

Superannuation  
Productivity Commission  
Locked Bag 2  
Collins St East Melbourne  
VIC 8003

28 October 2016

**Subject:** Superannuation: Alternative Default Models

Dear Karen

Thank you for inviting submissions in response to the Productivity Commission's Issues Paper entitled *Superannuation: Alternative Default Models*. We welcome the opportunity to contribute to this inquiry and appreciate the opportunity to speak with you and colleagues at the Commission's Melbourne office on 7 October.

The Commission has indicated in the Issues Paper that it does not expect submissions to follow a question or answer format. The Commission also encourages submitters to put forward alternative models to the three outlined in its paper. We have accepted this entreaty and devote our submission to explaining the characteristics of what we consider would be the preferred alternative default model for Australia. We also provide some further insights on the approaches to default models taken in New Zealand, Chile and Sweden from our international colleagues after those models were mentioned in the Issues Paper.

Our comments are in Attachments to this letter as follows:

1. Mercer's recommended alternative default model
2. Some comments on international alternative default models

## Who is Mercer?

Mercer is a global consulting leader in talent, health, retirement and investments. Mercer helps clients around the world advance the health, wealth and performance of their most vital asset – their people.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over \$50 billion in funds under administration locally and provide services to over 1.3 million super members and

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15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 213,000 members and more than \$20 billion in assets under management.

We would be delighted to meet again with members of this inquiry to discuss our submission.  
Please contact me or by email if you would like to arrange a discussion.

Yours sincerely,

**Dr David Knox**  
**Senior Partner**

## Attachment 1: Recommended alternative default model

### Key Principles

- All employees should be able to choose the superannuation fund that accepts their mandatory superannuation guarantee (SG) contributions.
- Where a new employee does not choose a fund, a default fund should be available to receive the SG contributions.
- All default funds must be a MySuper product, as approved by APRA.
- Employers above the ATO Small Business Superannuation Clearing House ('Clearing House') small business threshold (19 or fewer employees or annual aggregated turnover of \$2 million or less) would have to select a default fund for their employees, having regard to the outcomes that their chosen fund is reasonably expected to deliver to members relative to other MySuper products.
  - Different default funds could be chosen for different groups of employees.
- Employers below the prescribed size would have the option to select a default fund. If they did not select a fund, their new employees who had not exercised choice would be allocated to a MySuper product by the Clearing House.
- The Australian Government Actuary, with the support of an expert independent advisory committee, would filter a select list of 15 – 20 public offer MySuper products through a competitive process.
- The 'filter' would ensure the MySuper products selected offered a competitive combination of fees, investment arrangements, member services, and life and total and permanent disability insurance offerings.
- The criteria used to filter the list of 15 – 20 default funds would be made public prior to funds submitting their proposals to join the list. The Australian Government Actuary would undertake a regular reappraisal of funds on the list every five years.
- New employees of small employers would join the listed 15 – 20 default funds on a random (or rotational basis) over the five year period between reviews assuming they had not exercised choice and their employer had not selected a default fund.
- Through the use of the individual's Tax File Number, an employee would not be allocated to more than one default fund through the Clearing House.

## **Comments on our principles**

### ***All employees must have choice***

Mercer considers it essential in our compulsory superannuation system that all individuals have the right to choose the superannuation fund to which their mandatory SG contributions are paid. However, for those employees that are unwilling or unable to exercise this choice of fund, we consider there should be a system of 'default funds'. In this sense, we do not support the Commission's preferred objective baseline for its inquiry and third 'active choice' option of 'no-defaults'.

### ***Default arrangements have many advantages***

Default superannuation funds are, and have been accepted as, a necessary component of the Australian superannuation system. This is because not all employees, because of age, incapacity, disinterest or misunderstanding, can be expected to exercise choice of fund. The superannuation system, with different investment choices, insurance offerings and fee structures, is notoriously complex and long term as the final report of the Financial System Inquiry acknowledged. Choosing a superannuation fund cannot be compared with simpler decisions such as the choice of bank accounts or insurance where the customer's interface with the product and its benefits is often immediate. For most Australians, superannuation will not be accessible until the individual reaches preservation age which may be decades away. For many young and early middle-aged Australians, who are navigating university, finding a job, buying a house or raising children, choosing a superannuation fund is a distant priority.

