

**Submission to the Productivity Commission Inquiry into
Alternative default models**



October 2016

Introduction

This submission is made by:

- Independent Fund Administrators & Advisers Pty Ltd (IFAA), a Brisbane based administrator of industry superannuation funds and managed investment schemes. IFAA has approximately \$9.5 billion in funds under administration;
- QIEC Super – a profit for members industry fund established specifically for the benefit of all participants in the non-Government education sector, child and other care and community services in Queensland;
- Club Super - a profit for members industry fund established specifically for the benefit of employees in the sporting and recreational clubs and associated industries in Queensland.

IFAA, QIEC Super and Club Super appreciate the opportunity to make comment on the issues raised in the paper.

It is acknowledged that this inquiry is the second of a three stage review process by the Productivity Commission, arising out of the Government's response to the Financial System Inquiry:

1. A study to develop criteria to assess the efficiency and competitiveness of the superannuation system (to be finalised by November 2016);
2. An Inquiry to develop alternative models for allocating default members to Funds (to be finalised by August 2017);
3. An Inquiry to review the efficiency and competitiveness of the superannuation system (to commence after July 2017, after bedding down of the MySuper system). This will utilise the criteria developed in stage 1.

1. Executive summary

To begin with, it is appropriate to respond to some of the statements made in the issues paper.

Fee levels

The Commission has referred to conclusions from the Financial System Inquiry (FSI) in 2014, which stated that fees have not fallen by as much as would be expected given the scale of the superannuation system. The FSI considered this to be due to the absence of consumer driven competition, particularly in the default fund market. Given the MySuper regime was barely a year old at the time of the release of the FSI final report in December 2014, these statements were premature. Clearly a period of time was going to be required for the MySuper reforms to take effect. This has been acknowledged by the timing of the third stage of the Commission's review process, outlined above.

Additionally, and as outlined in our submission to stage one of the Commission's review process, the very extensive and constantly evolving legislative and regulatory landscape is a major component of cost within the industry, with these costs ultimately being borne by members. Therefore, the Government has played a significant role in dictating the cost structures in place in the industry. The costs associated with implementation of Stronger Super, MySuper and Superstream have been significant. While the benefits of these reforms may be expected to eventuate over time, it is unrealistic to expect that industry wide, short term cost reductions would occur.

Also, while member engagement levels across the industry may be relatively low, there is natural competition inherent between Funds in the industry to attract and retain members, which is enhanced by the publication of data by ratings agencies and regulators. This results in effective competition in the industry. It should be noted that any competitive process to allocate default members to products, whether an administrative model or market based model, as contemplated by the Commission, does not actually amount to consumer driven competition. Instead, this is Government mandated competition.

The issues paper also suggested the existing default fund system could lead to the persistence of high fees and low quality products. The reference to low quality products was made without any evidence presented to support that contention. The above statement also evidences a further focus on fees alone, and a view that lowest possible fees are optimal. The issues paper even flagged one possible competitive model as being a tender based solely on fees. In our view, this would clearly be inappropriate, and would be likely to produce sub-optimal outcomes, such as investment strategies being driven by the lowest cost investment, rather than what will produce the best long term return, balanced against acceptable risk. Across all markets, it is generally accepted that you get what you pay for. It is highly likely that very low cost products will not provide appropriate quality of service to members, and/or will provide a low quality product.

We recognise that keeping fees competitive is important in acting in the best interests of members. However, the focus on fees should be balanced against net returns and the services received by members. Lowest cost does not necessarily deliver on either of these objectives and we consider that net outcomes and provision of quality services should be of equal or greater importance. IFAA client Funds aim to offer competitive fees but also

superior service through a value proposition / customer intimacy strategy, which enhances member engagement. Through the provision of high levels of personalised service, including access to advice, we consider that members make more informed decisions, contributing to better retirement outcomes.

