



AUSTRALIAN INSTITUTE of  
SUPERANNUATION TRUSTEES

# Response to Productivity Commission Draft Report: Superannuation: Alternate Default Models

**3 May 2017**

## **AIST Submission**

### AIST

**The Australian Institute of Superannuation Trustees** is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public-sector funds.

As the principal advocate and peak representative body for the \$700 billion profit-to-members superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST provides professional training and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.

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### Executive summary

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Summary of key points made in our submission:

**Net returns are key:** AIST believes that the key factor by which funds should compete are long-term net investment returns. While costs are also important, they are primarily a driver of net returns. It is the net investment return over the long term that ultimately determines whether an adequate retirement benefit will be provided.

**The importance of an industrial-based legislative framework:** AIST strongly supports an industrial-based legislative framework to balance the interests of employees and employers in relation to superannuation default selection. The top performing retirement income systems in the world are industrially-based. In order to retain a universal system, it is vital to protect superannuation as a minimum term and condition of employment by enshrining it in industrial relations law.

**The importance of a quality filter and multi-criteria selection process:** AIST strongly supports the Commission's view that a quality filter is needed to short-list default funds and that the filter should be higher than the MySuper requirements. We submit that these processes already exist in the current default fund selection process (see infographic on page 15).

**The importance of an independent government body in the selection process:** Similarly, AIST agree with the Commission that an independent government body should oversee the selection and monitoring of default funds. We submit that this body already exists in the form of the independent Fair Work Commission (see infographic on page 15).

**Concentration of default funds carries risks:** AIST believes a default fund system offering only a small number of funds will limit choice and carries the risk of a pension fund oligarchy forming, as is the case in Chile where there are only six providers, producing suboptimal outcomes for members. We do not support limiting default funds to between 4 and 10 as the Commission has suggested.

**The benefits of industry-specific default funds need to be recognised:** AIST supports a centralised system, where employees are connected with default superannuation arrangements that are most appropriate to them. Such a system recognises that different industries have different demographics that may require a different investment management style, different services, such as intra-fund advice, and different insurance offerings.

**The role of SuperStream and Single Touch Payroll in system efficiency needs greater recognition:** AIST agree with the Commission that account proliferation is an issue across the super sector and needs to be addressed. However the Commission fails to recognise the very significant progress

and further potential of both SuperStream and Single Touch Payroll to dramatically accelerate account consolidation. AIST urge the Commission to further investigate the role of SuperStream and Single Touch Payroll in reducing account proliferation across both the default fund and Choice sector (see infographic on page 15).

**A fund-for-life model carries risks:** Even with the ever-present option of ‘choice’, a default system whereby a fund is allocated for life is likely to lead to a lowest common denominator marketing campaign focused on everything but maximising the member’s retirement income. Given that the level of interest and engagement with super has been shown to increase with age, we believe the benefits of being able to consider new default funds at milestone events - such as change of employment or relationship status - is an important driver of improved retirement outcomes.

**Insurance must remain a core element of default funds:** The Commission’s proposal to take insurance out of primary consideration in default fund selection is ill-advised and risky as it would significantly increase under-insurance in the community, especially for high risk groups such as emergency workers. Removing insurance from consideration of default super funds would very likely lead to significant increases in costs which would negatively impact on retirement outcomes.

**Alternative clearing house proposal fails to recognise existing infrastructure:** The Commission should further investigate the capability of the existing SuperStream infrastructure, including gateway governance arrangements and ‘contributions pass-through’ before it recommends moving to an alternate clearing house model. Any move away from the operation of a market-based system built on cross-industry collaboration and involving a range of competing providers to a centralised, government-owned and operated service should be undertaken with care.

**Greater regulatory guidance on disclosure is needed:** The protracted debate over ASIC’s controversial RG 97 regulation on disclosure of fees and costs in superannuation – now stretching to almost three years – highlights just how resistant some sections of the industry are to full and meaningful disclosure on fees and costs.

**Consistency and comparability on fee, cost and product disclosure must be improved:** Lack of consistency in data reporting – particularly of fees and returns, and lack of comparability associated with lifestyle investment strategies that can be complex – has made it difficult for industry analysts, let alone the average consumer, to compare MySuper funds. It is even more difficult to compare Choice products, leaving default members vulnerable to predatory marketing from financial services professionals who may interact with superannuation fund members but have no fiduciary obligations. AIST believes greater regulatory guidance on disclosure is needed across both MySuper and Choice to ensure default members who may want to move – including, as is more common, to other product options within their own fund – are adequately protected from making poor decisions.

**Benefits needed for both new and existing default members:** AIST strongly agrees with the Commission that funds that win default status for contributions of *new* default members should be required to extend the same fees and service terms to all their *existing* members of the default product. The very significant delay – up to five years in some cases – on the part of many retail funds in transitioning higher fee paying consumers in accrued default amounts into the less-costly MySuper space highlights just how important this requirement is. AIST submits that this principle should further extend to insurance.

**Support for greater transparency on mergers:** AIST supports mechanisms to encourage greater transparency on formal merger activity, though we also note that there are mechanisms to encourage consolidation already in place. AIST also submits that any proposal to improve transparency around fund merger activity should be broadened to require consideration by all funds (including retail legacy products) about whether they have been doing enough to wind up or merge, and this consideration should also be disclosed.

### Commentary on the four alternate models

**Assisted *employee* choice model:** AIST rejects the assisted employee choice model, notably the key elements of allocating an employee to a default fund only when they first enter the workforce; having a greatly reduced pool of default funds; and the exclusion of insurance from consideration. AIST notes that other elements of this model – e.g. an independent government body; a rigorous administrative filter; choices being supported by simple and comparable product information; and eligible products being required to meet higher minimum standards – are consistent with the existing default fund selection model operated by the Fair Work Commission.

**Fee-auction model will be a race to the bottom:** AIST is concerned that a fee-auction model would only deliver the cheapest fees at a given point-of-time. We would expect that in the process, a ‘race to the bottom’ on fees would be precipitated, with the results biased in favour of low-fee funds as a lowest common denominator. This would encourage movement away from medium to higher cost products that deliver much better net returns.

**Multi-criteria tender model:** The draft report rightly notes the complexity of this model and concerns about the tender process being captive to subjectivity, such as government influence. Additionally, and as we have noted in our commentary on the other models, we do not support limiting the default fund pool to a small group of funds.

**Assisted *employer* choice model has high risk of conflicts of interest:** AIST does not support the assisted employer choice model in the form proposed by the Commission. AIST is concerned that the voluntary ‘dual-list’ approach of this model which would increase the risk of an employer not acting in their employees’ best interests. This model lacks a legislative industrial-based framework to balance the interests of employer and employee for the selection of default funds.

## Recommendations

AIST has made the following recommendations in this submission:

Findings and information requests	AIST recommendations
<b>Draft finding 1.1</b>	<p><i>Policy action is needed to improve disclosure to enable easier comparison between default superannuation products which have very different investment and fee structures, and importantly to facilitate comparison between default and Choice products.</i></p> <p><i>AIST considers that policy action around both fund mergers and intra-fund consolidation is also needed to support optimal outcomes for default members.</i></p> <p><i>AIST proposes that the provision of additional superannuation benefits should be protected, and that these be allowable as circumstances that satisfy the choice of fund requirements, similar to existing exemptions for defined benefit arrangements.</i></p> <p><i>AIST recommends that these protections be implemented via a no-disadvantage test where, if prescribed additional benefits are provided, this meets the requirements for an exemption. Alternatively, the benefit of an employee is made in compliance with the choice of fund requirements if the employer contributions paid to the fund are in excess of either section 19(2) of the Superannuation Guarantee (Administration) Act 1992 or minimum MySuper requirements.</i></p>
<b>Draft finding 1.2</b>	<i>AIST acknowledges and supports the draft finding.</i>
<b>Draft finding 1.3</b>	<p><i>AIST supports contestability, competition and merit-based selection in the default fund process, and echoes the comments of the Commission that “a formal competitive process does not necessarily mean an auction or tender.”</i></p> <p><i>AIST rejects the notion that “a formal competitive process for allocating default members” requires a “new alternative process” given the existence of the Fair Work Commission process.</i></p>

<p><b>Draft finding 3.1 and draft recommendation 3.1</b></p>	<p><i>AIST recommends that the Commission recognise the need to build on Single Touch Payroll and SuperStream initiatives in order to resolve account proliferation issues rather than consider alternate and potentially disruptive approaches.</i></p> <p><i>AIST further recommends that the new employee commencement process via Single Touch Payroll be enhanced by the addition of a prompt for people to consider the consolidation of their existing super accounts into the account receiving their ongoing contributions from their employer.</i></p> <p><i>AIST recommends that the Commission recognise the need for further regulation to enable account consolidation through data matching.</i></p> <p><i>AIST strongly recommends that existing initiatives are used to better and more efficiently engage with new employees at each change of job continue, and that the Commission not proceed with its recommendation to allocate employees to default funds only once.</i></p>
<p><b>Draft recommendation 3.2</b></p>	<p><i>AIST recommends that the Commission further investigate the capability of the existing SuperStream infrastructure, including governance arrangements and contributions pass-through, before it recommends moving to an alternate clearing house model.</i></p>
<p><b>Draft finding 3.2</b></p>	<p><i>AIST agrees with this finding.</i></p>
<p><b>Draft finding 3.3</b></p>	<p><i>AIST recommends that insurance be a core factor in the selection of default products.</i></p> <p><i>AIST agrees that funds should compete on long-term net investment returns.</i></p>
<p><b>Draft finding 3.4</b></p>	<p><i>AIST endorses this recommendation and agrees that a four year review period should be a recommendation in the final report of phase 3.</i></p>
<p><b>Draft finding 3.5</b></p>	<p><i>AIST agrees with this finding and supports the role for the default fund selection body. AIST considers that the body charged with</i></p>

	<p><i>selection of default funds should be ongoing to allow it to build expertise and to promote accountability.</i></p>
<p><b>Draft recommendation 3.3</b></p>	<p><i>AIST recommends that any formal proposal to improve transparency around fund merger activity be broadened to require consideration by all funds (including retail legacy products) about whether they have been doing enough to wind up or merge, and that this consideration should be disclosed.</i></p> <p><i>AIST recommends that the Commission acknowledge the need for APRA to use its existing powers to apply greater scrutiny to encourage fund and product consolidation.</i></p> <p><i>AIST recommends that the Commission recommend that the Government legislate to provide Capital Gains Tax relief for super fund mergers on an ongoing basis.</i></p>
<p><b>Draft finding 5.1</b></p>	<p><i>AIST strongly recommends greater regulatory guidance on the comparability of all products to assist all parties involved in fund selection process. This should include both default funds and Choice funds. Default members might want to leave a default fund at some stage, and both members and employers might reasonably want to understand and compare their selection/default against the wider market of superannuation funds.</i></p> <p><i>AIST recommends that APRA publish a league table showing net returns to members over 1, 3, 5 and 10 years for all MySuper products and for each Choice investment option above an agreed threshold of assets or members.</i></p> <p><b><i>AIST does not support the assisted employee choice model.</i></b></p> <p><i>AIST supports the elements of having an independent government body (that is not APRA or ASIC) applying a ‘rigorous administrative filter’, choices being supported by simple and comparable product information, and eligible products being required to meet higher minimum standards.</i></p> <p><i>AIST does not support employees being allocated to default funds only at first entry to the workforce.</i></p>



