27 July 2018

Deputy Chair
Productivity Commission
Locked Bag 2, Collins St East
Melbourne VIC 8003

BY EMAIL: super@pc.gov.au

SUPERANNUATION: ASSESSING EFFICIENCY AND COMPETITIVENESS

The Financial Services Council (FSC) welcomes the opportunity to make a submission in response to the Productivity Commission's *Superannuation: Assessing Efficiency and Competitiveness* Draft Report (the Draft Report).

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world.

The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

This supplementary submission deals specifically with two alternative default models – the Commission's 'best in show' proposal and the employer-linked rollover model.

Also attached is analysis undertaken by Rice Warner on the 'best in show' proposal.

Please contact me with any questions in relation to this submission

Yours sincerely,

Allan Hansell
Director of Policy

TABLE OF CONTENTS

SUMMARY OF FSC RECOMMENDATIONS 3
1. TOP 10 'BEST IN SHOW' PROPOSAL 4
1.1 Costs and benefits of increased scale 5
1.2 Entrenchment of funds in the shortlist 6
1.3 Market disruption and system stability 6
1.4 Criteria for choosing 'best in show' 7
1.5 Focus on net performance 8
1.6 Incentive effects relating to performance 9
1.7 Length of list 10
1.8 Frequency of review 11
1.9 Expert panel 11
1.10 Enhanced MySuper criteria as alternative 12
2. EMPLOYER-LINKED ROLLOVER 14
2.1 Impact on members 14
2.2 Impact on the system 18
2.3 Addressing issues by homogenisation of product offering 19
2.4 Addressing issues by allowing opt-out 19
2.5 Interaction with other proposals 20
2.6 Conclusion 20

SUMMARY OF FSC RECOMMENDATIONS

FSC Recommendation 1

The Commission should closely consider the potential long-term market impacts of concentrating superannuation contributions in a small number of funds, and consider whether a longer 'best in show' list would assist in mitigating adverse impacts.

FSC Recommendation 2

The Commission publish more evidence to support its view that the 'best in show' proposal will not result in substantial increases in rollovers; or if there were substantial increases in rollovers this would not cause significant problems for the superannuation system.

FSC Recommendation 3

If the Commission continues to recommend the 'best in show' list, it should conduct a more detailed analysis of the benefits of lengthening the 'best in show' list.

FSC Recommendation 4

The Commission should consider avenues for developing a list of funds for members to choose that reduces reliance on the subjective judgement of an appointed panel. For example, this could be achieved by setting a threshold for inclusion in a shortlist that does not excessively limit the number of funds.

FSC Recommendation 5

The Commission should consider whether an elevated standard for MySuper products should be implemented before consideration is given to a full 'best in show' model, to determine whether the move to a universal higher standard for MySuper products could effectively create a "best in show" list of high performing default funds without the need for an additional selection panel process.

FSC Recommendation 6

The Commission should strongly reject the "employer-linked rollover" model in its final report to Government, retaining its recommendation for the "default once" model.

1. TOP 10 'BEST IN SHOW' PROPOSAL

The FSC commends the work done by the Commission to propose a new superannuation default model which involves new members to the superannuation system who do not choose a fund being allocated to default superannuation funds via a *best in show* approach. Under this system, a single shortlist of 10 superannuation products would be presented to all members who are new to the workforce and do not have a superannuation account. Any member who fails to make a choice within 60 days would be defaulted to a product on the shortlist via sequential allocation. Members would not be prevented from choosing any other fund (including an SMSF).

An independent panel would be established to run a competitive process for listing superannuation funds on the shortlist. The panel would run a selection process every four years.

This 'best in show' proposal sits alongside the Commission's proposal that members only 'default once', which means that this default process only occurs if the member has no existing superannuation account – once they have a super account, the default process no longer occurs.

While the FSC fully supports the Commission's proposal that fund members only 'default once', we have a variety of views within our membership on the top 10 'best in show' proposal.

There are several aspects of the 'best in show' model that, at least in principle, are a significant improvement over the current default system.

We are supportive of the default-once model which underpins the model. As noted in our previous submission, we believe any reform to the default system should remove selection of funds from the industrial relations system and stop the flow of compulsory contributions to chronically underperforming funds which are entrenched in current awards.

In principle, we also support a competitive model for allocating members to default funds. Not only does a merit-based default allocation system reduce the risk of disengaged consumers seeing poor outcomes from failing to make an active choice, it also has the potential to increase levels of consumer engagement by providing members with the opportunity to make a choice between funds they know will meet minimum standards.

However, implementation of the 'best in show' list as proposed by the Commission would represent a revolutionary change to the existing superannuation system. The FSC and our members believe that any system changes of this scale should be carefully considered to ensure all potential implications are fully addressed.

We have a range of questions about how a 'best in show' list would look, how it should be compiled, and what impact it would have for members, funds and the system more broadly.

This submission raises a number of the questions and concerns the FSC has with the operation of a 'best in show' system as currently proposed, however we look forward to ongoing engagement with the Commission and the Government to ensure that changes to the system will ensure the best outcomes for members over the long term.

To progress this debate, the FSC commissioned Rice Warner to conduct an analysis of the 'best in show' proposal which is attached to this submission. This submission from the FSC draws on the commentary by Rice Warner, however the FSC's views are contained in this submission alone.[1]

[1] In other words, the views expressed in the Rice Warner paper are theirs alone. Conversely, the views expressed in the submission should not be attributed to Rice Warner.

We note that the Commission's proposals involve a best in show list that has 'up to' 10 members, the discussion below does not restate 'up to' for the sake of clarity and brevity.

1.1 Costs and benefits of increased scale

Scale is important to the performance of superannuation funds. The Commission notes that funds on the shortlist are likely to see greater inflows of new members, both from default allocations and through switching.[2] Analysis by the Commission and Rice Warner shows that, at least to a point, fund expenses decrease as a percentage of FUM as scale increases.[3]

The FSC supports policies which encourage funds that lack sufficient scale to merge with larger, better performing funds. A 'best in show' model would be likely to encourage mergers across the industry, both funds outside and inside the default list.