Insurance

The issues paper is focussed on alternative competitive models to allocate default members to eligible products. However, one sentence is included, without any further elaboration, indicating that the Life and Total and Permanent Disability insurance which is currently bundled with default superannuation products would be allocated through a separate competitive process. This would be a very significant change and raises countless questions. This scenario might make sense in the situation where only a single Fund qualified to receive default members, as multiple insurers could compete to price the Fund's insurance offering. However, this model of a single 'winner' would create very significant disruption to the industry, and may result in many Funds becoming unviable and having to wind-up. This would in turn create major issues in terms of system stability, market concentration and reduced competition. This model may also unfairly benefit retail funds who may be part of a large conglomerate, who can subsidise them during any period where default status is not achieved, thereby ensuring their survival. This largesse is not available to not for profit superannuation funds. This in turn raises doubts about the integrity of the single 'winner' model.

In our view, the more sensible approach, is where multiple Funds qualify to receive default members. It should be recognised that each Fund and each MySuper product is likely to have a unique insurance benefit design, which at least meets minimum standards. It is very unclear how a competitive selection process for insurance would operate in this structure. We consider it would be unworkable for insurers to price the product variations across the potentially large number of Funds who qualify as having eligible products. Any suggestion that all default MySuper products should revert to a generic insurance offering, would be a significant retrograde step. While it might assist in any tender process, it would remove existing customisation of insurance offerings by Trustees, in response to the demographic differences and particular needs of their membership, and would not be in the best interests of members.

The Commission needs to provide further detail around any proposals for insurance offerings to be subject to a competitive process.

2. Potential consequences of competitive default model

A significant factor to be weighed is the implications on those Funds which may not be successful in any auction or competitive process. The issues paper has flagged that a cap might be imposed on the number of successful Funds in any competitive process. Any such cap would inevitably be arbitrary. This has the very real possibility of adversely impacting the ongoing viability of unsuccessful Funds, with associated consequences for its members. Such Funds may be doing a perfectly good job in acting in the best interests of their members, but may fail to make the shortlist of any competitive process. Funds in this circumstance may ultimately be forced to merge or wind-up. This then raises significant risks and issues around the closure of Funds and the transfer of member benefits to successor Funds. Such Fund closures may be entirely unnecessary, but could be the forced result of a

competitive process, particularly where an arbitrary cap is set on the maximum number of successful Funds. We do not consider that this outcome is in the best interests of the members impacted.

Over any given period, some Funds may meet particular criteria, and others may not. Over a different period, that result might be reversed. However, some Funds that are excluded from default Fund status for a period, which might be several years, may become unviable and have to wind-up, and so may never have the opportunity to regain default Fund status. This would be a perverse outcome, and would detract from competition in the industry.

It would also be of very significant concern if any new competitive model was to be used as a de facto tool to achieve Fund consolidation.

Another important consideration is the incentives that are created in an environment of a periodic competitive selection process, which might be repeated on a short term basis. To maximise their prospects in any short term selection process, Funds are likely to focus on short term outcomes, which might involve minimising investment costs. This may well be contrary to the best interests of the members, as it may not deliver optimal long term returns. Trustees should have a long term focus in managing superannuation monies. This outcome would also be at odds with one of the stated principles for a competitive model, which is to encourage long term investing.

Depending on the model adopted, potentially a small number of Funds could qualify for default status. It should not be assumed that all Funds which may be successful in a competitive process have appropriate systems, staff and liquidity already in place to cater for a potentially huge influx of new members. This raises prudential considerations.

In addition, any new competitive default process may result in members not being allocated to Funds which qualify them for customised insurance or which qualify them for higher levels of employer contributions. This result would not be in the member's best interests.

3. Existing default fund model

The issues paper outlined the current default fund model, which is largely based on the existing workplace relations system. There is no evidence presented that the current default fund process is inefficient or not serving the best interests of members, and so the case for change has not been made.