Yet, the adverse implications for retirement of a poor decision by an individual about their superannuation are significant and, for that reason, we consider the protections offered by default superannuation funds are necessary. Without a system of default funds, where an employee is allocated to a superannuation fund if they make no choice of fund, it is probable individuals would be offered incentives to join particular funds which may be inappropriate. Rather than funds being chosen on the basis of what they offer individuals, choice of fund could be based on marketing tactics that have no regard to the long term benefits for the individual and their retirement. In turn, 'active choice' could end up costing the overall retirement incomes system because individuals are not supported adequately and must rely upon the age pension. A default system ensures that an employer, charged to consider the best interests of their employees, selects an appropriately qualified MySuper product where an employee does not choose a fund. This has been the system in Australia and established processes for fund selection, including through competitive negotiation processes, exist.

Mercer considers it essential that large employers, such as employers with 20 or more employees, be responsible for selecting a default fund to accept superannuation contributions where an employee does not exercise choice. This obligation is consistent with the entity's obligations as an employer and recognises that many large employers have the resources to conduct tenders for

customised MySuper offerings with lower fees and, where appropriate, insurance arrangements designed specifically for their employees. APRA MySuper data demonstrates the growing number of tailored products that employers have negotiated with providers. Furthermore, corporate funds, which are not public offer, can be designed specifically for the demographics of the workforce

Mercer supports compelling employers that do not satisfy the Clearing House small business definition to select a default fund but we do not consider it appropriate to impose this obligation on smaller employers. A key advantage of compelling larger employers to select a default fund is the competitive pressure that this brings to the superannuation market and, from the employer's viewpoint, the opportunity to enhance their employment offering by securing superior superannuation benefits for their employees.

Attracted by the opportunity for new members, master trusts and industry funds compete to be the default fund for large employers and may offer lower fees and/ or improved insurance offerings. It is Mercer's experience that many major employers are able to develop and negotiate much better superannuation arrangements for their employees than are available to the general public. The removal of default funds from the overall system would remove this benefit to many employees.

However, this opportunity to secure additional benefits for employees is not available (or is very limited) for smaller employers. Further, the number of superannuation funds, variable fees, disparate group insurance offerings and suite of investment options are difficult considerations for a small employer to understand in respect of a few employees and particularly while they potentially struggle with business set-up and/ or other operational considerations.

### ***Proposed arrangements for small business***

Using the Clearing House is our recommendation to overcome the disadvantages posed by the lack of scale of small employers when selecting default funds. We consider the Clearing House, acting in accordance with a prescribed list of 15 – 20 default funds chosen by the Australian Government Actuary and other experts, would guarantee that contributions made on behalf of small employer employees that did not exercise choice were beneficial to those employee's interests. This is because the criteria used to identify the subset of 15–20 MySuper products would ensure they are competitive in respect of insurance for members, fees and investment returns. Further, we expect that the economies of scale associated with the "guaranteed" enrolment of new members would enable some funds to offer enhanced terms. The filter would also simplify the process for allocating eligible small business employees to default funds.

We consider that only public offer funds from the list of MySuper products that APRA approves should be able to nominate for inclusion on the list of 15–20 Clearing House default funds. At June 2016, there were 122 APRA-approved MySuper products, including 84 classified as public offer. Further investigation by Mercer revealed that of the 84 public offer funds, a number were restricted public offer (i.e. available only to the employees of a particular employer or employers, employees or former employees of an employer, or members of an industry, and including

spouses). Many of the approved MySuper products also had total assets below \$1 billion, or comparatively high fees.

We consider the filter determined by the Australian Government Actuary, in consultation with an independent committee, should be multi-pronged and have regard to the total fees, investment capabilities (including scale), performance (including net returns) and insurance offerings.

The suggested period for the 15–20 listed default funds to be reviewed is five years. As with all projects of this nature, there will be investment required from those included on the list and those wishing to be listed to demonstrate they deserve listing. For this reason, we suggest the review process should not be too frequent so as to place undue onus on any of the parties participating or to create uncertainty. We acknowledge, however, that sufficient frequency of the review is necessary to encourage competition between the listed and non-listed funds and to reduce the barrier to new entrants. We note that existing members of the successful MySuper products would benefit from any fee reductions arising from the competitive process, as the MySuper rules require all members to be subject to the same fee (though employer discounts may then apply).

### ***Insurance***

Group insurance through superannuation has been a tangible benefit for many Australian households through lower premiums than available to individuals. Automatic acceptance also means that that insurance is available to some individuals who may otherwise be unable to receive it.