Even without the 'best in show' proposal, significant rationalisation of super funds has been occurring, and Rice Warner forecasts this process to continue into the future (see section 4 of Rice Warner report). A strengthening of the MySuper rules will increase this consolidation process, particularly for the worst performing funds. The 'best in show' proposal will further speed up the rationalisation of funds, perhaps resulting in a speed of consolidation that is too fast.

The FSC also has concerns about potential adverse effects of concentrating the bulk of superannuation contributions into a small number of funds. Even if the bulk of existing members outside the top 10 do not roll their funds into a top 10 fund, a relatively static list of 10 'best in show' funds could see a small number of funds controlling an ever-growing portion of the default market over time (see 1.2 below). This level of scale has significant potential consequences for the superannuation system and the broader market. Of particular concern is the fact that, given sufficient scale, the investment decisions of one fund could materially impact underlying assets. This could happen inadvertently in the normal course of funds making investment decisions. Fund managers will find it more difficult to make material changes in asset allocations as trading volumes increase, and the risk of oversaturation of Australian markets could be large.

In addition it could also lead to scenarios where funds could deliberately make certain decisions which would impact markets for particular assets or asset classes and concentration of business ownership could encourage some monopoly pricing in the underlying businesses.

As smaller concentration of funds with large FUM may also create an environment in which the government feels pressure to regulate funds' underlying investments. Some commentators already call for super funds to invest more in particular asset classes; the pressure will increase with a more concentrated market and the ability to resist the pressures may diminish. Mandating (or prohibiting) particular asset investments is likely to be detrimental to member interests and long term returns.[4]

The potential negative impacts of market concentration could be addressed, in part, by increasing the number of funds represented on the list of 'best in show' funds. This would reduce the concentration of default fund flows.

We look forward to the Commission's additional work on economies of scale, which we hope will address these issues.

---

[2] P463

[3] See Rice Warner report at section 6.2.

[4] This issue is similar to the risks of political interference in investments of a National Default Fund, see the FSC's first submission to the Commission's draft report at sections 5.3 to 5.5.

FSC Recommendation 1

The Commission should closely consider the potential long-term market impacts of concentrating superannuation contributions in a small number of funds, and consider whether a longer 'best in show' list would assist in mitigating adverse impacts.

1.2 Entrenchment of funds in the shortlist

The FSC also has concerns about the potential for funds to become entrenched in the default list.

Over the period a fund is represented in the default list, it will have a level of certainty around increased cashflow through default contributions. Default allocations will also help these funds increase scale and reduce costs, and this effect will be compounded if a fund spends longer on the shortlist.

These outcomes may be beneficial for members of these funds. However, they may create an environment where the incumbency advantage for shortlisted fund is sufficiently great that it is difficult for other funds to compete their way into the top 10.

In the current system, an "illiquidity premium" is enjoyed by funds listed in awards. Because of the certainty they have around inflows, these funds are able to invest in unlisted assets that deliver a higher rate of return. This becomes an issue if it locks out otherwise high-performing funds from a shortlist.

Effectively, once a fund has been on the shortlist for a period of time, they are no longer competing on a level playing field with funds that are not on the list. This creates the potential for an entrenched shortlist of funds that changes very little over time.

The Commission has noted that it believes there will be competition for the shortlist, however some FSC members have raised concerns that a four-year period in the shortlist may widen the gap between incumbent funds and those outside the shortlist. Given funds outside the shortlist are likely to have few new default members, particularly if they are a newer entrant, it may also be difficult to have a product that can be meaningfully compared with those in the top 10.

Any shortlisting approach would need to be designed to ensure incumbents were not able to entrench their positions at the expense of new entrants who may perform as well or better if provided the same incumbency advantages.

1.3 Market disruption and system stability

The Commission argues the number of new members to the super system is about 474,000 per year with annual contributions of about $1 billion.[5] This represents the number of contributions per year that would be made under the 'best in show' proposal, meaning each fund on the top 10 list would have *increased* contributions of about $100m per year just from being on the list.[6] This figure would grow cumulatively so a particular fund will face an increase in contributions of $100m in the first year, $200m in the second and so on, compared to the situation where the fund was not on the 'best in show list'.

However, the actual impact on the super system may be significantly greater than this. The announcement of the list of top 10 funds could be very well publicised in the media, and members of funds outside the list could decide to roll their super into the funds on the list.

If large-scale rollovers did occur, then this would cause a number of problems, including substantial asset sales by the no longer listed funds, causing disruption to underlying asset markets. The problems caused by substantial rollover are considered in more detail in this submission in section 2.1.1 below. A massive growth in rollovers would create risks to the stability of the superannuation system as a whole — as noted by the Commission itself in relation to a proposal for automatic rollover out of funds that

---

[5] PC Draft Report p432.

[6] This assumes no new workforce entrants exercise choice. The increase in contributions will also be greater than $100m if the list is shorter than 10 funds.

lose top 10 status (see quote in Section 2.2.3 of this submission). However, the Commission does not consider this to be a substantial risk, arguing the model "is not expected to pose system stability risks" and "Any switching to shortlisted products by existing members of non-shortlisted products would likely occur slowly and over time." (see draft report at page 445).

The Commission undertook modelling of what would happen if existing members switched at higher levels than currently apply and found "investment returns on remaining balances and continuing contribution inflows from remaining members would support liquidity for the large majority of funds". (page 445). While the assumptions for the modelling are presented in Technical Supplement 7, the Commission has not disclosed the detailed results of the modelling as far as we are aware, which means the FSC is unable to comment or respond to the Commission's modelling results. Therefore, we consider the Commission should publish further detail of its analysis that rules out adverse impacts of the 'best in show' proposal.

