28 April 2017

Superannuation
Productivity Commission
Locked Bag 2, Collins Street East
Melbourne VIC 8003

Email: super@pc.gov.au

Dear Sir / Madam

RE: Productivity Commission Draft Report "Superannuation: Alternative Default Models"

BT Financial Group (BTFG) welcomes the opportunity to provide feedback on the Commission's draft report "*Superannuation: Alternative Default Models*" (draft report) released on 29 March 2017, which identifies four possible models to allocate new employees to default superannuation products.

Our comments and key recommendations on the issues discussed in the draft paper are detailed below.

1 Overall comments

BTFG supports the central recommendation in the Productivity Commission's draft report regarding the need to dismantle the current industrial awards-based system of allocating employees to default funds.

Whilst most employees have the opportunity to choose their superannuation fund, around one in five employees are prevented from doing so as a result of being subject to an enterprise agreement or workplace determination.

BTFG supports the principle that all Australians should be able to select who manages their retirement savings. As stated in our submission to Treasury dated 20 January 2016, we believe extending superannuation choice to individuals subject to an enterprise agreement or workplace determination is a reform that is long overdue.

Opening the system up to greater competition can promote better long-term outcomes for members, through lower average fees, improvements in service quality across the sector and encouraging greater product innovation.

As such, we support the Commission's assertion that freedom of choice is a "necessary condition to realise the benefits of competition in the superannuation market" and it is therefore essential to extend genuine member choice to all employees".[1]

[1] Productivity Commission Draft Report, *Superannuation: Alternative Default Models*, Overview p.7.

Recommendation 1(a)
BTFG recommends that the Government open the superannuation system up to greater competition by legislating to extend choice of fund to all employees, including those who are currently unable to choose their fund as a result of being subject to an enterprise agreement or workplace determination.

We also support the Commission's key recommendation that new employees should only be allocated to default funds once – when they first join the workforce, and where they do not already have an existing superannuation account (the 'first-timer pool'), with individuals retaining that account as they move jobs, unless they choose a different fund at any point.

Since the advent of compulsory super 25 years ago, the structure of employment in Australia has undertaken a significant change. Jobs for life are no longer the norm and individuals increasingly work across multiple employers and even multiple industries over their working life. The allocation of default superannuation contributions also needs to modernise and adapt to the changing nature of employment.

We believe this proposal will go a long way towards stemming the unnecessary proliferation of multiple funds, which is especially problematic among younger members and can ultimately reduce a person's retirement balance by around $25,000 on average.[2]

BTFG is also supportive of the Commission's recommendation that, regardless of which alternative model is selected by the Government (if any), the allocation of employees to default funds will be applied prospectively (i.e. limited solely to the 'first-timer pool'), which will remove the need to unnecessarily transfer existing default members to the new default product(s).

Recommendation 1(b)
BTFG recommends that the Commission proceed with its proposed recommendation that new employees should only be allocated to default funds once – when they first join the workforce, and where they do not already have an existing superannuation account (the 'first-timer pool').

In addition, we support the prospective application of any new default model, such that individuals already in an existing default fund will not need to be transferred to a new default product.

2 Comments on the four proposed models

In our view, Models 1 and 2 (with some modifications, as described in section 2.1 and 2.2 below) could be workable alternatives, as would the hybrid model that is being proposed by the Financial Services Council (discussed in section 2.3). We do not, however, support the multi-criteria tender model or the fee-based auction model (discussed in sections 2.4 and 2.5 respectively).

2.1 Model 1: Assisted employee choice

Under this model, employees would be required to choose a superannuation product themselves, but would be nudged towards a shortlist of between 4 and 10 funds deemed to be 'good' by a newly-established Government body.

[2] Productivity Commission Draft Report, *Superannuation: Alternative Default Models*, Overview p.9.

One of the main advantages of this model is that it would reduce the complexity of choosing a superannuation fund for a majority of employees by nudging them towards better quality funds without imposing one by default.

Other advantages of this model include:

- Increased supply-side competition – this model could potentially focus competition on product aspects of value to members;
- Dilution of principal-agent relationships;
- Reduced burden on employers to select a default fund; and
- Lower search costs for many employees.

BTFG considers that the assisted employee choice model, with some modifications, could potentially achieve the Committee's desired objectives of improving scale and efficiency within the industry, enhancing competition and delivering better outcomes for fund members.

However, we do not support the need for the creation of a shortlist of between 4 and 10 funds by a Government body from which employees would be required to choose. Although we acknowledge that it may be difficult for members to choose from a long list of possible default funds, such as from the existing population of MySuper products, we believe the creation of a very short list of between 4 and 10 funds is unnecessary and is likely to have unintended negative consequences for the stability of the system.