	<p><i>AIST does not support having a shortlist of between 4-10 funds, and is concerned that this would reduce scope for innovation and tailoring of product for different employment sectors, as well as materially increasing instability in the system.</i></p> <p><i>AIST does not support having a fund of last resort rather than a default fund.</i></p>
<b>Draft finding 6.1</b>	<p><b><i>AIST does not support the fee-based auction model.</i></b></p> <p><i>AIST supports an approach based upon net returns to members, rather than a ‘race to the bottom on fees’.</i></p>
<b>Draft finding 7.1</b>	<p><b><i>AIST does not support the multi-criteria tender model in the form proposed by the Commission.</i></b></p> <p><i>While AIST support the elements of having a pre-qualification process, detailed assessment criteria applied by an independent criteria selection body, and robust accountability mechanisms, we do not support having between 5-10 winners, and the sequential allocation of members.</i></p> <p><i>Additionally, AIST is concerned about the risk of subjectivity if this model was applied outside a quasi-judicial body.</i></p> <p><i>AIST recommends that superannuation funds seeking default status be required to have a rigorous arrears collection process in place.</i></p>
<b>Draft finding 8.1</b>	<p><i>AIST recommends that the Commission require a legislative industrial-based framework to balance the interests of employer and employee in any model for the selection of default superannuation funds.</i></p> <p><i>AIST recommends that the Commission continue to explore the benefits of extending fiduciary responsibilities to employers in Australia.</i></p> <p><b><i>AIST does not support the assisted employer choice model in the form proposed by the Commission</i></b></p> <p><i>AIST supports a detailed assessment criteria applied by an independent selection body, and robust accountability mechanisms.</i></p>

*AIST does not support a voluntary 'dual-list' approach and believes it would increase the risk of an employer not acting in employees' best interest. This model lacks a legislative industrial-based framework to balance the interests of employer and employee for the selection of default funds.*

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### Introduction

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We appreciate the opportunity to respond to the Productivity Commission's draft report on alternative default models – phase two of the Commission's review of default fund selection.

This submission – our second to the Commission on default fund selection – focuses on key issues raised in the draft report and should be viewed in the context of the broader views expressed in our first submission.

The views expressed in this submission are based on the following key beliefs:

**Australia's super system is recognised as one of the best in the world** – it's currently ranked among the top three retirement systems in the Melbourne Mercer Global Pension Index. The existing default fund system – which has consistently outperformed the rest of the super sector over the medium and long term – has been a major contributor to this success.

**The compulsory and complex nature of Australia's superannuation system** means it is vital that all Australian workers have access to robust default arrangements.

**The default system must act as a safety net** – a form of consumer protection – to ensure the best possible retirement outcomes for those who are disengaged or ill-equipped to make an informed decision. It must also serve those members - who for a variety of reasons - *actively* choose a default fund and trust it to serve their best interests.

**The default system must be underpinned by robust governance and regulation to enforce high levels of transparency, (meaningful) disclosure and management of conflicts of interest.** That said, disclosure alone cannot be relied upon to fully protect consumers when it comes to selecting a default fund or, indeed, choosing any super product.

**Superannuation has resulted in Australia having a strong national savings record** and, with more than \$2 trillion under management, it is a key segment of Australia's financial system. However, superannuation is much more than a financial product or commodity – it is a form of social policy. Unlike consumers signing up for a bank loan or a savings product, members' capital is at risk in a super fund. An inferior outcome for default fund members is not only bad for individuals; it will also put greater pressure on Government expenditure with higher than otherwise numbers of retirees requiring the Age Pension. Superannuation plays a major role in funding the Australian economy and profit-to-member default funds have a solid track record of providing long term capital for nation-building infrastructure investment. Competition that leads to a race to the bottom on fees and costs within the default sector will create risks at both an individual and national level.

### **AIST's approach to this submission**

The Commission has stated that the existing default fund selection process will be considered in phase three of its review and therefore should not be considered in a response to this draft report. However we feel it is appropriate and prudent to draw on insights from our working knowledge and deep experience with the existing process of default fund selection to inform some of our responses to the report. For example, we note that certain key elements common to some of the Commission's proposed alternative default models – i.e. a quality filter, a multi-criteria selection process and a government body to oversee the selection of funds – are also key elements of the existing default fund selection model (see infographic on page 15). We strongly support these key elements and are pleased that the Commission has recognised their role in a robust default selection process.

### **Default funds do not exist in isolation**

While the Commission's review of default arrangements does not extend to a review of the Choice sector, this submission – where relevant – reflects on the inferior experience of members in the Choice sector where competition has not led to greater engagement, lower fees, or indeed, superior member outcomes. We argue that poor disclosure and regulation of the Choice sector makes consumers – including default members – vulnerable to predatory marketing. We submit that this is a major risk in our super system that is relevant to any review of the default fund system.

### **The role of SuperStream and Single Touch Payroll**

There are many different routes involved in the 'default' process and this submission urges the Commission to take all of these into account and comment on their effect. In particular, we note the significant benefits of innovation and the introduction of new technology across the super industry with the implementation of SuperStream and Single Touch Payroll (STP). The Commission is rightly concerned about the need to address account proliferation and we note that this is a stated objective of the proposed draft models. Yet with SuperStream and STP, this work is well underway, and at a significant implementation cost. We believe that these developments will ultimately lead to faster account consolidation than any of the suggested measures to combat account proliferation in the four proposed models.

We urge the Commission to further investigate these processes, notably in regards to their key role in accelerating account consolidation in both the default and Choice sector and also providing clearing house services.

### Assumptions lack evidence

We take this opportunity to raise concerns about some of the key assumptions made in the draft report. There is no evidence to support the Productivity Commission's stated and fundamental premise that member-driven competition will improve member outcomes. Indeed, all the evidence – notably the outperformance of the default system compared with the more competitive non-default (Choice) system – is to the contrary. Competition among for-profit providers in the Choice sector has seen them very successfully lobby to deliver major carve-outs to consumer protection and the result is scandals, higher fees and poorer returns. Given that this flawed premise on the benefits of consumer driven competition is a key basis for the Commission's inquiry, we believe it should be supported by strong evidence or else modified.

We note that the Commission has commented that there is an 'information problem at the core of failures within the super system,' but that none of the proposed alternate models directly address this issue. This submission notes that a more robust regulatory framework is needed to improve disclosure of fees and costs across the super sector to ensure both consumers and industry practitioners have access to the information required to make meaningful comparisons.

### Terms of reference

We are concerned that the terms of references provided by the Treasurer for this study of default fund selection have not been fully explored by the Commission and could compromise the outcome of this inquiry.

We note that the Commission recommended changes to the existing default fund system in its 2012 review of default fund selection, and that changes to extend contestability, competition and merit-based selection were subsequently introduced and passed by parliament in 2013.

In 2014, the Government advised the Federal Court that it was actively considering the appointments to fill the vacancies on the Expert Panel. However, there has been no subsequent evidence of this, and the positions remain unfilled.

The Terms of Reference require the Commission to consider the nature of competition in the superannuation industry and the effect of government policy and regulation on the competitiveness and efficiency of the system. The inaction of the Government on this matter, and the subsequent impact on the contestability, competition and merit-based selection of the system relate directly to this term of reference. As an independent body and, in fulfilment of this term of reference, the Commission should comment on this.

### Evidence-based change

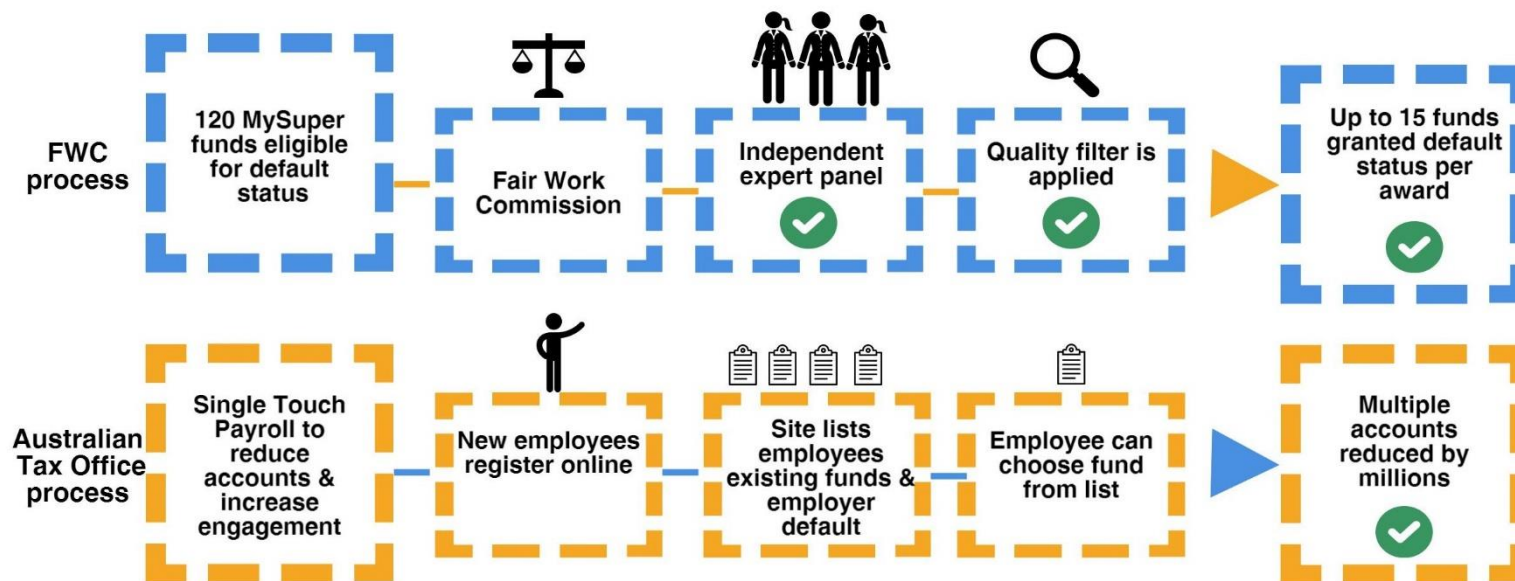
It is estimated that almost two-thirds of fund members currently rely on their employer's default fund. Any radical overhaul of the existing, out-performing default fund system will involve significant cost and disruption and potentially lead to some funds facing liquidity problems. Since the Cooper Review of 2010, the super industry has experienced an almost continuous period of reform, development and implementation. Constant tinkering has made public confidence fragile. More changes are ahead from 1 July, 2017 when the new tax rules take effect. While we accept that there will always be room for improvement and further policy change is inevitable, we strongly caution against any significant structural changes to default superannuation without hard evidence and a cost-benefit analysis which clearly shows that such changes will lead to real improvements for members.