Rice Warner has noted cases where switching occurs due to endorsements, for example the Barefoot Investor's book endorsed a Hostplus Indexed product leading to a significant increase in inflows. Many funds use ratings from SuperRatings and Chant West in their advertising; we would expect that they only do this because they have a real impact. It would be expected that a Government 'best in show' list would have a much larger impact than any of these non-government endorsements.

The risks of substantial rollovers can be mitigated by expanding the length of the 'best in show' list beyond 10 funds – this will mean fewer funds will be subject to outwards rollovers and the size of the inwards rollovers per fund will be smaller (see discussion on length of 'best in show' list in Section 1.7 below).

We note that enhanced MySuper criteria will not cause these market disruption or system stability risks (see Section 1.10 below).

FSC recommendation 2

The Commission publish more evidence to support its view that the 'best in show' proposal will not result in substantial increases in rollovers; or if there were substantial increases in rollovers this would not cause significant problems for the superannuation system.

1.4 Criteria for choosing 'best in show'

The Commission recommends funds be chosen for the 'best in show' list based on multiple criteria. The main focus will be on likelihood of producing high net returns for members, while other proposed criteria include the match between risk/return and the likely members; fees and costs; governance practices; compliance with the *Insurance in Superannuation Voluntary Code*; and administrative efficiency (page 435).

We consider it will be quite difficult to make a clear determination of the funds that should be on the 'best in show' list against multiple criteria, particularly when those funds have different characteristics – for example, it would be difficult to compare lifecycle products against risk based funds against a new, innovative product. The listing of some funds maybe clear, but there may be 15 or more funds where the decision is lineball and drawing a line is difficult. There could be 15 funds with similar ratings across multiple criteria; or alternatively 15 funds with quite disparate rankings on different criteria.

These ratings difficulties are more acute with a shorter list, providing arguments for the 'best in show' list to be longer than 10 funds if the proposal is adopted (see Section 1.7). Allowing the panel to choose more than 10 funds will enable them to include a larger number of funds that are hard to distinguish as per the example above.

The difficulties in rating across multiple criteria increase the pressure on getting the expert panel right, which will also be difficult (see Section 1.9). It will also increase the likelihood of challenges to the decision (the Commission argues 'best in show' decisions would be subject to judicial review but not merits review, see page 34).

We also have some other observations about the criteria for choosing funds:

- The list doesn't put significant weight on innovation or meeting member needs, including through tailoring of offerings.[7] This will mean, all else equal, a discouragement of innovation and tailoring to members within the 'best in show' list, and potentially reducing innovation and the meeting of member needs across the industry. We note the Commission has indicated super funds have room for improvement on these measures (see section 4.5 of the draft report).
  - However, including these factors in the criteria list will be difficult as hard to measure, and will exacerbate the issues raised above about the difficulties of rating across multiple criteria.
- To some extent, the criterion 'fees and costs' and 'administrative efficiency' duplicate each other – a reduction in administrative efficiency will mean higher costs and probably higher fees, assuming similar application of risk management and other best practice protocols.
- Similarly, the criterion 'net returns' duplicates 'fees and costs' as net returns are gross returns minus fees.
- Also in relation to fees:
  - It is not clear how the criterion would assess fixed fees versus asset-based (percentage) fees: would a fund with higher relative fixed fees be assessed as better or worse than a fund with higher relative asset-based fees? Or would the assessment just be on total fees as a % of funds under management? If so, this would discriminate against funds with greater share of small account balances.[8]
  - A focus on fees will discourage active investment, investment in unlisted assets, innovation and member services. This will not be to the benefit of members.
- It is not clear how the more qualitative criteria such as governance practices would be assessed.
- While there are disadvantages with a longer list of criteria, noted above, there could easily be ongoing additions to the criteria due to political pressure, a situation that would be hard to prevent completely. Some potential additions to the criteria include the following:
  - Compliance with various investment principles such as ASX corporate governance guidelines, the UN Principles for Responsible Investment, ESG guidelines and so on.
  - Degree of compliance with Australian laws, particularly tax laws
  - Ever-increasing disclosure laws, including relating to tax

1.5 Focus on net performance

As noted above, the Commission argues "the key focus of the selection process should be on a fund's likelihood of producing high net returns for members" (page 435).

Ideally, this would be an appropriate focus for the selection process, as providing high net returns is central to the superannuation system. However, there are some important issues with this approach:

- The FSC's first submission raised a number of concerns with the Commission's figures and analysis relating to historical net performance, including the comparisons against a benchmark.

[7] These factors, innovation and tailoring to members, are included on page 435 of the draft report but the terminology used suggest they may not be included in the main criteria for selecting 'best in show' funds.

[8] Funds with many smaller balances would, all else equal, charge higher fees, even if they are operating efficiently, because of the fixed costs per account.

  - The data on performance has improved over time, particularly with the introduction of MySuper, but this provides insufficient history of returns so far. This suggests that if 'best in show' is implemented, then the use of historical data should be delayed until a reasonable and comparable historical time series is available.[9]
- It is well known that past performance no guarantee of future performance[10] – in fact ASIC requires funds to disclose this.[11]
- There is no clear way to deal with new entrants to the super market. If the 'best in show' relies heavily on historical performance, then this will exclude new entrants. If a different measure is used just for new entrants, it could easily treat new entrants and established funds unequally. The Commission recommends performance of similar products overseas could be used (see page 435 of draft report) but it is hard to see how overseas performance figures could be made comparable with Australian figures (see our first submission).
- Other metrics may provide important information about how a fund can be expected to perform for members, including whether funds are true to label, value for money, and have high levels of member satisfaction/engagement. The riskiness of returns is also important and it is unclear how this would be included in the criteria.

Finally, to the extent that performance has weight, this will create various behavioural incentives for funds, as outlined below.