Under the current default Fund model, in some cases, selection of a default Fund, negotiated in good faith by the industrial parties, can qualify the members for a higher level of employer contribution where a member contribution is made, or provide access to customised insurance that specifically caters for the needs of members in that particular industry. The industrial parties, via the Fair Work Commission, are making informed decisions in the best interests of those members, many of whom do not feel able to make informed decisions themselves. This still allows members to make a choice, but provides for well considered default arrangements in the absence of a member decision.

In the case of QIEC Super and Club Super, and we expect more broadly, the industrial parties that negotiate default fund selections are working to secure the best outcome for members. This evidences the best interests test at work.

Therefore, we consider that the existing default system is effective and does not need to be abandoned. This raises the question as to whether the argument to impose a competitive model, and to uncouple default fund selection from the workplace relations system, is more ideological than evidential. However, we have presented below, our views on the alternative models outlined by the Commission.

4. New default models under consideration

The issues paper flags three main models for consideration:

1. No default system;
2. Administrative model;
3. Market based model

Commentary on each of these models is set out below.

1. No default system

The issues paper outlines the Commission's preferred baseline as being no default system at all. The paper suggests that being required to nominate a superannuation fund upon commencing employment is comparable to being required to nominate a bank account. This comparison is fundamentally flawed. Nominating a bank account is a matter of quoting factual detail about the person's account, which in most cases will already be in place. There is a far wider choice of superannuation funds available, with a nomination requiring an understanding of the features and costs and benefits of many alternative funds, and a decision as to which is optimal for the member. This is a far more complex decision, requiring considerably more time to make an appropriate selection, with greater opportunity to make an inappropriate selection. The nomination of a bank account and a superannuation fund couldn't be more different.

Disengagement and lack of understanding of superannuation across the industry, means many people do not feel equipped to make informed decisions. The issues paper estimated that around two-thirds of superannuation fund members are default members. Engagement and financial literacy cannot be created overnight by a new regulatory regime.

Under this proposal, it would be expected that many employees will feel unable to make an informed decision. This may result in delays in nominating Funds, which may in turn result in delays in Superannuation Guarantee contributions being made, which could create compliance implications for employers. Alternatively, members may end up making uninformed or poor decisions, which may not actually be in their best interests. For example, they may choose a Fund which does not attract higher levels of employer contribution, or offers inferior insurance, or inferior net outcomes. This could result in lower retirement balances, greater reliance on the Age Pension, and a reduction in the efficiency of the system.

Another likely outcome is that employees will look to their employer for guidance. Unless employers hold an Australian Financial Services Licence, they must not provide advice to their employees. However, this model may result in employers providing employees with an informal list of Funds, for their employees to choose from. This raises the spectre of Funds offering inducements to employers to be included on their informal list. This would be contrary to the criteria of requiring any model to have integrity.

Based on existing engagement levels across the industry and the levels of knowledge of superannuation, the option of having no default system at all, is not considered appropriate for the reasons outlined above. It is also doubtful that it would meet all of the criteria nominated by the Commission to assess alternative models.

2. Administrative model

The issues paper outlines that an administrative model would take the form of Funds having to lodge a submission to Government evidencing that they meet certain criteria to qualify as eligible to receive default members. Such criteria would effectively act as a filter.

One option flagged is for the criteria to incorporate the currently legislated criteria for MySuper products to be listed in awards. We consider that this approach would be a good starting point, or a variation on it, under any administrative model. We also consider that any criteria that are settled upon, should include qualitative components, such as access to service and advice, as in our view, these factors are critical in assisting members to optimise their retirement outcomes.

We consider that there should be no arbitrary cap placed on the number of successful Funds under this model. For Funds which meet the criteria, there would seem to be no basis upon which to include some and exclude others.

In terms of timing, a repeatable process conducted on a minimum 3 yearly basis would seem appropriate. Any shorter period would likely lead to inefficiencies and increase the likelihood of short term gaming of the system.