### How the current default fund selection ticks the boxes

The existing Fair Work Commission (FWC) model & Single Touch Payroll (STP) addresses the Productivity Commission's 4 criteria for default fund selection:

- ✓ Expert body/panel for selection process
- ✓ Quality filter above MySuper status
- ✓ Intention to reduce number of default funds
- ✓ Process to address multiple account issue

### All four boxes ticked:



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## Response to draft findings and recommendations

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### Draft finding 1.1

***Complementary policy action (including to extend genuine member choice to all employees) will be needed to deliver the full potential of member-driven competition under the alternative models developed in this Inquiry and under current default arrangements.***

AIST does not accept the fundamental premise of the Productivity Commission's Draft finding 1.1.

Before addressing whether complementary policy action is needed to support either new or current default arrangements, we note that the Commission makes assertions about the value ("full potential") of member-driven competition, without providing any evidence to support it.

Evidence suggests that the Commission's presumption that member-driven competition improves member outcomes is flawed. As the table below from the Commission's own 2012 report shows, the default investment options of profit-to-member funds have – with the exception of year 2009 – consistently outperformed whole of fund returns for the 'Choice' sector. Neither choice of fund nor choice of investment option have been demonstrated to deliver improved retirement outcomes for those members. Instead so-called member-driven competition has led to lower net returns, higher fees and members making decisions that are clearly not in their best interests.

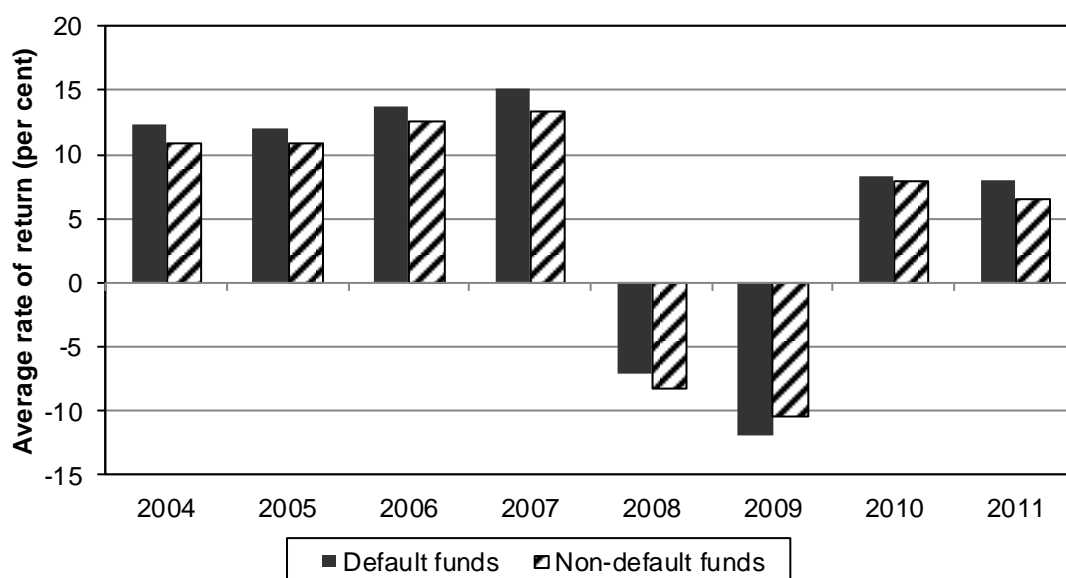
Reduced net returns don't only cost the members who have chosen those options; the community subsidises those choices through tax concessions, and may be called upon again through increased Age Pension expenditure when those members retire.

The "full potential of member driven competition" is, on the evidence, lower retirement incomes and higher government expenditure.



**Figure 4.1** Superannuation fund performance

*Default funds versus non-default funds*



Sources: Productivity Commission estimates based on APRA fund-level profiles and financial performance data 2011 (APRA 2012j); FWA (2012e)

No one is more aware of failings of the Choice sector than the retail sector itself, which has regularly complained about using whole-of-fund returns as a benchmark for comparison because, it says, returns from member-selected investment options have dragged down overall fund returns.

### Policy action on disclosure

As discussed in other sections of this submission, poor disclosure across the super sector is a concern and impacts on the efficiency of default fund selection. Policy action to improve disclosure is needed to enable easier comparison between default superannuation products which have very different investment and fee structures, and importantly to facilitate comparison between default and Choice products.

### Policy action on mergers

As outlined on page 30, AIST considers that policy action around both fund mergers and intra-fund consolidation is needed to support optimal outcomes for default members.

### **Circumstances where exemptions from Choice are in members' best interests**

The proposal, from recommendation 12 in the Final Report of the Financial System Inquiry (FSI, "the Final Report") to extend choice of fund to all employees was introduced into Parliament in 2016 but the Bill lapsed on prorogation. It was clear, prior to the Bill lapsing, that it didn't have the support in the Senate to pass.

The proposed legislation continued some exemptions from an employer being required to offer employees choice of fund, while removing the exemption where contributions are made in accordance with enterprise agreements or workplace determinations.

Neither the Government nor the FSI provided a compelling case in support of this recommendation, which is especially significant given it has been established that the performance of superannuation funds nominated in industrial instruments is higher than that of the average performing super funds.

Just as there are justifiable reasons to exempt members of defined benefit funds from choice of fund, AIST submits that there are other circumstances where providing such an exemption is in members' best interests. As part of our submission to Treasury on the exposure draft of the lapsed Bill<sup>1</sup>, AIST proposed a legislative amendment protecting these additional benefits by continuing to allow an exemption in such cases.

A purpose of the (existing and ongoing) defined benefit exemption is to protect retirement, resignation and retrenchment benefits that are different from - and in excess of - other superannuation arrangements. AIST's proposition follows this same logic.

A common characteristic of environments where choice of fund is not available is that they often provide benefits in excess of that provided by the *Superannuation Guarantee (Administration) Act 1992* (SGAA), including additional employer contributions, enhanced insurance arrangements, and, in the case of some government funds, guaranteed levels of retirement benefits.

In some instances, insurance cover has been provided on a basis and at a rate reflecting that all or most employees of an employer or an industry will be in the same fund. These arrangements are compromised if the fund does not cover these employees. Bespoke insurance arrangements and automatic acceptance may be threatened, and higher premiums may result.

These additional benefits arise as a result of enterprise bargaining, where the respective claims of employees and their representatives and the employer are negotiated. These negotiations may

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<sup>1</sup> Garcia, T. (2016). *Re: Extending superannuation choice to enterprise agreements and workplace determinations*. [online] Melbourne: Australian Institute of Superannuation Trustees, p.8. Available at: <http://tinyurl.com/hel2ope> [Accessed 18 Apr. 2017].

involve the removal of existing conditions and the addition of new conditions. It is the outcome of these negotiations, and the trade-offs they may entail, that are voted on in enterprise agreements.

On a collective basis, enterprise agreements allow employees to decide which super fund(s) (the recipient(s) of their deferred wages) are best for their circumstances. This is particularly important where the outcome involves the provision of additional superannuation benefits.

It is therefore not in the interests of members of such funds to switch into superannuation funds that offer lesser benefits and may remove certainty and security.

We also note that the choice of fund regime has not reduced account proliferation. ASIC in its initial submission to the Financial System Inquiry (FSI) noted that choice of fund had not resulted in a reduction of duplicated accounts:

*These [choice of superannuation fund] changes also made it possible for members with multiple accounts to more easily consolidate these accounts and reduce the amount of fees they pay for maintaining multiple accounts. However, in practice, this consolidation did not lead to a decrease in the number of accounts in the industry. The number of accounts continued to grow to more than 30 million, even though the number of employed persons in Australia is roughly 40% of this number. This means that for every employed person there are approximately 2.5 accounts. A large number of these accounts are small, unclaimed or lost and some are for retirees receiving superannuation in the form of a pension<sup>2</sup>.*

### Recommendations

*Policy action is needed to improve disclosure to enable easier comparison between default superannuation products which have very different investment and fee structures, and importantly to facilitate comparison between default and Choice products.*

*AIST considers that policy action around both fund mergers and intra-fund consolidation is also needed to support optimal outcomes for default members.*

*AIST proposes that the provision of additional superannuation benefits should be protected, and that these be allowable as circumstances that satisfy the choice of fund requirements, similar to existing exemptions for defined benefit arrangements.*

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<sup>2</sup> ASIC, (2014). *Financial System Inquiry: Submission by the Australian Securities and Investments Commission*. April 2014. [pdf] Canberra: Australian Securities & Investments Commission, p.227. Available at: <http://tinyurl.com/pptq436> [Accessed 25 Mar. 2015].

*AIST recommends that these protections be implemented via a no-disadvantage test where, if prescribed additional benefits are provided, this meets the requirements for an exemption. Alternatively, the benefit of an employee is made in compliance with the choice of fund requirements if the employer contributions paid to the fund are in excess of either section 19(2) of the **Superannuation Guarantee (Administration) Act 1992** or minimum MySuper requirements.*

### Draft finding 1.2

***Where there is third-party involvement in the selection of a default product, there needs to be effective regulation or arrangements in place to ensure these third parties act in the best interests of members.***

AIST acknowledges and supports the draft finding.

### Draft finding 1.3

***For the purposes of this Inquiry, a formal competitive process for allocating default members constitutes any new alternative process that permits open participation (contestability), encourages rivalry between funds (competition) to the benefit of members, and involves products being selected for members based on merit.***

AIST supports contestability, competition and merit-based selection in the default fund process, and echoes the comments of the Commission that “a formal competitive process does not necessarily mean an auction or tender.”

AIST rejects the notion that “a formal competitive process for allocating default members” requires a “new alternative process” given the existence of the Fair Work Commission process.

### Draft finding 3.1 and draft recommendation 3.1

AIST’s response to draft finding 3.1 and draft recommendation 3.1 are presented together

***Draft finding 3.1: The current arrangements where members can be defaulted to a new account on every change of job increases the proliferation of accounts. This materially adds to costs for members and reduces member balances at retirement.***

***Draft recommendation 3.1: To avoid perpetuating the legacy problems of the current system, any future alternative system for allocating members to default products should be premised on employees being assigned a default product only once, when they join the workforce.***

AIST recognises that there are too many superannuation accounts in the system but submits that new measures to reduce account proliferation are unnecessary given the significant improvements in productivity and efficiency currently underway as a result of SuperStream and other Stronger Super initiatives. Implementation of these initiatives has been underway for the past five years and is on track to be completed in about 18 months' time.

SuperStream has facilitated account consolidation and addressed inefficiencies in superannuation transactions, especially between employers and super funds. It has had the strong support of successive governments and close collaboration between the ATO, the superannuation industry, employers, payroll providers, gateways, and administrators.

APRA statistics<sup>3</sup> show that the number of member accounts reduced by around one million in the year to June 2016, from 28.93 million to 27.97 million for an estimated 12 million employed persons.<sup>4</sup> This is still too many but is a 20 per cent reduction from the high watermark of 33 million in 2010.