1.6 Incentive effects relating to performance

The weight on performance in the selection criteria for 'best in show' will provide incentives for funds, depending on whether the fund is likely or unlikely to be on the list. In general terms, these incentives will be stronger if the list is shorter or the list is reviewed less frequently.

1.6.1 Fund that is likely to be selected for 'best in show' list

For funds with good prospects of being selected for the shortlist, there will be an incentive to choose similar investment strategies of the other funds that are likely to make the list (or are already on the list). This will minimise the downside risk – in other words, playing it safe with investment strategy will maximise the fund's chance of being on the list.[12] This homogenisation of investment strategies will have a number of effects:

- The similarity in investments will mean fund members face similar returns, and face similar adverse impacts in market declines.
- A concentration of investment in some assets will increase both the benefits and costs relating to increased scale (see Section 1.1). However, as the market becomes more concentrated, the costs of scale become more significant.
- The illiquidity and idiosyncratic risks of unlisted assets will likely mean these funds reduce their exposure to this asset class. Reduced investment in these assets, which include infrastructure and venture capital, could be detrimental to the Australian economy as a whole.
  - However, stronger cashflows to the 'best in show' funds may offset this impact (see Section 1.2).

---

[9] Rice Warner has suggested the 'best in show' proposal, if implemented, should be delayed until 2025.
[10] See for example https://frontieradvisors.com.au/how-long-should-investors-stick-with-underperforming-fund-managers/
[11] See Rice Warner report, section 7.2.
[12] If a fund takes an unusual investment strategy, this would substantially increase the risk of lower return compared to the rest of the 'top 10' list, while if return is above the rest of the top 10 list, this will not substantially improve the chances of being on the list.

- Conversely, investment into listed securities is likely to increase. Given the focus on costs in the selection criteria (see Section 1.4), this could mean that super funds make increasing use of low cost options such as ETFs.

1.6.2 Fund that is less likely to be on the shortlist

A fund with only a small chance on getting on the 'top 10' list will potentially alter its investment strategy to favour short term outcomes in order to meet best in show performance criteria, rather than implementing the long term investment strategy required to manage the retirement savings of its members. This may include taking on riskier short term investments. As Rice Warner notes, if the risky investment strategy is successful they may make the list at the next tender. If the strategy is unsuccessful the fund will not suffer significant detriment relative to being off the list, but members in the fund are likely to be loft worse off.

1.7 Length of list

The Commission in its draft report recommends the 'best in show' list be no longer than 10. The Commission suggests that a longer list will mute competition, will make member choice harder, and could allow mediocre funds to be on the list.

However, a list that is too short might mean that:

- worthwhile products are left off the list;
- competition might be muted because the likelihood of getting on the list is too low; and
- the number of options for members might be too small (see page 435).

This analysis seems reasonable, although the Commission's argument that a longer list will mean 'mediocrity' could be tolerated seems unlikely if the MySuper criteria are elevated as the Commission proposes and the 'best in show' list is still substantially shorter than the total number of MySuper funds.

In broad terms, a shorter 'best in show' list raises the stakes for being on the list – and heightens the various incentives on market participants. We make the following additional observations:

- The Commission argues a longer list may mute competition. However, as Rice Warner argues a shorter list means each fund is less likely to be on the list, discouraging some funds from competing to be on the list. A longer list will conversely mean more funds try to compete to be on the list, with more funds focussing their strategies on default rather than choice.
- Even if a longer list does mute competition, it will also mute the unwanted incentives created by this competition, including the incentives for some funds to homogenise investments and for other funds to take on too many risks (see Section 1.6).
- A shorter list will encourage more concentration of the market, discussed in Section 0. Beyond a certain point, concentration could easily lead to reduced competition between participants.
- It is not clear what will happen if funds on the 'best in show' list were to merge. If there are no additions to list, the list of 10 products will become shorter, with the funds on the list gaining a further increased share of default members and contributions. This occurred in New Zealand as detailed in the attached Rice Warner report.
    - A longer period between reviews would likely exacerbate this issue as more mergers are likely to occur over longer periods between reviews.
- With a longer 'best in show' list, the potential disruption to the super system discussed in Section 1.3, caused by rollovers out of funds that leave the list, will be reduced. This is because more funds will be on or remain on the list, so won't be subject to outwards rollover, and the number of funds that would receive inwards rollovers would be larger.
- A longer list will make it easier for the expert panel to address any situations where it is hard to rank a number of nearly equal funds or funds that rank very differently on the criteria (see Section 1.4).

- A longer list will decrease the costs of any mistakes the expert panel might make, as the contributions to each fund on the list will be proportionally smaller and the number of fund members caught up in any error would be smaller.
- A shorter list would create higher stakes for funds who may narrowly miss out on a place in the top 10. This would increase the potential for decisions to be challenged (the Commission argues 'best in show' decisions would be subject to judicial review but not merits review, see page 34).

Given most of the issues with the 'best in show' proposal raised in this submission would be ameliorated by having a longer list, we consider the Commission should give serious consideration to recommending an extension to the list.

We note that a longer list would make the choice decision by new fund members more difficult, but this needs to be weighed against the issues faced by a longer list – it seems unlikely that the costs of a more difficult choice by an individual just once in their life could outweigh the numerous issues caused by having a shorter list.

FSC recommendation 3

If the Commission continues to recommend the 'best in show' list, it should conduct a more detailed analysis of the benefits of lengthening the 'best in show' list.

