

- we would be unlikely to bid or tender to become a national default scheme;
- a tender process could raise serious issues if there were one or only a handful of successful bidders;
- a quality filter raises fewer issues, but if one were to be introduced, it should apply only to defined contribution-style products;
- employers must continue to play a key role in allocating default products; and
- there are very strong reasons why DB schemes need special consideration. Our preference would be for an exemption that would allow multi-employer DB arrangements – such as ours – to be exempted from any new default requirements i.e. employers and employee representatives continue to be able to choose or enter into industrial agreements that include a defined benefit scheme as a default.