Retention of the default system, as we have proposed, will also enable the continuation of group insurance arrangements offering ‘automatic acceptance’ of cover to many members, as well as offerings tailored to specific employee groups. These would be under threat under a compulsory employee choice system. We do not support the suggestion on page 10 of the Issues Paper to allocate life and total and permanent disability insurance currently bundled with default superannuation products through a ‘separate competitive process’. Whilst it is unclear what the Commission has in mind, it seems likely an approach along these lines would add considerable complexity for funds and members. We are concerned that such an approach would represent a significant and unnecessary burden for industry, have an adverse impact on acceptance conditions and may be unworkable (e.g. we envisage each fund may have to deal with a multitude of insurers). Under paragraph 22 of SPS 120 *Insurance in Superannuation*, trustees must already develop and implement a selection process to choose an insurer that considers the reasonableness of the premiums to be charged, claims philosophy, terms of cover, exclusions and performance of the insurer.

### ***Concluding remarks***

As outlined in our first Principle, Mercer believes that all new employees should be able to choose the superannuation fund that receives the SG contributions paid by their employer. This will enhance competition within the market and member involvement.

We also recognise that many individuals are disengaged from their superannuation and/or are not in a position to make a reasonable choice. This disengagement was an important finding of the recent Financial System Inquiry (FSI) which stated that compulsory contributions, coupled with a complex system, had contributed to 'disengaged consumers and weak member-driven competition' (p 10). The FSI final report highlighted the fact that disclosure will not, in itself, necessarily lead to the best long term outcomes. The report found the existing financial system framework 'relies heavily on disclosure, financial advice and financial literacy' but this could be ineffective because of consumer disengagement, complex documents and products, behavioural biases, misaligned interests and low financial literacy (p 199). We therefore recommend the continuation of default APRA-approved MySuper products to be chosen by the employer which provide considerable benefits to many employees.

However we also recognise that many small businesses within the Clearing House small business threshold are not in a sound position to select a default MySuper product for their employees. As such, we recommend an expanded role for the Clearing House and that the Australian Government Actuary, in consultation with an independent expert committee, select a list of 15 – 20 default funds to be used for employees of small business employers who do not select a default fund.

## **Attachment 2: Some comments on international alternative default models**

Following release of the Commission's Issues Paper, Mercer Australia approached our colleagues in New Zealand, Chile and Sweden for their impressions of the default models in those jurisdictions. Their responses are in the comments following the Productivity Commission descriptions below.

### **New Zealand**

*KiwiSaver is an opt out defined contribution scheme. Individuals can choose the rate at which contributions are deducted from their pay. While employees are free to choose their fund (and switch funds at any time), those who do not make a choice are enrolled in their employer's chosen scheme, which must be one of nine default schemes determined through a government tender process. If the employer does not have an employer chosen KiwiSaver scheme its employees will be automatically allocated to one of the default KiwiSaver scheme via Inland Revenue). Employees are given three months to choose another scheme before their enrolment in the default is confirmed. The current nine default providers were determined by an expert panel in March 2014 based on criteria such as fees, credibility and organisational and investment capabilities. The maximum number of default funds is pre determined before the bids are assessed by the panel. (Productivity Commission Issues Paper, page 9)*

#### Comment

The New Zealand Government has appointed default KiwiSaver providers twice during the history of the scheme. The first time was in preparation for the launch of KiwiSaver in 2007, when six default providers were appointed for a term of seven years. The second time occurred to coincide with the completion of the initial seven year period. The process commenced in 2013 and concluded with the appointment of nine default providers from 1 July 2014 for another seven year term. In both cases, providers were selected by way of an open competitive tender process where the relevant Ministers were assisted by a panel of independent external experts to evaluate submitted tenders and to select the final providers. In both cases, each potential provider was measured against a set of criteria, including:

- Security and organisational credibility.
- Organisational capability.
- Proposed design of the providers Default KiwiSaver Scheme (for the 2007 process).
- Administration capability.
- Competitive fee levels.
- Investment capacity/capability; and
- Investor education to encourage default members to actively choose a fund (which was introduced for the 2014 process).



The tender processes both in 2006 and 2013 were similar in many respects, as follows:

Stage 1: Registration of Interest (only occurred in 2013).

Stage 2: Request for Proposal – issued to providers that are shortlisted in Stage 1.

Stage 3: Due Diligence including appropriate stress testing of the potential new default providers' systems and processes for dealing with projected volumes and ability to be operational in required timeframes.