1.8 Frequency of review

The Commission has recommended that the selection process for the 'best in show' list be conducted every four years. However, it has provided little rationale for the choice of this four year review period. While the FSC does not have a particular view on the length of this period (if 'best in show' goes ahead), we make note that a longer period between reviews will:

- Increase the costs of any mistakes on fund members and the overall system
- Increase the entrenchment of funds (see Section 1.2), potentially reducing competitive pressures
- Force funds not on the shortlist to focus on choice customers and tailoring of member benefits
- Enable listed funds to make more long-term/unlisted investments because inflow is secured for longer (while this may increase returns, it will also further increase entrenchment) and increase stability of fund strategies more broadly.
- Heighten the problems caused by merging of funds (see section 1.7) – more mergers will occur over longer periods, all else being equal.
- Make it harder for new entrants to enter the default market as they will need to wait longer between each tender.
- Reduce the compliance costs to industry and government – which will ultimately flow through as lower fees for fund members and lower costs to taxpayers.

To some extent, the length of the 'best in show' list and the frequency of review have offsetting effects as a shorter list and less frequent reviews both raise the stakes for being on the list.

1.9 Expert panel

The FSC has already noted concerns with the idea of an expert panel being appointed to select a shortlist of funds.

We remain concerned that it would be difficult to appoint a panel of individuals who have sufficient knowledge and expertise to undertake the role without having a (real or perceived) conflict.

Conflict is partly about perception. The often-politicised nature of the superannuation industry means that someone who has worked for a superannuation fund in any capacity, even retired, is likely to be

seen to be conflicted. The same will be true for anyone who has advised a fund, worked for an industry association or even advised an association.

Current and retired regulators may both be seen to be conflicted, particularly in relation to perceived bias against any fund they have brought action against. They are also less likely to bring business expertise to the process.

Other eminent individuals who are perceived as less likely to be conflicted are unlikely to have the level of industry knowledge and expertise that would be required to effectively perform the role.

Using executives from bodies such as the Reserve Bank to appoint the panel will not avoid this problem – the group appointing the panel will still face exactly the same difficulties as a Minister or anyone else would face: it will still be difficult to appoint people to the panel with both sufficient knowledge and a lack of real or perceived conflict.

As noted by Rice Warner, another option would be to acknowledge the perceived bias of most otherwise-qualified candidates upfront and appoint a balance of members from across the sector (for example, equal representatives from industry and retail fund affiliated backgrounds). However, it would be difficult to appoint a truly representative group balancing all interests. Even a former CIO will be seen to have biases toward or against particular investment approaches which may be difficult to balance with other panel members.

The FSC believes the easiest way to remove the issue of a conflicted panel would be to reduce the reliance on this panel to judge funds, and instead creating a more objective threshold for funds to meet with less regard for the exact number of funds chosen.

Conflicted decisions would also be seen as less of a problem if the list of funds was longer, making the stakes less extreme for funds seeking inclusion (see Section 1.7).

FSC Recommendation 4

The Commission should consider avenues for developing a list of funds for members to choose that reduces reliance on the subjective judgement of an appointed panel. For example, this could be achieved by setting a threshold for inclusion in a shortlist that does not excessively limit the number of funds.

1.10 Enhanced MySuper criteria as alternative

The Commission has recommended that the MySuper authorisation process be strengthened to increase the standard of MySuper products in the market (Draft Recommendation 4). It also proposes that the list of MySuper products meeting this higher standard could be offered alongside the 'best in show' shortlist for consideration by members who wish to choose from a wider list of well-performing funds.

As noted in the FSC's previous submission, we support the proposed elevation in the standard of MySuper products and increased APRA engagement in enforcing minimum standards for ongoing MySuper authorisation. This level of stringency is suitable for products being offered as default options to disengaged consumers.

1.10.1 Reporting transfer of members to higher fee choice products

We note the Commission's preference for an elevated MySuper system to require reporting of the number of members switching into higher-fee choice products.

While we do not oppose this recommendation, it may be difficult to draw useful conclusions from this data due to the wide range of reasons for customers shifting between products. For example, this

reporting could capture circumstances where members are switched into a higher fee product when changing jobs, because they move out of a corporate plan with discounted fees but choose to remain with their current fund rather than switching to a new default.

If this information is to be used by APRA to inform decision-making, the context of switching behaviour must be considered.

1.10.2 Enhanced MySuper as a transitional reform

We also consider that this measure, along with the removal of the Fair Work Commission (FWC) from default decision-making, could be implemented ahead of any implementation of a 'best in show' list, to begin the process of rationalising funds without significant disruption to the market.

Simply removing the FWC process would be unlikely to disrupt the system as there would be no need for employers and members to change funds. The introduction of choice in the default market would largely only impact new employees, and those engaged members who are currently locked into funds through the award system and wish to switch.

Given the difficulty in predicting future performance based on past performance (see 1.4 above), an approach that removes underperforming funds rather than concentrating new members into a very small number of funds may be a safer approach.

During this transitional period, the Single Touch Payroll system could show the full list of elevated MySuper products that meet this standard. Over time, the number of MySuper products may be sufficiently reduced through this process that a 'best in show' list is created organically.

FSC Recommendation 5

The Commission should consider whether an elevated standard for MySuper products should be implemented before consideration is given to a full 'best in show' model, to determine whether the move to a universal higher standard for MySuper products could effectively create a "best in show" list of high performing default funds without the need for an additional selection panel process.

2. EMPLOYER-LINKED ROLLOVER

As indicated in the first FSC submission to the Commission, the FSC does not support the 'employer-linked rollover' proposal, which would see default members and their balances move to a new super fund each time they change jobs or employers.

This supplementary submission expands on the concerns we raised in our first submission on this proposal.

Our most significant concern is that the FSC cannot identify a clear benefit for consumers in this model, and in fact it is likely that this proposal would be detrimental to some consumers (as outlined later in this submission). Instead of focussing on the consumer, this proposal seems designed to entrench the employer centric nature of the superannuation system.

The comments below indicate a comparison of the 'employer linked rollover' proposal with the Commission's recommended 'default once' model. Our comments on other default models are in our first submission and the first section of this supplementary submission.