The precondition for account consolidation was legislation in 2011 that allowed super funds to use Tax File Numbers to locate duplicate accounts within a fund. This allowed intra-fund consolidation and provided a basis for further consolidation initiatives.

In 2014, the Government introduced the intra-fund consolidation legislation which now requires superannuation funds to implement a process of consolidating super accounts where members have more than one account within the same fund.

Account consolidation has been accelerated by new online services and streamlining of rollover processes. Super fund members are now able to go to the consumer-friendly MyGov site or their own super fund site and easily consolidate their accounts. Other ATO enabling services such as SuperTICK and SuperMatch have been developed in collaboration with the superannuation industry as consolidation tools.

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<sup>3</sup> Australian Prudential Regulation Authority, *APRA Annual Superannuation Bulletin* (June 2016), Table 10 Changes in membership profile by fund type.

<sup>4</sup> Australian Bureau of Statistics, *Labour Force Statistics*, Catalogue 6202.0 March 2017

The SuperStream transaction processing rules require that rollover requests (and contributions) are processed by the 'from' fund and the 'to' fund within three business days, down from the previous 30-day requirement.

AIST understands from participation in ATO consultative forums that ATO records show rapid account consolidation over recent periods, with high volumes and high values now being recorded.

While the costs to date of SuperStream have been largely borne by super funds and are estimated to be well over \$1 billion, overall savings are estimated to be far greater – in the billions of dollars per year. These benefits flow to both employers and super funds which may in turn pass them on to members. AIST looks forward to the early release of ATO statistics further detailing these savings.

### **Single Touch Payroll will further reduce account proliferation**

Another significant initiative that is set to accelerate account consolidation is Single Touch Payroll. Changing jobs is an important milestone event. It is often associated with a change in financial circumstances, and necessarily involves members advising their new employer about address, contact information and bank account details. It is appropriate that consideration of one's superannuation fund remains part of this process, as it is now.

Single Touch Payroll project does this, providing a multi-purpose gate that is designed to make this process as simple as possible, and to provide a benefit to individuals and employers.

Single Touch Payroll requires employers with 20 or more employees to report salary, PAYG withholding tax and superannuation guarantee amounts from 1 July 2018 (with voluntary commencement from 1 July 2017). The project also involves the development of online forms to support new employee commencement, including tax file number declaration and choice of superannuation fund.

AIST is contributing to the cooperative design of these forms. It is settled that new employees will be given the option to select the super fund into which their ongoing contributions will be paid. It is anticipated that the forms will be pre-populated with the employee's details including their existing super fund/s and (AIST hopes) their new employer's default fund.

It is clear from the ATO's draft design principles for employee commencement<sup>5</sup> that encouragement of account consolidation is one of the primary objectives:

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<sup>5</sup> Australian Taxation Office (2017). *STP Industry Engagement Forum*, 6 April 2017, slides 26 and 27.

- *The process should lead to an improvement in both the employee and employer experience when commencing a new job, or updating their employment information.*
- *The process should improve the quality of data available to the employer for meeting payroll and superannuation requirements.*
- *The process should make the employee on-boarding process more efficient.*
- *The process should encourage active consideration of alternatives to the employer's default fund.*
- *This exploration process should be fund agnostic – i.e. with no inherent bias to a particular fund or sector.*
- *Nevertheless, the process should not encourage the unnecessary proliferation of multiple member accounts (e.g. by including avenues to facilitate consolidation of accounts by a member and the simple selection of an existing account where desired).*
- *The process should avoid creation of 'false' choices (e.g. fund not accepting contributions) which will only lead to re-work/exceptions by employee and employer.*

In addition, one of the ATO's draft compliance principles is<sup>6</sup>:

- *Encourage employee engagement with their tax and superannuation*

Not only will these processes continue the acceleration of account consolidation, they will also encourage employee engagement and make it simpler still for new employees to reflect on their superannuation choices at the milestone of starting a new job.

Almost as importantly, these processes will be simple and straightforward; a help to consumers, rather than an obstacle. In answer to its own question 'Why are we changing?' the ATO responds<sup>7</sup>:

- *Focused on reducing the regulatory burden for all Australians... Reducing the red tape*

The timetable for these changes means that the new employee commencement functionality is imminent. It is scheduled to be available from September 2017.

While the use of new online forms will be voluntary and paper forms will remain available for some time, the convenience of this approach to a modern, mobile workforce is self-evident, and use of the paper forms may soon become as unusual as use of a paper account withdrawal slip at a bank branch office.

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<sup>6</sup> Australian Taxation Office (2017), *STP Industry Engagement Forum*, 6 April 2017, slide 59

<sup>7</sup> Australian Taxation Office (2017), *STP Industry Engagement Forum*, 6 April 2017, slide 5.

### Recommendations

*AIST recommends that the Commission recognise the need to build on Single Touch Payroll and SuperStream initiatives in order to resolve account proliferation issues rather than consider alternate and potentially disruptive approaches.*

*AIST further recommends that the new employee commencement process via Single Touch Payroll be enhanced by the addition of a prompt for people to consider the consolidation of their existing super accounts into the account receiving their ongoing contributions from their employer.*

### Improving exchange of information will increase account consolidation

The issue of lost super is separate from, but related to, the issue of multiple accounts and account proliferation. Many accounts are lost as a result of proliferation of accounts, and until recently it was hard to keep track of them.

While many initiatives are aimed at increasing member engagement, there are also initiatives that could assist super funds and the ATO reduce the rate of account proliferation. For example, regulations enabling the ATO to actively send matched account details of unclaimed monies to super funds would greatly assist the resolution of historic issues.

### Recommendation

*AIST recommends that the Commission recognise the need for further regulation to enable account consolidation through data matching.*

### One default fund for life encourages disengagement and ongoing lack of engagement

The draft report presents the account consolidation problem as the main reason for allocating members to default funds at the start of their working life. AIST submits that the above commentary removes the justification for this approach.

In regards to the Commission's 'one default fund for life' proposal, we have major concerns which we address in our response to Draft Finding 5.1.



### Recommendation

*AIST strongly recommends that existing initiatives are used to better and more efficiently engage with new employees at each change of job continue, and that the Commission not proceed with its recommendation to allocate employees to default funds only once.*

### Draft recommendation 3.2

***The Australian Government should establish a centralised online service for members, employers and the Government that builds on existing functionality of myGov and Single Touch Payroll. The service should:***

- ***allow members to register online their choice to open, close or consolidate accounts when they are submitting their Tax File Number on starting a new job***
- ***facilitate the carryover of existing member accounts when members change jobs***
- ***collect information about member choices (including on whether they are electing to open a default account) for their employer and the Government.***

***There should be universal participation in this process by employees and employers.***

The recommendation seeks the establishment of a single centralised clearing house - a national payment hub by which employers make superannuation contributions to multiple funds. It appears that the recommendation is for a centralised payment system, with links to the electronic transmission of data. While the commentary refers to Single Touch Payroll and SuperStream, it does not mention the New Payments Platform nor suggest how this would be integrated with this proposal.

While the Commission appears to see merit in the nationalisation of clearing houses, the commentary and recommendation seem to overlook the significant initiatives that have recently been put in place and that already deliver many of the benefits that the Commission's report is seeking.

The report references SuperStream and the Small Business Clearing House, but does not mention the implementation of the gateways and the gateway network. Gateways, which sometimes operate under the auspices of clearing houses, operate to facilitate the effective operation of the Superannuation Transaction Network. Rules, standards, and security and integrity requirements are set through this process.

The report makes a recommendation about developing a centralised clearing house and housing it within the ATO. Any move from the operation of a market-based system built on cross-industry collaboration and involving a range of competing providers to a centralised, government-owned and operated service should be undertaken with care.

Furthermore, SuperStream has also involved the legislative and actual implementation of a contributions pass-through requirement. This means that if a superannuation fund offers a MySuper product, then that superannuation fund is required to pass on contributions data it receives from any of its default employers relating to any other superannuation funds. This is another initiative that can simplify the administration of superannuation for employers, and means that an employer need only ever send their superannuation contributions to one super fund.

The Commission seems particularly impressed by the use of a clearing house for the collection of employer and member contributions in New Zealand, and the allocation of those contributions to the appropriate fund. It is not clear from the commentary or AIST's understanding of the New Zealand model what features of their model are not already available in the Australian environment. Given the far greater size and complexity of the Australian environment, it seems to be high-risk to move from a successful model that is close to maturity and that has widespread stakeholder acceptance to a model that has mixed results, and is not amongst the top-performing systems in the world.

It is assumed that the appeal of the KiwiSaver clearing house model is that it has avoided a situation where many individuals have multiple small accounts, many in mislaid accounts. AIST submits that this is more a function of their 10 year history of activity, and asserts that the account consolidation benefits of SuperStream, Single Touch payroll and various enabling services in Australia will take less time to achieve the same result.

### Recommendation

*AIST recommends that the Commission further investigate the capability of the existing SuperStream infrastructure, including governance arrangements and contributions pass-through, before it recommends moving to an alternate clearing house model.*

### Draft finding 3.2

***There are strong grounds for requiring a fund that wins default status for contributions of new default members to extend the same fees and service terms to all its existing members of the default product.***

AIST agrees with this finding.

### Draft finding 3.3

***The default product in all models will focus on the accumulation stage and include investment, administration of member accounts and intra-fund advice. It will be a simple and low-cost (but not conservative) product aimed at the needs of those who are disengaged from the system.***

- ***A bundled insurance product will not be a factor in the selection of products and is best addressed through regulation and regulator oversight.***
- ***Funds will primarily compete on long-term net investment returns and costs, subject to meeting a threshold quality of service, not on the quality or range of ancillary services per se.***

AIST agrees with appropriateness of having a simple default product focussed on the accumulation stage.

AIST supports a centralised system, where employees are connected with default superannuation arrangements which are most appropriate to them. AIST agrees that consideration of what is in the best interests of members is best reflected through fund features such as:

- **Default investments:** Different industries have different demographics. The default asset allocation or investment management style of a fund that supports younger employees in retail businesses may not be appropriate for a fund which serves older employees in the telecommunications industry, for example.
- **Customer facilities:** Provision of customer services such as intra-fund advice or online calculators usually depends on how financially literate a fund's membership is.
- **Insurance:** Widespread concern with under-insurance in Australia was one of the reasons why provision of death and total and permanent disability (TPD) insurance has been permissible under superannuation legislation, and is required as a default (with capacity to opt out) in MySuper products.

Consistent with AIST's view that people should be encouraged to focus on their superannuation every time they change employment, the change from accumulation to pension phase should also provide a strong point for review. Given members' higher balances at that point, and the fact that they would be receiving a highly visible income stream from it in future, default products are less needed than in the accumulation phase. The design of any default product and requirements of providers are also likely to be different.

### **The importance of insurance**

Insurance within default superannuation addresses the needs of those retiring for reasons other than age – such as disability or caring for a family member – and should be seen as a core feature.

This is consistent with both the SIS Act and the *Social Security Act 1991* (which has pensions to cover retiring with a disability or to take up caring responsibilities).