Stage 4: Negotiation of Fees.

Stage 5: Approval of default provider selection and confirmation of terms of appointment.

Shortlisting was conducted at each stage. Each default provider was required to have a default investment option which included a 15 – 25 per cent allocation in growth assets, as well as offering a suite of other investment products. Mercer New Zealand advises the advantages of the tender process to appoint default KiwiSaver providers are its transparency and fairness, limited number of default providers selected and the appointment term, which is adequate to maximise value to investors. The current number of providers is broadly optimal for the NZ population in terms of:

- ensuring competitive tension between providers to encourage a high level of service to members;
- supporting sufficient scale to enable default providers to commit to investment in technology and process; and
- efficiency in regulatory over-sight.

Another advantage of the tender process was that the Government may insert additional requirements in subsequent processes that are important to it. For example, in the 2013/14 process, the Crown added the requirement that Default Providers provide investment choice education to default members.

'Investors' can join KiwiSaver through the automatic enrolment process, by actively choosing to join a specific KiwiSaver scheme or by joining the KiwiSaver scheme their employer has selected as its preferred scheme. Investors can also become members of KiwiSaver via the automatic enrolment process when they commence a new job and are not a KiwiSaver member already and their employer does not have a preferred provider. In that instance, Inland Revenue provisionally allocates that investor to one of the nine government appointed default providers. Contributions will be invested in the scheme's conservative investment fund option of that provider. The investor can elect to change providers at any time.

Mercer New Zealand advises the allocation of members is an equitable and reasonably well-understood process. The use of Inland Revenue as the central administrator (it receives employee

and employer contributions and passes them to the providers and administers the annual member tax credits) is very efficient.

It is noted that member engagement and average balances are not as high for default members as for active choice members and there have been delays in providers being informed they have been allocated an investor. Further, there has, as yet, been no test of what happens to default investors when the provider they are invested with is unsuccessful during a subsequent tender process. The Government has proposed that these investors would be transferred to other default providers but the mechanics for this transfer have not been tested as default licences were granted to all those current default providers along with some new default providers at the second tender process. This possible outcome and the associated consequences must be carefully considered in any tender system.

## Chile

*In 2008, the Chilean Government introduced a public tender system designed to increase competition between authorised pension funds and reduce fees. This involves a tender every two years where funds bid on being the default fund for new employees entering the workforce. The fund with the lowest administration fee (which must be lower than the fee in effect at the date of the bidding process) wins the tender and is designated as the default fund. New workers entering the workforce are obliged to join the default fund and remain with it until the end of the fund's 24 month default term. The winning fund must offer the same fee level in its default bid to all of its members, regardless of whether they are existing members or new employees. All employees have the ability to switch from their existing fund to the default fund, and new employees are able to choose another fund at the end of the 24 month period.*

(Productivity Commission Issues Paper, page 9)

### Comment

The Chilean system has six providers (or AFPs). Employees must make contributions to these AFPs although only around 5.5 million of the 9.5 million members currently make contributions because of the presence of independent workers, the informal labour market and evasion. The contribution rate equals 10 per cent of employee earnings, and administrative fees are levied on top of the mandatory contributions. Employers are not involved. At retirement, the accumulated benefit can be used to buy an immediate annuity, a temporary income with a deferred annuity, programmed withdrawals or a combination.

The Government has been concerned about the level of fees that the for-profit AFPs impose. AFPs' fees range from 0.77 per cent to 2.36 per cent of salaries for contributors (amounting to a total contribution by employees ranging from 10.77 per cent to 12.36 per cent of gross income).

The Government is considering the establishment of a State AFP although no details have been released.

In 2008, the Government introduced major pension reforms that had a significant effect on the level of Chilean system operating expenses as reported by the OECD. The quoted expenses decreased from 1.205 per cent of assets in 2008 to 0.642 per cent in 2011 (being the latest figures published by the OECD). The major causes of these reduced expenses were:

1. The government introduced a tendering program that takes place every two years for new employees. The tender is administered by the Superintendent of Pensions. All new workers entering the labour market enter the AFP with the lowest fees and must remain with that AFP for at least 24 months. This fee must apply to all contributors within that AFP and not just the new entrants. The successful tenderer in 2008, in the first auction, was a new provider (Modelo). Modelo won again in 2010 and grew to 1.2 million members due to the mandatory arrangements of receiving contributions from all new employees. A small AFP won the tender in 2012.
2. The new arrangements after the first tender were very different from the previous structure as the new AFP had fewer offices around the country, a different and cheaper service structure and limited investment in education. Commissions for sales staff were also removed as there was no competition.
3. The insurance arrangements, covering both life and invalidity insurance, were also tendered in the marketplace. Previously these arrangements represented half the operational costs. This tender process reduced these fees by 15-20 per cent. Importantly, increased efficiency was also introduced as employers are now responsible for paying this insurance whereas previously it was the responsibility of each worker.