The Terms of Reference require the Commission to consider, inter alia, the complexity costs of any proposed models, and to ensure that any competitive model is low cost and easy to administer. Further to these objectives, we consider that a single set of criteria would be appropriate, rather than different criteria for different segments of employees. This would achieve relative simplicity and comparability.

The issues paper also flagged whether a centralised model (Government decision) or decentralised model (employer decision) should be adopted for the distribution of default members to eligible products. We consider a decentralised model to be highly preferable, as it would be more efficient as employers have direct contact with their employees. A centralised model would require Government to create an arbitrary process to allocate default members to eligible products and would be unnecessarily bureaucratic.

The issues paper flags that the Commission has interpreted any new model as needing to address the flow of new default members. Therefore, the subsequent question flagged in the paper as to what should happen to default members in products that lose their approval under the filter, appears to be redundant. That is, there should be no automatic consequences for existing default members in any Fund which subsequently loses their approval status. However, it will be important to consider the impact on the members of Funds who do not attain default status, to ensure they are not disadvantaged.

3. Market based model

As outlined above, the option of basing a market based model only on fee levels, is considered inappropriate, and is not supported. Under a market based model, there would

need to be several criteria, including qualitative components. This raises the question as to how to assess the tender responses of different Funds, and how to trade off against competing results on different measures. Creating an appropriately rigorous and transparent framework would be difficult and potentially complex. This may be particularly difficult in the case of qualitative factors.

The issues paper flags a number of potential metrics in a market based model, including historical net returns. However, as ASIC require superannuation funds to clearly disclose to members, past performance is not an accurate predictor of future returns. Therefore, historical returns might be considered a dubious basis on which to select default funds.

In addition, any focus on fees encourages low investment management fees. As outlined previously, this may in turn promote passive investment strategies, which may not be in the long term interests of members.

As with the administrative model, we consider:

- that no artificial cap be placed upon successful Funds in a market based system;
- any such process be repeated on a minimum 3 yearly basis;
- selection of eligible Funds should be decentralised (via employer or employee)

The issues paper also flagged the possibility of the administrative model and market based model being combined. This would create further unnecessary complexity and cost.

Overseas models

The issues paper outlined variations on competitive default fund systems utilised in Chile, New Zealand, Sweden and the United Kingdom. The structural and regulatory differences in retirement income systems between countries, is inevitably very significant, and any consideration of transplanting policy settings should be undertaken with extreme caution.

5. Conclusions

We consider that the existing default fund system is working effectively, and is actually serving the best interests of members. Significant recasting of this model to some form of competitive process, would need to demonstrate how it will produce superior outcomes for members.

If there is to be a change, any new model would need to be carefully devised. Of the options presented, we consider that a decentralised administrative model, including qualitative components, and broadly based on the existing criteria required for MySuper products to be listed in awards, is the most appropriate. This model should set no caps on the number of successful Funds, and could be repeated on a minimum 3 yearly basis. In our view, this model would best measure up against the Commission's nominated criteria for assessing alternative models, being:

- members' best interests;
- competition;
- integrity;
- stability; and
- system wide costs.

Any new process should be relatively simple, and low cost. It should also be recognised that any new process requiring submission of tenders (or similar) will represent a cost to the Funds, which will ultimately be borne by members. Such costs may be considered unproductive, as they are not contributing toward the member's retirement.

Given the intention appears to be to uncouple the default Fund system from the workplace relations system, it would appear that there would no longer be a role for the Fair Work Commission in any competitive process. Instead, a new Government body may need to be created to manage any competitive process.

Any new process should not disadvantage small to medium superannuation funds, and should not become a de facto tool to achieve Fund consolidation. If the Australian superannuation landscape ultimately mirrors the banking industry and becomes a small number of large players, that will significantly reduce competition and diversity in the market, and will result in greatly increased concentration risk, to the detriment of members.