The issue of insurance in defaults is discussed more fully in our response to draft Finding 5.1.

AIST believes that a recommendation to take insurance out of primary consideration is ill-advised and risky. It would dramatically increase under-insurance in the community. Problems with insurance cover are most likely to become apparent after a traumatic event, with the consequences being most critical for the individuals involved.

AIST therefore submits that insurance must continue to be an explicit and specific factor in the selection of default products.

### **Recommendation**

*AIST recommends that insurance be a core factor in the selection of default products.*

### **Long-term net investment returns and costs**

AIST believes that the key factor by which funds should compete are long-term net investment returns. While costs are also important, it is net returns that ultimately matter most when it comes to individual retirement outcomes.

Critically, the definition of a 'net investment return' depends on the inputs which go into determining the 'net investment return'. For example, some funds describe 'net investment return' as being before tax. The effects of fees which are partly defined as a flat rate and partly as a percentage of account balance, and of event-based fees such as buy-sell spreads can also make comparison difficult. Further, there are inconsistencies about the treatment of tax deductibility with some funds passing the deductibility for administration fees and insurance premiums back to members while others do not. The treatment of all these inputs therefore needs to be

transparent, and defined in regulation, to enable consumer comparisons as well as analysis of fees and costs at system level.

AIST has strongly advocated that all super funds – whether they be offering a default or Choice product – must act in the best interests of members, be assessed based on long-term net returns. Additionally, they should be subject to a regulatory framework which provides sufficient consumer protection, based on a level playing field across products and services to deliver greater transparency and comparability.

### Recommendation

*AIST agrees that funds should compete on long-term net investment returns.*

## Draft finding 3.4

***The desirable frequency for the selection process is between four and eight years, with the greater frequency best used in the early period.***

Four-yearly reviews of modern awards are part of existing Fair Work Commission processes, and Parliament has determined that this is the appropriate period for review of default fund arrangements. Reflecting on this, AIST is of the view that such frequency is appropriate on an ongoing basis for the review of default funds under a default selection model. A review every three years or less would mean that the system would seem to be under almost constant review, while frequency of more than five years would be insufficient scrutiny of such an important function.

### Recommendation

*AIST endorses this recommendation and agrees that a four year review period should be a recommendation in the final report of phase 3.*

### Draft finding 3.5

***The selection of eligible default products should be administered by a government body, and be subject to strong governance rules. The decision-making body must:***

- ***have a strong focus on fund member interests***
- ***have sufficient expertise to evaluate products***
- ***be independent and free of real or perceived conflicts of interest***
- ***have processes that are transparent and afford procedural fairness***
- ***be accountable for its decisions.***

AIST supports the selection of default funds by a government body that has the characteristics identified by the Commission. However, we do not support the creation of a new body for this purpose, noting that such a body already exists to administer the selection of defaults. To create a new one is cumbersome, bureaucratic and increases the risk of politicisation, but is highly unlikely to have the judicial and legislative controls that regulate the Fair Work Commission.

We have already mentioned the characteristics of the Fair Work Commission in this submission, and again draw your attention to both the more developed characteristics of a default system, and the practicalities of utilising an extant model.

We note that the default fund selection process by the existing government body worked harmoniously prior to the establishment of these criteria. Specifically, there is no evidence of super funds that sought to be considered for inclusion in a default fund listing being excluded from fair consideration in this process. It was open for any fund to seek the support for listing from either an employer or employee representative, and it is noted that some (but not many) retail funds did this.

AIST supports the finding that the body should have sufficient expertise to evaluate potential default products.

Elsewhere in this submission we address the need for comparable and consistent disclosure, and submit that the APRA Data Dissemination Tool should be made available for this and other purposes as soon as possible. It was scheduled for release in 2015 but remains in development.

The suggestion that that the panel determining eligibility for preferred default status would meet only for the period it was required and then cease operations does not seem to be consistent with accountability or the building of the requisite expertise.

### Recommendation

*AIST agrees with this finding and supports the role for the default fund selection body. AIST considers that the body charged with selection of default funds should be ongoing to allow it to build expertise and to promote accountability.*

### Draft recommendation 3.3

***The Australian Government should introduce a formal framework that specifies the process and obligations of trustees when making or considering merger proposals. As part of the framework, trustees would be required to disclose all merger attempts involving their fund, as well as the reasons for any decisions.***

AIST supports mechanisms to encourage greater transparency by super funds, including in relation to merger activity, and seeks that this be applied on a level-playing field basis. However, we also note that there are mechanisms to encourage consolidation already in place. Each round of major regulatory change has resulted in widespread consolidation; for example, following both the introduction of Registerable Superannuation Entity (RSE) licensing and the Stronger Super reforms.

An inhibitor to merger activity have been the perceptions around the operation of the successor fund transfer rules.

AIST notes APRA's consultation on draft SPG 227 Successor Fund Transfers and looks forward to the finalisation of that guidance in mid-2017. This guidance will provide clarity around the operation of the 'equivalence' test in a way that should facilitate future merger activity from the perspectives of both exiting and receiving funds. Once that is released, any failure to consider merger or wind-up on the part of a trustee for a fund that had been underperforming for 3-5 years would be far more difficult to defend than is now the case.

Additionally, the SIS Act contains a MySuper scale test. Funds with a MySuper product are already required to determine annually whether their default members are disadvantaged by small scale in comparison with default member in other funds.

APRA oversees compliance with this requirement, and there is no evidence that it is not working. APRA has stated that it will be increasing scrutiny of scale, and it is reasonable to expect that this will encourage lower performing funds to consider merging with other better performing funds.

Successive Governments have provided Capital Gains Tax relief for funds merging by specified dates. The current relief expires on 30 June 2017, and the merger of funds has been facilitated by this measure. However, the time restrictions on this relief acts against ongoing consideration of mergers, and CGT relief should be provided on an ongoing basis.

With the introduction of MySuper, funds had five years until 1 July 2017 to transfer 'Accrued Default Amounts' (ADAs) into MySuper products. While the substantial majority of profit-to-member super funds transitioned all the ADAs at, or shortly after, the introduction of their MySuper products, there was a very significant delay on the part of many retail funds. As at December 2016<sup>8</sup>, \$14.9 billion dollars of accrued default amounts still remained outside of MySuper products and the higher standards applicable under the MySuper regime. The greater fee transparency and prohibition on commissions in MySuper might reasonably be supposed to be a factor in the delayed transfer.

In contrast to the 120 MySuper products, there are approximately 44,000 Choice investment options. The overwhelming majority of these are related to banks and retail institutions, with some financial institutions having thousands of products. Many have near to identical investment strategies but differing cost structures. It is common for bank-owned funds to add investment options simply because they are asked to do so by a single financial planner. In some cases, bank funds offer a Choice investment option with an investment strategy identical to their MySuper offering, but with a higher fee structure.

A framework to improve transparency around merger activity that is effective in promoting member interests by reducing the number of underperforming funds or products must also include a requirement to consider intra-fund consolidation against a members' best interest test. Such consideration should extend to legacy products, which frequently involve high costs and low net returns to members. This could be achieved by making amendments on this basis into APRA's Prudential Standard SPS 510 on Governance.

We recommend that transparency around fund mergers is limited to formal offers, where at least one fund has conducted due diligence.

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<sup>8</sup> APRA (2017). *Quarterly Superannuation Performance*. December 2016 (issued 21 February 2017). [online] Canberra: Australian Prudential Regulation Authority, p.9. Available at: <http://tinyurl.com/k7ddbzd> [Accessed 21 Apr. 2017].



### Recommendations

*AIST recommends that any formal proposal to improve transparency around fund merger activity be broadened to require consideration by all funds (including retail legacy products) about whether they have been doing enough to wind up or merge, and that this consideration should be disclosed.*

*AIST recommends that the Commission acknowledge the need for APRA to use its existing powers to apply greater scrutiny to encourage fund and product consolidation.*

*AIST recommends that the Commission recommend that the Government legislate to provide Capital Gains Tax relief for super fund mergers on an ongoing basis.*

### Draft finding 5.1 – The assisted employee choice model

***Relative to the baseline, the assisted employee choice model would:***

- ***significantly reduce the complexity employees face in choosing a product and lead to more employees choosing high-performing products that meet their needs, thereby increasing member benefits***
- ***focus competition on product aspects of value to members, put downward pressure on fees (through greater product comparability) and likely curtail wasteful product proliferation***
- ***better align funds' interests with those of members***
- ***support a stable superannuation system***
- ***have lower search costs for many employees and very low costs for employers, but with government and funds incurring additional costs associated with regulatory structures.***

AIST rejects the assisted employee choice model, when combined with other features favoured by the Commission such as allocating an employee to a default fund only when they first enter the workforce, a greatly reduced pool of default funds and the exclusion of insurance from consideration when shortlisting potential default funds, because it is likely to lead to significantly worsened retirement outcomes.

AIST considers that competition is unlikely to focus on matters of long term benefit to members and is most unlikely to curtail product proliferation.

### **Allocating members to a default fund only when first entering the workforce**

AIST notes that account proliferation is a primary driver for the Commission's preference for members to be allocated to a default fund only when they first join the workforce. As demonstrated in our response to Draft Finding 3.1, that issue is in the process of being resolved through the combination of legislative and technological change embodied in SuperStream and One Touch Payroll.

AIST is deeply concerned that requiring first time employees to select a fund that they may stay with for life risks creating a wide scope for mis-selling, even when the available products have been pre-qualified. The highest vulnerability lies in young people, once recruited into a fund, being induced to invest into a suboptimal Choice product.

Young people joining the labour market for the first time are furthest from retirement, and typically have the least interest and knowledge about superannuation or other financial matters relating to retirement. They are also more likely to make decisions or allow decisions to be made on their behalf on the basis of short-term considerations, even short-term inducements. Even with the ever-present option of choice, a default system whereby a fund is allocated for life is likely to lead to a lowest common denominator marketing campaign, focused on aspects other than maximising retirement income.

By contrast, older members – those entering middle age and beyond – have a greater appreciation of the reality of retirement. They have much higher interest and knowledge about superannuation, particularly as their fund balances increase, and are less likely to be distracted by short term inducements.

Milestone events such as health issues, change in employment and relationship status should all give prompts to review retirement readiness, and it is counter-intuitive to suggest that one of these prompts (consideration of superannuation at change of job) should be removed.

The additional protections which apply to MySuper members may result in these members being regarded as a burden to a trustee with a duty to generate profits for shareholders. Once an employee has joined a fund, they are vulnerable to being encouraged into Choice products which are likely to generate higher profitability, even though that may not be in the interest of the member. This is particularly the case when sales staff who are not engaged by the trustee have regular interactions with the member and can raise superannuation-related matters in the context of a broader conversation about the person's financial arrangements.

### Comparability of products is important

For both consumers and third parties, comparability of products is important. Despite all the rhetoric about MySuper enabling easy comparison between funds, this has not been the case. The inclusion of complex life cycle investment options in a simple, default product has made comparability difficult, especially where there are 5, 10 or more stages to compare. This has been compounded by variations in the types of fees, insurance offerings, declared risk appetites and strategic asset allocations.