2.1 Impact on members

2.1.1 Estimate of increases in rollovers

According to the Commission, the number of people re-entering the labour force or changing job is about 1.6 million people per year.[13] As an upper bound, this represents the number of people who will be affected by the employer-linked automatic rollover proposal.[14] This compares to the existing number of rollovers of 222,000 per year.[15] Therefore, the automatic rollover proposal would result in the total number of rollovers to grow to be up to 1.8m per year, an increase of 720% (again an upper bound estimate).[16]

We are unable to determine the dollar value of the additional rollovers that would occur under the automatic rollover proposal, however we would expect it to be particularly large. As a simplified analysis, the average balance across all large APRA-regulated super funds was $112k as at June 2017; if this is multiplied by the *increase* in rollovers of 1.6m this suggests a broad ballpark estimate of the increased value of rollovers of $179.2 billion.[17] This compares to the value of rollovers into large APRA funds of $140 billion for the year to June 2017.[18]

If the Commission wishes to have a more accurate estimate of the rollover figure, we suggest existing government data sets (ATO and SuperStream) — in theory — provide this information, though it could be quite complex to bring this data together and derive an estimate.

2.1.2 Member engagement

The proposal would further fuel member disengagement by what could be a constant chopping and changing of the member into different funds based on their employment patterns. Employees who change industry more frequently will be most affected as they will likely lose track of which fund they have at any point in time. The Commission's research shows many super consumers are currently disengaged in their super fund (see draft report in Chapter 5); this is likely to be made worse with frequent changes.

---

[13] See draft report at page 433.
[14] The actual figure will be lower, as some people will move to a new job and not be subject to automatic rollover as they are already a member of the target fund.
[15] See draft report at page 433.
[16] We have assumed that there is no overlap between the number of members who rollover funds and the number of people
[17] Source: APRA annual fund level statistics.
[18] Source: APRA annual fund level statistics.

In contrast, the default once proposal would likely support increased engagement in superannuation as the link between the employer and the superannuation fund would be replaced by an enhanced engagement between the employee and their superannuation fund.

By establishing a default system that encourages rather than discourages engagement, trustees are more likely to invest in engagement tools (e.g. apps) which would ultimately benefit all members.

2.1.3 Tailoring of products to members & customer choice

The employer-linked rollover model would mean a more homogeneous membership profile, as employees in a particular industry are more likely to be in that industry's default fund. Therefore, it might be argued that the employer-linked rollover model will enable funds to improve their tailoring of products to that industry. For example, if schoolteachers are likely to be in a particular fund, then the investments, insurance, administration, advice and retirement products could all be tailored to school teachers.

However, this is argument is misleading. Funds with diverse membership from many different industries can tailor their products to each member's industry of employment. Funds are making increasing use of data on members, although the Commission argues there is scope for substantial improvement. The Commission's draft finding 4.5 states "Superannuation funds make insufficient use of their own (or imputed) data to develop and price products (including insurance)."

If super funds address this finding and expand their use of data, this will mean the tailoring of products to the member's industry of employment will be occurring without the need for rollover into a different fund. If a fund member changes their industry of employment, a fund that makes full use of data will amend its offering to that member to reflect the changed circumstances of the member. And this will occur without the numerous problems with employer-linked rollover as detailed elsewhere in this submission.

Mandatory employer-linked rollover would significantly harm many forms of customisation that occurs under the current system:

- Members who had made a binding death benefit nomination would lose this nomination. On death, the existing super balance would likely not go to the member's preferred beneficiary. This could be a particular problem in family law cases, for children of earlier marriages, or for same sex couples.
- Any choice of investment option would be lost, and the member would likely be transferred into the default investment option. The Commission argues these default options perform well on average (see technical supplement 4, figure 4.13) however many default options will perform less well than the average. In addition, if a member actively sought out investment in (say) venture capital or global infrastructure, why should those choices be arbitrarily lost when they change jobs? In addition, the mandated change to the default investment option may occur just before a boom in the old fund's tailored investment product causing unnecessary consumer angst.
- Consumers who specifically chose a super fund for any reason would have that decision revoked, another rejection of consumer sovereignty. A member may have chosen a fund because it has high investment returns, provides investment options desired by the member, provides desired retirement products, has better customer service or is more aligned with the member's beliefs. Regardless of the reasons, the customer would be mandatorily removed from the chosen fund.
- In relation to insurance (see more detail in Section 2.1.2):
    - Members who had tailored their insurance cover (either up or down) would lose this tailoring
    - Members who have opt-out insurance and had chosen to opt-out would have insurance reactivated

- Members who had opt-in insurance and had voluntarily taken out insurance would have the insurance deactivated
  - Members who had chosen a fund because of the insurance product on offer (particularly opt-out IP insurance) would lose this benefit
- Members who have deliberately established more than one fund (for example one fund is used for insurance while another is used for investment) will in all likelihood find the accounts are compulsorily merged.

The loss of tailoring could be addressed by opt-out (see section 2.4) or mandating homogenisation of products (see section 2.3) but each of these 'solutions' has significant issues as discussed below.

None of these harms to tailoring occur under the 'default once' proposal.

2.1.4 Changing nature of work – gig economy and multiple employers

It is not clear how this model would work for the many individuals who have multiple employers. It is unclear which employer's superannuation fund would be their default fund under the employer-linked rollover model.

This is a significant issue. According to ABS data, 891,700 jobs were secondary jobs as at September 2017, with 6.9% of employees holding second jobs.[19] This figure seems likely to increase over time, including with the increasing penetration of the gig economy and contract work.[20]

One possibility is that the super contributions from each job would go to the default for that job, unless the employee elects otherwise. But this approach encourages account proliferation, which defeats the whole purpose for this proposal. In addition, it isn't clear how this approach would work for employees who start and end multiple different jobs at overlapping times.