In our view, new employees should instead be required to choose a fund from a list of higher-quality MySuper products, established through a more stringent MySuper authorisation process by APRA. Any MySuper product that meets the more stringent MySuper authorisation process should qualify for selection by employees.

While we expect the existing 109 MySuper funds will reduce in number quite quickly as a result of opening up the default fund process, we believe a higher standard for all MySuper funds would accelerate the process, as non-qualifying funds would be required to merge with more efficient and competitive funds. This could see the number of Public Offer MySuper funds available reduced to just 20 or 30 funds in a few years, negating the requirement to stipulate a specific number of funds from which to choose.

One of the advantages of our modified approach is that employees would be able to make informed comparisons between these 'MySuper products' through the product dashboards that trustees of MySuper products are already required to prepare in a consistent and comparable format. This would remove the need for the development of another new fact sheet for this purpose.

The other main advantage of our proposal is that, since any MySuper product that meets the stricter APRA authorisation process would qualify for the 'enhanced MySuper products' list, existing default super members would also benefit from the increased quality filter, not just new entrants to the workforce.

Under this proposal there would be no need for the establishment of an entirely new Government body specifically to select a shortlist of MySuper products from which an employee (or an employer, under Model 2) can choose.

BTFG strongly opposes the creation of a new Government body responsible for such a task. In our view, it would be extremely difficult, if not altogether impossible, to establish an 'expert panel' whose members have sufficient expertise to undertake the role of shortlisting the most appropriate funds, and also be completely independent and devoid of any conflict of interest or of duty (and remain detached from the politics inherent in the industry).

The difficulty of finding non-conflicted qualified experts was demonstrated when the Full Federal Court had to review the makeup of the FWC expert panel in 2014. In his decision Justice Perram J stated "It struck me that the qualification provisions are likely to generate problems of the very kind which have arisen. Most of the people who are qualified will also be disqualified"[3].

Recommendation 2(a)
BTFG considers that the assisted employee choice model, with some modifications as suggested, could potentially achieve the Committee's desired objectives of increased efficiency and competition and ultimately result in better retirement outcomes for members.

However, we believe the creation of a very short list of between 4 and 10 funds is unnecessary. Employees should instead be able choose a fund from list of higher-quality MySuper products, established through a more stringent MySuper authorisation process by APRA. Over time this list will contract to become a short list through market forces.

Additionally, BTFG does not support the establishment of Government body to assess the quality of default funds and select a shortlist of funds that employees can choose from.

2.2 Model 2: Assisted employer choice (with employee protections)

Under this model, employers would choose a default product for their employees who do not exercise choice from one of two lists:

- A list of products that meet mandatory minimum standards (light filter); or
- A narrower list of 'preferred default' products that meet stricter criteria around investment performance and other product features, similar to the tender criteria in Model 3 (heavy filter).

BTFG considers that, as with Model 1, the assisted employer choice model could potentially achieve the Productivity Commission's desired objectives, with some modifications.

We do not, however, support employers having to choose from a shorter list of products under either the light or heavy filter. Instead, we believe employers should be able to choose any fund from a list of higher-quality MySuper products, established through a more stringent MySuper authorisation process. Any MySuper product that meets the more stringent MySuper authorisation process, which may include easily accessible information, education and tools for members, should qualify to be selected by employers as their default.

The advantages of this modified approach are discussed in greater detail in section 2.1 above, and include:

[3] Financial Services Council Limited v Industry Super Funds Australia PTY LTD (2014) 447 NSD 36

- The ability for employers to use the current MySuper product dashboards to compare between products;
- The ability for all default super members , not just new workforce entrants, to benefit from the higher quality standards; and
- The removal of the need to create a new Government body tasked with selecting a shortlist of 'preferred default' products from which an employer can choose.

As stated previously, BTFG strongly opposes the establishment of an entirely new Government body specifically for this purpose. We believe it would be extremely difficult, if not altogether impossible, to establish an 'expert panel' whose members have sufficient expertise to undertake the role of shortlisting the most appropriate funds, but who would be completely independent and devoid of any conflict (and remain detached from the politics inherent in the industry).

Recommendation 2(b)
BTFG considers that the assisted employee choice model, with some modifications, could potentially achieve the Committee's desired objectives of increased efficiency and competition and ultimately result in better retirement outcomes for members.