Market analysts who compare many features of a product and then decide a rating for it have not provided a solution. Different analysts do not always compare the same features, nor do they give them the same weightings, and their ratings can be published in different and confusing ways. None of this assists in selecting an appropriate fund.

Independent rating agencies typically focus on publishing top 10 performance tables rather than tables that include the poor performers. It is difficult, if not impossible, for a member in a long-term underperforming fund to benchmark their fund's performance. AIST strongly supports AustralianSuper's recommendation for a net benefit league table published by APRA which easily allows members to identify poor performing investment options/funds over the long term. This is long overdue.

### Recommendations

*AIST strongly recommends greater regulatory guidance on the comparability of all products to assist all parties involved in fund selection process. This should include both default funds and Choice funds. Default members might want to leave a default fund at some stage, and both members and employers might reasonably want to understand and compare their selection/default against the wider market of superannuation funds.*

*AIST recommends that APRA publish a league table showing net returns to members over 1, 3, 5 and 10 years for all MySuper products and for each Choice investment option above an agreed threshold of assets or members.*

### Appropriate regulation drives informed choice

The Productivity Commission has noted that ‘the freedom to make choices is necessary to realise the benefits of competition.’ We do not dispute that consumers should be responsible for their financial decisions. However, we do strongly believe that consumer decisions should be based on informed choice provided within an appropriate regulatory environment.

An appropriate regulatory environment is critical to both protecting consumers and to the stability and competitiveness of the financial system. The World Bank has examined an outcomes based assessment framework for pension systems. According to the World Bank<sup>9</sup>, a core element of improving pension system efficiency is to ensure that costs that do not increase returns are reduced. They go on to note that transparent capital markets, good disclosure, and cost control and transparency are important components of ‘efficiency’, and that ‘competition by itself appears to be inadequate to drive lower costs if individual choice alone is involved. Lack of transparency is a big issue in determining costs.’ We would add that even full transparency is insufficient to provide for informed choice if individuals have neither the financial literacy nor the desire to engage in meaningful choice.

### Behavioural finance issues

AIST is aware of the issues faced by Australians for whom the important issue of superannuation can take a back seat when confronted with other major issues. An example was offered by Peter Kell of ASIC<sup>10</sup>:

*[Mr Kell:] ...If you are, say, a 19-year-old buying your first car, a flashy, red good-looking car— ....—typically, your overwhelming focus will be on that car. Your discussion will be around 'What is this car going to do for me?' When it comes to 'Do you need a loan for it?' often the question is 'How much can you afford to pay?' rather than 'Here's the interest rate, and here are some insurances because you do not want this beautiful new car that you are about to buy get damaged.' The focus for those add-on products tends to be overwhelmingly on the underlying product. In many cases, consumers do not understand what they are getting with the add-ons. This is a problem that occurred across the industry.*

In this case, it is understandable that the consumer may not have given their full attention to the terms of how their purchase is to be financed.

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<sup>9</sup> The World Bank, (2016). Outcomes based assessment for private pensions: a handbook. [online] The World Bank. Available at: <https://tinyurl.com/keyrhr5> [Accessed 11 Apr. 2017].

<sup>10</sup> Evidence to Senate Economics References Committee, Parliament of Australia, Sydney, 26 April 2017, 4 (Peter Kell, Deputy Chairman, Australian Securities & Investments Commission)

Under the Commission's assisted employee choice model, young people who may not yet be equipped to make financial decisions will be required to decide their superannuation arrangements early on. In many cases, casual staff in retail and hospitality will be aged under 18. Australian law does not deem minors financially competent to enter into contracts involving real estate or life insurance. It is not clear why superannuation would be different.

### **Sales staff with no fiduciary obligations**

Although the offering of superannuation is largely protected against most variable reward-based remuneration, being sold from within a culture where sales are culturally important is likely to influence staff to act in a way that is not consistent with members' best interests.

We are concerned that where staff of other entities (i.e. not the trustee) in a financial group are involved with superannuation clients, there are two distinct issues:

- Staff with no fiduciary obligations to the members may provide services which are inappropriate; and
- Disclosure of services being rendered by third parties which would normally be rendered by trustee staff is evidence of undisclosed related party transactions, and may give the fund the capacity to offer artificially reduced administration fees.

AIST considers that this scenario is not within the spirit of laws such as the FoFA reforms, or mandatory fee and cost disclosure as described in ASIC Regulatory Guide RG 97. We believe that this has the real potential to disadvantage fund members.

### **Reduced number of default funds**

Much of the Commission's agenda appears to be directed towards consolidation in the superannuation sector, with its models proposing between 4 and 10 default funds nationally.

While accepting that some consolidation may be worthwhile, AIST cautions against driving this to the levels proposed by the Commission for four main reasons.

Firstly, a tightly limited number of default funds would represent a significant barrier to innovation.

Within the MySuper environment, funds offer a variety of "single diversified investment" products. Others offer very simple age based lifecycle products with varying glide paths, while "mass customised" lifecycle products with a variety of glide paths within a single product are being promoted in the market but have not yet been adopted by any fund.

Unduly restricting the number of default funds significantly limits the prospects for funds seeking to refine and differentiate their offerings. The outcome is likely to be a more homogeneous industry even more closely tracking their peers than is the case at present.

Secondly, restricting the number of default funds would restrict the capacity to offer products tailored to members drawn from particular employers (in the case of corporate funds) or industry sectors in the case of industry specific superannuation funds.

The Commission would need to demonstrate how any proposed change would outweigh this loss of utility.

Different industries have different demographics that may require a different investment management style, different services, such as intra-fund advice and different insurance offerings. A default fund system offering only a small number of funds will limit such offerings. Unlike choosing a bank account where capital is guaranteed and there is often daily interaction, choosing a sub-optimum “set and forget” super account can have major consequences. We do not support limiting default funds to between 4 and 10 as the Commission has suggested.

Thirdly, the type of market concentration proposed by the Commission has been shown to serve consumers poorly across a range of industries – banking, telecommunications, postal services and airlines to name a few. Where barriers to entry are high, as would be the case with 4-8 year determination of default funds, there is a high risk of profit-to-shareholder funds seeking to make use of incumbency to maximise profit – for example, by advising members to switch to Choice products that are more profitable to the provider.

Internationally, there is evidence to suggest that limiting the number of default fund providers to a small group is not in members’ best interests. The sub-optimal outcome for Chilean workers following radical privatisation reforms to the country’s pension system is a case in point. In a 2016 report<sup>11</sup> Borzutzky et al note the very significant decline in pension providers in the Chilean pension system between 1980 and 2007. The report points to poor net returns for members and a significant concentration in pension fund management, with six funds currently responsible for managing workers’ savings. The report notes that “although management charges have fluctuated, they have remained exceedingly high,” with the pension fund administrators retaining between a quarter and one third of workers’ contributions. The report says “the question of high profits is compounded by a lack of market competition” with the three largest pension fund administrators managing 86% of accounts.

Fourthly, funds not forming part of the default pool would need to market themselves more vigorously to attract a continuing flow of members. Additional marketing would come at an immediate deadweight cost to the system as a whole, to the detriment of existing members.

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<sup>11</sup> Borzutzky, S. and Hyde, M. (2016). Chile's private pension system at 35: impact and lessons. *Journal of International and Comparative Social Policy*, [online] 32(1), pp.57-73. Available at: <http://tinyurl.com/kdzhj62> [Accessed 1 May 2017].

Funds associated with an existing commercial distribution network - such as banks or major retailers - would have an immediate advantage in such a situation and are well placed to offer incidental inducements to attract consumers with a short -term focus.

### **Exclusion of insurance from consideration in pre-qualification of default products**

In its 2016 report the Commission acknowledged that “the provision of insurance in superannuation could mean some members are able to obtain insurance that they would not be able to otherwise” but “the Commission ... considers issues relating to perceived underinsurance to be out of scope.”

AIST rejects that position.

Provision of death and TPD insurance should continue to be mandatory in default products on an opt-out basis as it provides a benefit in the event of premature retirement or death that may otherwise be unavailable to workers. Given that the purpose of superannuation is to provide income in retirement, it is logical that if a person’s working life is curtailed, insurance is provided to make up for the loss of income and consequent superannuation savings. On that basis, it should be included in the assessment of default products. Difficulties around comparability could be readily overcome, for example by requiring specification of weekly cost for a given level of death and TPD cover for members with selected demographic characteristics.

Where some funds have historically had great difficulty insuring higher risk occupations, other funds that service “difficult” industries (e.g. police and emergency services, building, heavy manufacturing) have been able to negotiate group insurance successfully with a history of value. AIST is concerned that the Commission’s proposal to remove insurance as a core element in the selection of default funds may be motivated by its agenda to heavily reduce the number of default funds, and to undermine a major rationale for industry based funds.

Most variation in MySuper products is around investment strategy (single diversified vs lifecycle) and insurance. It is therefore likely that attempts to game outcomes or to extract a revenue advantage are most likely to occur in the shadows, where there is the most opportunity for complication and there is the least scrutiny.

The risk of accounts being eroded by insurance premiums needs to be balanced against the risk of members dying or becoming disabled and having no insurance cover. Introducing insurance as an add-on to a base product granted default status risks very high costs if the default fund is part of a vertically integrated financial services provider. The “best interests” duty of trustees has been shown to be inadequate in dealing with commercial entities which mostly select related party investment managers and insurers. In the past, this has been done without any attempt at testing whether the services were being provided at a fair market price. As recently as 2013, the former

government amended the SIS Act to provide a legislative override of trust deed provisions mandating the use of specified service providers (SIS s.58A).

Experience in the Australian superannuation industry shows that, unless services such as the provision of insurance form an explicit part of the default offering and are assessed as part of that offering, either it will not be provided by the profit-to-shareholder sector, or it will be provided by a related party at excessive cost.

### **Other aspects of the assisted employee choice model**

AIST notes that this model is effectively a 'no default' model as it nudges consumers towards a shortlist of preferred funds from which they must then choose. Nonetheless, this model has characteristics of the existing system (e.g., an independent government body, a rigorous administrative filter and the aspiration to be simple and comparable).

However, unlike the current system, this model requires change to legislation, and the shortlist of between four to ten funds will cause systemic instability, as more than 90% of existing default funds would be excluded from the default market. For example, there will be no room in this system for corporate funds, which (in common with other profit-to-member funds) are generally high performing.

AIST shares the view expressed by the Commission on page 84 that ASIC and APRA should not be directly involved in the final step of selecting preferred default products.

Transition to the shortlist would cause instability to the system.

While this model may reduce the proliferation on new accounts, as previously stated, AIST is of the view that continued implementation of various ATO SuperStream and Single Touch Payroll initiatives would be a better, more efficient and effective means of addressing this issue.