A second approach would set up a system to send all contributions to one fund determined by an adjudication algorithm. But it is hard to see what metric could be reasonably used to determine the fund to receive a contribution. If size of contribution or length of tenure at an employer are used, then this would result in the chosen fund changing frequently for those who move jobs frequently. A third option is for the contribution to go to the fund with the highest existing balance, but this would not necessarily be the fund linked to the industry where the member does the most work.

With this second or third approach, the employer would not know where to send contributions, and a new system will have to be set up to provide this information to employers. Alternatively, a superannuation clearing house will need to be established. It is not clear that either of these major changes should be made just to deal with this issue.

With all of these options, there is another issue – some rollovers would still occur where employees start and end multiple jobs, and the risk is that money would be rolled into and out of particular funds over and over again.

This analysis should make it clear that the employer-linked rollover proposal is particularly unsuitable for those who work in multiple jobs. By contrast, the default once model does not face these issues.

2.1.5 Insurance

Each time a rollover occurs under the employer-linked rollover model, any existing insurance cover attached to the original fund would cease and new default insurance cover would commence under the new fund (if the member has opt-out insurance[21]).

---

[19] Source: http://www.abs.gov.au/AUSSTATS/subscriber.nsf/log?openagent&6150055003do001_2016201709.xls&6150.0.55.003&Data%20Cubes&D7028A29A1181F74CA2582C500175F78&0&September%202017&10.07.2018&Latest

[20] The historical data appears to have a small upward trend over time, see previous footnote.

[21] Under legislation currently before Parliament, opt-out insurance is provided for members aged 25 or over and with an account balance greater than $6,000.

This causes a number of problems.

Not only is the process of ceasing/commencing insurance cover inefficient, but the amount of default cover offered will change under the new fund, as will the terms and conditions. Any fund members who carefully tailored their insurance cover would lose that tailoring. Those who previously increased their cover would likely have a sudden and unwanted decrease in cover and find themselves underinsured, and may be unable to increase their cover again if their health has deteriorated since the previous increase. Similarly, those that previously reduced their cover would probably face an unexpected higher level of cover and higher insurance premiums.[22]

In addition, fund members who specifically chose a super fund because of its insurance offerings would lose access to the preferred insurance products. This is clearly to the detriment of the member. This is particularly a problem for income protection insurance (also called salary continuance insurance) where the differences between funds can be large. Some funds provide Income Protection (IP) insurance on an opt-out basis with limited exclusions – which means people who would otherwise be denied IP insurance or find it expensive are able to obtain IP at a lower cost. A person who chooses a particular fund because it offers opt-out IP are likely to find the new fund offers IP on an opt-in basis, or doesn't offer IP at all, so the IP would also be lost under mandatory employer-linked rollover.

Fund members who had chosen a high level of insurance cover in the old fund may find that they will need to go through a lengthy application process to restore this level of cover in the new fund, as some funds require underwriting for higher levels of cover and not all funds allow rollover of higher cover. This is a completely unnecessary compliance cost on the member if they had already been accepted for the higher level of cover in their old fund. The situation becomes worse if the new fund or insurer declines to provide the higher level of cover when the old fund was able to provide this cover, perhaps because the fund member's health has deteriorated since the cover was originally provided. In this case, the member has clearly been made worse off by the rollover process.

Also the opt-in and opt-out decisions from the departing fund will not be carried over into the new fund. A member who is under 25 or has a low balance and has opted in to insurance will find themselves without cover. Conversely, a member who is over 25 with a higher balance and has opted-out of insurance will suddenly find insurance reactivated.

In addition where a fund allows for the provision of a grandfathered TPD "Own Occupation" definition (those that joined prior to July 2014) the transition to another employer fund under the Employer Linked proposal would see this grandfathered definition forfeited.[23] This would result in a material reduction in their rights to benefits and is a common reason why some successor fund transfers are unable to proceed.

All of these insurance situations produce perverse outcomes for members making them worse off. The default once proposal does not face these problems.

2.1.6 Transaction costs

Given the estimated large increase in rollovers of 720% or $179 billion, the employer-linked rollover proposal would entail a large increase in transaction costs in the superannuation system. As exit fees are in the process of being banned, the costs could be shared by all in the superannuation system (rather than just those members who are subject to rollovers).

The transaction costs include the costs of the following:

- Establishing a new account at the new fund, including costs of the mailouts to the new members.

[22] This does depend on the difference in insurance pricing and coverage between the old and new fund.

[23] Own occupation TPD provides a TPD payout where the injured person is unable to work in their own industry of work, even if they are able to work in different industries. This form of insurance is unable to be offered now, but some fund members who had 'own occupation' TPD from before July 2014 have been grandfathered.

- Deactivating the account at the old fund
- The transaction costs of disposing of assets underlying the member's account at the old fund, including the tax liabilities incurred due to this disposal
- The transaction costs of acquiring assets underlying the member's account at the new fund
- The costs of returning or redirecting voluntary contributions that are incorrectly sent to the old fund. This is likely to occur for some fund members as the member may not know about (or recall) the change in fund for some time.
- It is unclear how the rollover would work for fund members with both accumulation and pension accounts (particularly because they are using a Transition to Retirement strategy). The member are likely to want both accounts at the same provider; it is unclear if the mandatory rollover would require both accumulation and pension accounts to be transferred (which would be complex) or if just the accumulation account would be transferred (which would increase system and member costs).

These costs could be reflected in buy/sell spreads, reducing the impact on the people that don't move funds but increasing the impact on the people who do. To the extent that the costs of rollover are imposed on the members who change jobs, this would mean a disproportionate impact on younger people (aged 15–24) and employees with have lower earnings.[24]

Regardless of who wears the costs, they are an unnecessary and unwarranted burden.

By contrast, under the default once model, none of these enforced rollovers occur. The transaction costs of the default once model are lower than under the current model, because it minimises unnecessary account duplication and therefore improves economies of scale.