However, we believe the creation of a shorter list of products under either the light or heavy filter process is unnecessary. Employers should instead be able to choose any fund from a list of higher-quality MySuper products, established through a more stringent MySuper authorisation process. Any MySuper product that meets the more stringent MySuper authorisation process should qualify to be selected by employers as their default.

Additionally, BTFG does not support the establishment of a Government body to assess the quality of default funds and select a shortlist of funds that employers can choose from.

2.3 Hybrid of Models 1 and 2 (FSC's proposed option)

We understand that the Financial Services Council (FSC) is proposing a hybrid model, being a combination of Models 1 and 2, whereby:

1. Consumers have a universal right to choose their fund, subject to:
    - An enhanced APRA approval process for MySuper products that raises the average quality of products;
    - A significantly smaller population of MySuper products to choose from within the next decade (in the range of 20 – 30), removing the need for a shortlist;
    - Consumers being nudged towards this smaller set of high-quality MySuper products; and
    - Improved data presentation by APRA to help consumers make comparisons.
2. Employers would retain the right to select a default fund for their employees who do not exercise choice, albeit that:
    - The MySuper population to choose from is smaller and of a higher quality due to APRA's enhanced approval process;
    - Penalties would be strengthened for funds and related parties found to be offering inducements to employers; and

- Legislation is introduced to extend choice of fund to all employees, including those who are currently unable to choose their fund as a result of subject to an enterprise agreement or workplace determination.

BTFG supports the hybrid model proposed by the FSC. In our view, such a model has the potential to bring together the best aspects of options 1 and 2 and deliver efficient outcomes for consumers and employers, without introducing the risk of unintended outcomes and causing unnecessary disruption to the operation of the system.

Recommendation 2(c)
BTFG recommends that the Committee consider the hybrid model proposed by the FSC with a view to determining whether it could potentially achieve the Committee's desired objectives as a viable alternative default model.

2.4 Model 3: Multi-criteria tender

BTFG does not support the proposed multi-criteria tender model for the following reasons:

- Potential risks would arise for the integrity of the system, since the model is open to subjective judgements. The establishment of objective and quantifiable criteria to evaluate the bids would be difficult, especially for factors like service levels and member satisfaction;
- Depending on weighting given to fee levels, funds will reduce the level of customer service facilities in a bid to be the lowest cost fund;
- There is also a risk under this model that the weightings given to the assessment criteria may not reflect the needs of all, or even a majority, of default members, for example a fund with an older median demographic may prioritise intrafund advice over insurance and
- The costs associated with funds participating in the tender processes are likely to be significant, which would increase the overall costs of the system. These increased costs are likely to be borne ultimately by fund members and could actually reduce members' retirement balances.

Recommendation 2(d)
The Commission should not recommend the multi-criteria tender model for allocating default members to superannuation funds in its final report to Government.

2.5 Model 4: Fee-based auction

This model would undoubtedly exert downward pressure on fees across the industry. It would also result in potentially greater transparency and comparability in the area of fees charged by funds.

However, BTFG does not support the fee-based auction model as the disadvantages, in our view, far outweigh the potential advantages outlined above. These disadvantages are as follows:

- Although this model will likely bring down fee levels across the industry, the narrow focus on fees would lead to incentives for funds to cut service quality and shift to low-cost, passive investments that may not maximise long-term net returns;

- Funds may be tempted to bid an unsustainable fee structure, in the hope that the greater scale economies from new members eventually decrease their costs;
- Investment performance may also suffer due to funds avoiding or decreasing exposure to higher-cost illiquid investment opportunities, like infrastructure;
- This model could result in a much more concentrated market with adverse impact on fund viability and competition over the long term. Once the winning fund(s) is/are appointed, it would be difficult for new entrants to enter the market to compete for a share of the default pool;
- Systemic risk could result from margins being squeezed to such an extent that it undermines the compliance and regulatory frameworks of the winning fund(s) as they look for ways to minimise their costs, even if at the cost of meeting their regulatory requirements, behind the scenes;
- The costs associated with funds participating in the auction processes are likely to be significant, which would increase the overall costs of the system. These increased costs are likely to be borne ultimately by fund members and could actually reduce members' retirement balances; and
- The Chilean experience is evidence that a tender process based purely on fees may still not achieve the low cost fees that such a model purports to achieve, with research showing that the fees in Chile do not compare favourably internationally for similar investments.

Recommendation 2(e)
The Commission should not recommend the fee-based auction model for allocating default members to superannuation funds in its final report to Government.

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We would be pleased to discuss any element of our submission with the Committee.

Yours sincerely

Melinda Howes
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BT Financial Group