### **Recommendations**

***AIST does not support the assisted employee choice model.***

*AIST supports the elements of having an independent government body (that is not APRA or ASIC) applying a 'rigorous administrative filter', choices being supported by simple and comparable product information, and eligible products being required to meet higher minimum standards.*

*AIST does not support employees being allocated to default funds only at first entry to the workforce.*



*AIST does not support having a shortlist of between 4-10 funds, and is concerned that this would reduce scope for innovation and tailoring of product for different employment sectors, as well as materially increasing instability in the system.*

*AIST does not support having a fund of last resort rather than a default fund.*

### Draft finding 6.1 – The fee-based auction model

***Relative to the baseline, the fee-based auction model would:***

- ***promote member benefits by exerting downward pressure on fees***
- ***focus competition on, and elevate transparency of, member fees***
- ***likely assist integrity due to its simplicity and accountability mechanisms***
- ***be unlikely to compromise long-term stability because the model as designed would not lead to excessive concentration of funds or volatile movement of members and assets***
- ***have slightly lower system-wide costs, mainly due to lower search costs for members.***

AIST is concerned that this model would only deliver cheapest fees at a given point-of-time. We would expect that in the process, a ‘race to the bottom’ on fees would be precipitated, with the results biased in favour of low-fee funds as a lowest common denominator. This would encourage movement away from high-performing and medium to higher cost products that deliver much better net returns.

We believe that this could lead to inventiveness on hiding fees, and would reward funds which are able to game definitions of fees. This has happened with disclosure and reporting as required under RG 97 and APRA data reporting and can be seen, for example, in the use of buy/sell spreads, investments via interposed entities below first-level related parties, as well as non-disclosure of other relevant information such as asset management styles. There is also the risk that some integrated financial services businesses could cross-subsidise fees for default products from other parts of the business in order to gain customers who can generate higher profits on a “whole of wallet” basis.

As a result of this bias, the contest would appear to be stacked in favour of the fund that appears to be cheapest. No evidence has been provided that this model would deliver on the other criteria.

AIST raises the question: Why is the test not based upon net-return-to-members? We note that the criteria used under the Fair Work Act – past performance, target returns and assessment of capacity to deliver – ensures that a safety net is provided which is both higher than that provided

by minimum MySuper standards as well as being capable of being tailored to employees in specific industries.

AIST believes that without any controls to ensure the sustainability of this structure, there is an incentive to engage in a 'bait-and-switch'; that is, offering an attractive default product with a view to advising default members to transition to more profitable Choice products. AIST believes that there are a variety of hurdles that need to be passed before this model could be entertained.

AIST also notes that it is common for Product Disclosure Statements to indicate that fees may be charged across a very wide range. It would be disturbing if a fund could win a fee based auction based on current fees but then raise them, or apply new fees permitted under the PDS, without prior agreement of the body overseeing the auction. It would be only slightly less disturbing if such fee rises were applied to default members only after the fund had ceased to be a default provider. AIST's submissions under Draft Finding 5.1 relating to comparability of products, regulation of disclosure, inclusion of insurance in defaults and too stringent a reduction in the number of default funds apply also to the fee based auction model.

### Recommendations

***AIST does not support the fee-based auction model.***

*AIST supports an approach based upon net returns to members, rather than a 'race to the bottom on fees'.*

## Draft finding 7.1 – The multi-criteria tender model

***Relative to the baseline, the multi-criteria tender model would:***

- ***promote member benefits by focusing competition on member satisfaction and long-term net returns***
- ***focus competition on aspects of performance that matter to members, and more generally through the winning bid providing a market-wide performance benchmark***
- ***create risks for integrity due to its vulnerability to subjective judgments, yet on the other hand promote integrity through stronger accountability mechanisms***
- ***not create any material risks to stability, since it is unlikely to lead to excessive concentration or volatile movement of members and assets***
- ***have slightly lower system-wide costs, mainly due to lower search costs for members.***

AIST agrees that assessment against multiple criteria with a weighting towards net returns and member satisfaction is the appropriate way to determine which funds should be authorised as defaults. That is the mechanism proposed to be undertaken by the expert panel of the Fair Work Commission under currently legislated arrangements.

While we agree with the criteria identified by the Commission we also submit that these should be coupled with more specific requirements for the selection of individual funds under the existing Fair Work Commission requirements:<sup>12</sup>

• Long-term return target/risk target	• Governance practices
• Ability to deliver return	• Appropriateness of insurance
• Appropriateness of fees & returns	• Quality of advice
• MySuper net returns	• Administrative efficiency

These criteria were arrived at following extensive consultation with the superannuation industry, and reflect a consensus at the time about the relevant criteria.

AIST also supports recommendation 15 of the recently released report into non-payment of the Superannuation Guarantee by the Senate Economics References Committee<sup>13</sup> where it was recommended that:

*The committee recommends that superannuation funds seeking default status in industry awards be required to have a rigorous arrears collection process in place.*

AIST notes that this model also restricts the number of default funds to between 1 and 10.

AIST reiterates its concerns about an undue restriction in the number of default funds, as set out in our response to Draft Finding 5.1; namely:

- Barriers to innovation;
- Restricting the capacity to offer products tailored to members drawn from particular employers (in the case of corporate funds) or industry sectors in the case of industry specific superannuation funds;

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<sup>12</sup> Fair Work Commission (2016). *Default superannuation list*. [online] Available at: <http://tinyurl.com/lbbg5n8> [Accessed 27 Apr. 2017].

<sup>13</sup> Senate Economics References Committee (2017). *Superbad – Wage theft and non-compliance of the Superannuation Guarantee*. May 2017. [online] Canberra: The Senate. Available at: <https://tinyurl.com/moaye5j> [Accessed 3 May 2017].

- Demonstrated poor consumer outcomes; and
- Inefficient marketing by funds excluded from the default process, to the cost of their members.

We also have concerns about the proposed sequential allocation of default members under this model to a panel of pre-approved funds. The investment options of current offerings within the default market are difficult to compare, particularly between single investment strategies and lifecycle products. Thus, even for “good” funds which are approved under the pre-qualification process, there are likely to be significant differences in investment outcomes from year to year, and potentially from age group to age group. Exposure to such differences for default members within a single workplace is likely to lead to concern on the part of those employees whose funds have apparently performed less well.

It is proposed that the tender would be administered by an independent panel, constituted by the Australian Government. The panel would advise the relevant Minister on which fund or funds should be selected for default status. The Minister would be free to accept or reject the advice, though his or her reasons would have to be made public. We agree with the Commission that this arrangement ‘create risks for integrity due to its vulnerability to subjective judgments’. We submit that the risks of political interference and industry lobbying in the tender process are unacceptably high.

AIST’s commentary under Draft Finding 5.1 relating to comparability of products, regulation of disclosure, inclusion of insurance in defaults and too stringent a reduction in the number of default funds apply also to the multi-criteria tender model.

### Recommendations

***AIST does not support the multi-criteria tender model in the form proposed by the Commission.***

*While AIST support the elements of having a pre-qualification process, detailed assessment criteria applied by an independent criteria selection body, and robust accountability mechanisms, we do not support having between 5-10 winners, and the sequential allocation of members.*

*Additionally, AIST is concerned about the risk of subjectivity if this model was applied outside a quasi-judicial body.*

*AIST recommends that superannuation funds seeking default status be required to have a rigorous arrears collection process in place.*

### Draft finding 8.1 – The assisted employer choice (with employee protections) model

***Relative to the baseline, assisted employer choice (with employee protections) — employing both a light filter for mandatory minimum standards and a heavy filter for a preferred default list — would:***

- ***enhance member benefits by increasing the likelihood of members being placed in higher quality products, and reducing the likelihood of them being in a poor product***
- ***promote healthy competition by presenting product providers with incentives to perform strongly against the preferred list selection criteria or compete for corporate tenders and facilitating greater comparability, but there would still be some scope for unhealthy and wasteful marketing to employers***
- ***increase the potential for agency problems given the involvement of employers, although the risk to the integrity of the system would lie primarily in the appointment process for the preferred default list selection panel***
- ***create few stability concerns***
- ***reduce search costs for employees, while increasing search costs for employers and regulatory costs for funds and government.***

The Commission correctly identifies that employers do not have a fiduciary obligation to operate in their employees' best interests, and this then leads to the finding about needing to ensure effective regulation of employers as third parties. This requires a legislative framework to balance the interests of employees and employers in relation to superannuation default selection.

AIST strongly supports such a framework being industrially-based. Industrial relations law affects people's wages and conditions of work in the workplace. Superannuation is effectively deferred wages paid to an employee by their employer and therefore it is a natural extension for the default system to be underscored by an industrially-based framework. Indeed, this is recognised internationally, where the top performing pension systems (as measured in the Melbourne Mercer Global Pension Index) are industrially-based.

The aim of industrial relations law is to achieve fair, equitable and productive workplaces for all parties involved.

We note that an industrial-based legislative framework is currently possible under the auspices of the *Fair Work Act 2009*. The Object of the Fair Work Act (section 3) provides elements that AIST submits are necessary in the effective regulation of third party arrangements. These include:

- A balanced framework for cooperative and productive workplace relations
- Being fair to working Australians and flexible for businesses
- Acknowledging the special circumstances of small and medium-sized business

Unions and employer organisations have a long history of working co-operatively around the selection of default funds. They are best placed to understand unique aspects of the workforce – such as insurance needs – and this knowledge is valuable in the final selection of a default fund in an award.

These organisations are also often active participants on the super fund boards that they sponsor. Employer organisations are therefore more highly engaged and knowledgeable than most individual employers and their ongoing role in default fund selection is preferable to that of individual employers who do not have fiduciary obligations to their work force.

### Recommendation

*AIST recommends that the Commission require a legislative industrial-based framework to balance the interests of employer and employee in any model for the selection of default superannuation funds.*

### Introducing employer fiduciary responsibilities

If the Commission is suggesting a legislative obligation on employers to act in members' best interests in relation to superannuation default selection, then that may have merit. This would also involve a major additional responsibility upon employers.

In the United States, the *Employee Retirement Income Security Act of 1974* (ERISA) sets standards of fiduciary responsibilities for employers that manage private-sector retirement plans. The basic fiduciary responsibilities applicable to retirement plans include the duties to:

- Act prudently
- Comply with pension plan requirements
- Offer a broad range of investment options

While the circumstances of pension plan arrangements in the United States are quite different from those in Australia, it is useful to note the protections that this could provide to employees as

fund members. In the US, fund members have been able to take action against their employer for being charged excessive fees and for not having sufficient expertise in such areas as investments.

The Commission should explicitly consider whether similar obligations and accountability should also be provided in the Australian system if its assisted employer choice model were to be recommended.

### Recommendation

*AIST recommends that the Commission continue to explore the benefits of extending fiduciary responsibilities to employers in Australia.*

As evidenced by Industry Super Australia<sup>14</sup>, the problem of employer selecting default funds due to inducements – legal or otherwise - is a concern. While AIST supports employers being involved in the default selection process (as they are currently) this is only appropriate where there is a heavy filter and regulation to prevent inappropriate behaviours such as inducements, soft third-line forcing, and other inappropriate cross-selling.