2.2 Impact on the system

2.2.1 Impact on Competition

Mandatory employer-linked rollover will harm competition. A fund that is not providing what customers want (providing low returns, poor customer service, or any other factor) will over time lose members, providing competitive pressure on the fund to improve its service or merge with a better preforming fund. However, if the fund is the default for a particular industry it will constantly be propped up by the inwards rollovers from new employees in the industry. Under the current system, only new employees *who default* are placed in a poorly performing default; under the employer-linked rollover, *all* new employees will be placed in the poorly performing fund.

This will harm competition in the industry and result in poorer retirement outcomes for more people. The Commission argues being placed in a poorly performing default for their whole career could cost an employee $635,000 at retirement (see draft report at page 12). Under the employer-linked rollover proposal this problem will affect many more people.

By contrast, the default once proposal increases competition compared to the current system – if a fund member switches to a more competitive fund, they will remain with this fund even if they change employer and make no choice. This benefit does not occur under the current system, as a fund member may have a second account set up at the new employer's default. The harmful impact on competition is heightened under the employer-linked rollover proposal, as the fund member's entire balance will be transferred to the new employers' default.

2.2.2 Fund cashflow and investment certainty

Under choice of fund, all funds face some uncertainty about whether members will roll out of their fund. However, the employer-linked rollover model will substantially increase this cashflow uncertainty.

[24] Source: https://www.rba.gov.au/publications/bulletin/2012/dec/1.html

Funds will not only face rollovers because of conscious decisions of members, they will also face rollovers even when members have no desire to change fund. The heightened uncertainty about total funds under management will mean super funds need to increase holdings of cash and other liquid assets, while reducing investment in illiquid assets.

This is likely to be detrimental to long-term returns and potentially the economy as a whole (see also the discussion on this issue relating to top 10 best in show in section 1.6).

The 'default once' model will not have this adverse effect on fund cashflow certainty.[25]

2.2.3 System stability

The Commission raised concerns about the impact on the stability of the superannuation system for a similar proposal – automatic rollover from funds that fail to win a default contest (such as the top 10 best in show): [26]

> This approach would likely significantly increase member churn with adverse consequences not just for liquidity but for system stability. As noted earlier, the Commission has eschewed options that could adversely affect system stability. The benefits of any lowering of fees or improved service quality would be swept away should such a scenario emerge. The Commission agrees with the Australian Institute of Superannuation Trustees (sub. 28, p. 33), which argued: "Existing members should remain in their fund until they either exercise choice, provided the relevant fund remains entitled to receive default superannuation payments."

The FSC considers these concerns equally apply to the employer-linked automatic rollover proposal.

The default once model does not cause these concerns for system stability.

2.3 Addressing issues by homogenisation of product offering

Many of the concerns about the loss of tailored offering raised in section 2.1.3 above could be addressed by requiring funds to offer similar products, and requiring details of member elections/decisions to be transferred between funds. However, this enforced homogenisation of funds would discourage innovation in fund services. Ironically, it could also *discourage* tailoring beyond the mandated similar products, and discourage the very customisation to industry of employment that the proposal is meant to encourage.

In addition, this variation of the proposal would result in further curtailment of competition between funds (in addition to the reduced competition from the main proposal, see section 2.2.1) as funds become homogenised and are therefore only able to compete in the remaining areas that aren't homogenised.

There are arguments for expanding existing rollover infrastructure (such as SuperStream) to transfer details of member elections/decisions between funds, but this would require further detailed analysis and consultation with the industry. Implementation of this would also take some time.

None of these homogenisation issues are faced by the default once proposal.

2.4 Addressing issues by allowing opt-out

The concerns with the employer-linked rollover proposal might be addressed by allowing fund members to opt out from the mandatory rollover. This would mean that members who wished to remain with their existing fund would not be forced out. While this would reduce the concerns, they would still remain for those who do not opt out.

[25] In fact, default once may increase cashflow certainty: Under 'default once' the contributions will continue to the existing fund while under the current system new employees who fail to choose a fund will be defaulted to a different fund, suddenly ending contributions to the first fund.

[26] Productivity Commission 2017, Superannuation: Alternative Default Models, Draft Report, page 73.

In broad terms, if most fail to opt out of the employer-linked rollover, then most of the adverse effects will occur; and if most opt out then this defeats the purpose of the proposal. It seems likely that most will fail to opt out, and the problems will remain for most members (given low opt out rates for insurance in super).

Nevertheless, as some people would opt-out, the purposes of the proposal, such as the ability of funds to tailor to industry of employment, would be partly thwarted; and the super system would become more complex.

2.5 Interaction with other proposals

2.5.1 Online standard choice form being developed by the ATO

The ATO is developing an online form to allow new employees to exercise superannuation choice as part of the employee onboarding process. The employer-linked rollover proposal runs contrary to this approach. The ATO's approach is making the choice for new employees more transparent and consumer oriented; by contrast the employer-linked proposal will take over this process and mandate a change in fund, reducing the consumer focus.

2.5.2 Comparison with default once

The FSC can see no substantial benefit of the automatic rollover proposal compared to the Commission's 'default once' proposal. The supposed benefits of automatic rollover are illusory or minimal.

The default once proposal will be more effective at immediately halting the proliferation of multiple accounts by ensuring consumers carry over their existing accounts when they change jobs, rather than potentially having a new account established each time under the employer-linked rollover model.

As a consequence of being able to significantly stem the flow of future unintended account proliferation, the default once model will ensure members do not unnecessarily pay fees for multiple accounts or duplicate insurance policies, ultimately resulting in a reduction in the overall erosion of members' retirement balances.

The further comments above show in many other areas the automatic rollover proposal compares poorly to the Commission's 'default once' proposal.

2.6 Conclusion

FSC recommendation 6

The Commission should strongly reject the "employer-linked rollover" model in its final report to Government, retaining its recommendation for the "default once" model.