The public perception of AFPs in Chile is poor even though the real returns (net of price inflation) have been good. One of the reasons is that wages have risen considerably in the last 20-30 years so that the value of the final retirement benefit is low when compared to the final salary. Also, some members have had interruptions to their contributions.

Our Mercer colleagues in Chile state the requirements for participation in the two-year tender processes are established and the bidding rules are understood. However, member education is lacking and the limited size of the pension system and number of AFPs restricts the effectiveness of the tender process. Our colleagues also note that once new employee contributions are paid into the cheaper providers, contributors tend to remain with their existing providers after the 24 month period ends even though this may no longer be in their interests, highlighting potential inertia in the system.

## Sweden

*Under Sweden's 'premium pension' system, employers contribute 2.5 per cent of wages to each employee's premium pension account. The Swedish Pensions Agency forwards the contributions to the pension fund chosen by each individual employee. Employees who do not choose a fund are allocated to the government run default fund. Initially, two thirds of people chose a fund other than the default. However, most employees now revert to the default fund, which is seen as low cost, in part due to a relatively passive investment strategy and economies of scale.*

(Productivity Commission Issues Paper, page 9)

### Comment

The default 'premium pension account', which accepts the 2.5 per cent employer premium pension contributions for Swedish employees that do not choose a fund, is called S  fa and it is managed by AP7. The account is essentially a lifestyle structure comprised of two 'building blocks' (an equity portfolio and a bond portfolio). The premium pension is specifically designed to complement the 'income pension'. Together, the premium pension and income pension comprise the Swedish State pension and everyone with a premium pension has an income pension. The income pension is linked to economic performance and income growth, while the premium pension improves risk diversification through exposure to global capital markets. The two pensions are thus complementary. Prior to age 55, equities are invested in a global equity fund to spread risk and reduce dependence on individual markets. Thereafter, the fund transfers 3-4 per cent of an individual's capital to fixed interest funds every year until the individual reaches age 75, reducing the vulnerability of their investment to equity market movements.. AP7 is not required to make a profit and may utilise leveraging in the fund, the default level being up to 150 per cent of the equity portfolio. Surviving members of S  fa benefit from inheritance gains when other members die and those who stay in the default are eligible for a guaranteed lifetime pension which is not available to those who exercise choice.

The government has appointed separate investment managers to manage the state pension assets. As at 31 August 2016, 32 per cent of total Swedish premium pension assets were invested in S  fa and remaining pension assets were invested in personal pension accounts which individuals may have chosen based upon advice (for commission) or online recommendation. Use of S  fa over the last five years has increased as follows:

**Funds in the Premium Pension System in 2015 and Capital Managed 2011-2015**  
 December 31, billions of SEK

	Number of registered funds 2015	Managed capital				
		2011	2012	2013	2014	2015
Equity funds	564	159	193	240	295	347
Mixed funds	93	41	51	63	77	67
Generation funds	35	60	71	90	114	128
Interest funds	138	28	24	27	27	25
AP7 S��fa/Premium Savings Fund		105	132	182	246	272
<b>Total</b>	<b>830</b>	<b>393</b>	<b>471</b>	<b>602</b>	<b>759</b>	<b>839</b>

Mercer Swedish colleagues advise that advantages of the Swedish approach to default funds include improved oversight, increased transparency, greater commitment to cost minimisation and lower management fees. The fund has historically achieved good performance. Key disadvantages are the risks that a large proportion of the Swedish population will be impacted if things go wrong. Mercer Swedish colleagues felt that having more than 800 pension funds, once personal pension accounts were considered, was too many and fund governance could be improved. There were also risks posed by rogue advisers that could damage members' confidence in the pension system.

It is also worth noting that the premium pension forms one of the components of the Swedish retirement system, with most employees also being members of employer sponsored occupational pension plans with higher contribution levels than the 2.5 per cent which goes to the State premium pension account.