The inherent conflict of interest in an employer recommending a default fund from a provider from which it receives other financial services is well recognised by the general public. An AIST-commissioned Essential Media poll conducted earlier this year found that almost three out of four respondents agreed that an employer shouldn't be able to select a default fund that is associated with their bank.<sup>15</sup>

AIST supports AustralianSuper's recommendation for regulation to prohibit an employer from choosing, as its default fund, a superannuation fund that is part of a financial institution from which it receives other financial services.

AIST does not support a light filter of sub-optimal funds being applied in any default fund model.

AIST's submissions under Draft Finding 5.1 relating to comparability of products, regulation of disclosure, inclusion of insurance in defaults and too stringent a reduction in the number of default funds apply also to the assisted employer choice model.

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<sup>14</sup> Ryan, P. (2015). Big banks accused of offering inducements to win business superannuation accounts: survey. *ABC News*. [online] Available at: <http://tinyurl.com/p9edyg8> [Accessed 3 May 2017].

<sup>15</sup> Essential Media Poll conducted for AIST in February 2017, based on 1014 respondents

### Recommendations

***AIST does not support the assisted employer choice model in the form proposed by the Commission***

*AIST supports detailed assessment criteria applied by an independent selection body, and robust accountability mechanisms. AIST does not support a voluntary 'dual-list' approach would increase the risk of an employer not acting in employees' best interest. This model lacks a legislative industrial-based framework to balance the interests of employer and employee for the selection of default funds.*



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## Response to information requests

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### Information request 3.1

***The Commission is seeking comment from the industry on the effect on fund participation in the competitive process of moving to the first-timer pool of default members.***

- ***Are there any funds that might choose not to participate due to the lower value of the pool, and what is the threshold minimum pool size (per fund) at which this might happen?***
- ***How would the move to a first-timer pool of default members affect the fees and product features that funds would offer when competing for new members?***

The current experience is that relatively few funds have sought default status, and those that have, have rarely been refused.

Funds with a focus on specific industries would be unable to tie their fund to the award for that industry, leaving workers in those industries without a fund that may have been mass-customised for them. Industry-focused funds (other than those that traditionally enrol new entrants to the workforce in industries such as retail or hospitality) would be structurally discouraged from participating in a whole-of-workforce exercise, and the benefits of an industry focus would have little value. This would reduce competition across the board.

Over time the industry is likely to consolidate and become homogenous and undifferentiated, much like top tier banking.

### Information request 3.2

***The Commission is seeking feedback on the merits and implementation issues of its proposal to improve transparency around fund merger activity.***

- ***What (if any) complementary regulatory action would be needed to ensure that the framework is effective in promoting mergers and the exit of underperforming funds?***
- ***Are there any likely unintended consequences from introducing the proposed framework? To what extent and how could those unintended consequences be addressed through policy design?***

Finalisation of APRA's revision of SPG 227 Successor Fund Transfers will provide clarity around the operation of the 'equivalence' test in a way that should facilitate future merger activity.

APRA's Prudential Standard SPS 510 on Governance should be amended to improve transparency around merger activity that is effective in promoting intra-fund consolidation as well as mergers between funds, specifically by adding a requirement to consider the merger of under-performing products, including legacy products, against a member's best interest test.

If the proposed framework was introduced on a narrow basis (and without effective application to the retail sector) it would have the unintended consequence of shielding that sector from an appropriate transparency and accountability requirement applicable to the profit-to-member sector.

### Information request 3.3

***The Commission is seeking comment on its approach to, and alternative ways of estimating the size and value of, the turnover and first-timer pools and the benefits from reducing account proliferation due to moving to the first-timer approach.***

AIST does not agree that the first-timer measure is the best approach to reducing account proliferation. Part of the focus of this submission has been to ensure that the considerable value that will be realised due to the work presently being undertaken at the ATO on new employee on-boarding can be leveraged.

As previously noted, part of the SuperStream and Single Touch Payroll reforms, online forms are being developed to encourage consolidation and to stop new account proliferation. Such forms will enable new employees to select a fund from one they may already use or select the default fund associated with their new employer and with the use of radio buttons or tick-boxes to facilitate rollover of their benefit between funds. Such a facility to transfer super between funds with a single click already exists at the MyGov website and the ATO is leveraging the functionality of this website to further improve the superannuation experience of members.

### Information request 5.1

***In terms of a shortlist of superannuation products, what evidence is available on the size of the list that would best facilitate the majority of employees to choose a fund that meets their needs?***

***What specific information should be included alongside such a shortlist to help employees to choose between products? In what format should the information be presented? What evidence is there for how the metrics would assist employees to make decisions?***

***What institutional arrangements would best suit a last-resort fund? Should it be managed by existing eligible rollover funds or the Future Fund?***

***Under a system of active employee choice, what would be the costs and benefits of prohibiting funds or related parties from offering prospective members a short-term benefit that is unrelated to the superannuation product? What specific form should any such prohibitions take?***

Each model proposed by the PC anticipates fewer default funds, generally between 4 and 10. This means that 92-97% of existing default funds (i.e., funds that provide a MySuper offering) would lose their default status. Whatever the transition arrangements, this would result in many funds becoming cash flow negative, would disrupt efficient business models, and require a restructuring of asset allocations and investment strategies. The flow on effects to the economy, fund members and investment returns could be large and negative, leading to stranded products and members, potentially increasing the cost of the Age Pension over time.

The default superannuation system needs to protect individuals. The system recognises low levels of financial literacy, especially among younger employees, and protects consumers from the risk of being subject to predatory behaviour.

Super is very different to banking. Choosing an under-performing super fund puts capital at risk. A bank account is used for disbursing funds, rather than for long term investment and there is no government compulsion to use one, let alone to have 9.5% of your salary going into it for the long term.

Further, there is no direct negative impact on the community at large from a person choosing a flawed banking product. By contrast, governments provide tax concessions for superannuation as a quid pro quo for compelling part of a person's wages to be diverted to long term saving, and in the expectation of future savings on Age Pension outlays. If, because a person chooses an

underperforming fund, those future savings don't materialise, then the government (and the community at large) has wasted the tax expenditure.

There is ample evidence that consumers react far more strongly to a short term benefit than to one that is only apparent in the long term. When this is taken into account together with the relatively low levels of financial literacy among Australian consumers, it follows that there is a very strong potential for the offer of short term inducement to severely distort the flow of superannuation funds away from funds that perform well in the long term.

For this reason, if (against the strong recommendation of AIST) a member choice model were adopted, prohibitions on short term inducements would need to be wide-ranging and to have powerful penalties involved if there were a breach.

In particular, the definition of "associate" would need to be carefully considered, to prevent businesses that were apparently independent from offering benefits only to those who joined a particular fund.

An appropriate sanction might be a civil penalty, together with the fund and any fund associated with any party that participated in the scheme being banned from consideration of being a default fund for (say) 20 years.

The examples given show the difficulties of having a last resort fund. Future Fund has no obligations to any individual members. The relationship between the Future Fund and Government means that it may be far more susceptible to government interference than super funds whose boards should not be subject to direct government interference.

Likewise, the proposal for eligible rollover funds to be considered as last resort funds is opposed. With the honourable exception of AUSfund, eligible rollover funds generally have a track record of low investment returns, high embedded fees and lack of activity to reunite account-holders with their active superannuation accounts. Further, these accounts are virtually obsolete.

### Information request 6.1

***Is the format of a first-priced sealed bid with a best-and-final-offer stage and potentially multiple winners the best fit for a fee-based auction? Are there any risks associated with these design elements that have not been identified?***

***Regarding transparency, what would fall under the exemption of information that, if it were disclosed, could reasonably be expected to have commercially adverse consequences for the bidder?***

***Could a fee-based auction be designed to facilitate second-order competition between funds on non-fee aspects of performance, such as member services?***

We are not certain that the flaws that we identified with fee-based auctions can be fixed by varying the format of the auction itself.

In passing, the suggestion that this model might operate under a cloak of secrecy to protect commercial interests means that it would be hard to have confidence that the decision was made in the best interests of members.

Furthermore, profit to member funds do not have discretionary reserves and so would be discouraged and disadvantaged from participating in a bid compared to retail funds.

### Information request 7.1

***Which aspects of member services should be included in the tender criteria? Do default members value the same services as Choice members?***

***How should default members be allocated across the set of winning products? Are there problems with sequentially allocating members into products with different investment strategies, fees and services, as is implied by this model? What role could a best-and-final-offer stage play in providing a select number of funds the opportunity to improve their offer?***

***Regarding transparency, are there any problems with only withholding information that can reasonably be shown to be commercially sensitive? What information would fall under this exemption?***

The weighting of the criteria should be overwhelmingly toward those criteria that relate to the fund's ability to maximise requirement outcomes and deliver the best net investment return to members. We note that the eight Fair Work Commission criteria do this.

AIST notes that a major factor in the design of MySuper was that default members should not be required to pay for a lot of “bells and whistles” like extensive financial planning and very large numbers of investment options within a fund. Members who choose to invest in a default product but wish to have additional services are at liberty to put part of their superannuation into a Choice product. The fact that even Choice members did not often use the services they were sold was a driving factor in FoFA reforms.

AIST notes that in countries such as Chile that have undertaken fee based auctions for default pension funds, the features of the fund (including the investment strategy) have been tightly specified. While this facilitated comparability, it works against innovation.

The regular auction process necessarily created a short-term performance focus, and for long-term savers in a pension system this is contrary to their best interests. Such short-termism also affects investment mandates limiting the access to investments that optimise members' returns over the long-term.

As noted in our response to Draft finding 7.1, AIST considers that sequential allocation of members to default funds would introduce unnecessary problems to workplaces.

Allocation should be undertaken on the basis used by the FWC, at an award level, that has regard to the needs of particular industries. We note the importance of insurance for default members many of whom are unlikely to have cover outside of fund.

All trustees should be focused on delivering the best retirement outcome for their members, and use of different investment strategies, fees and services should be assessed against this test.

### Information request 8.1

***What are the main drivers of costs to employers in selecting default products on behalf of their employees? Would a shortlist of preferred default products make this task easier for employers? Is there an ideal minimum number of products that should be nominated on the preferred default list?***

***Are there other specific criteria in addition to those proposed under the minimum standards criteria that default products should meet to protect members and help to achieve better outcomes for them in the long term?***

***Would a dual-list approach, allowing employers to select a product from one of two lists, provide them with sufficient flexibility to select tailored default products that best meet the needs of their employees?***

***Which types of employers prefer to retain a role in default product selection? To what extent are default products or corporate fund offerings considered important benefits offered to prospective employees in competitive labour markets?***

AIST addresses most of the above issues in our response to 5.1 and draft finding 8.1.

Employers are usually most focussed on administrative efficiency and low costs for their business, and similarly want their choice of default fund to deliver efficiency, simplicity and easy resolution of problems. While most employers would not want their employees to be disadvantaged, they have no obligation to ensure that this would be the case.

While it would be inappropriate and often illegal for employers to be motivated by incentives (such as the prospect of a cheaper business loan) to select a fund that meets their needs rather than those of their employees, this is a significant risk for any model that operates outside of an industrial relations framework.