Mercer Consulting (Australia) Pty Ltd
ABN 55 153 168 140
AFS Licence # 411770
Collins Square
727 Collins Street Melbourne VIC 3008
GPO Box 9946 Melbourne VIC 3001

Fax +61 3 8640 0800

www.mercer.com.au

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MAKE TOMORROW, TODAY

Ms Karen Chester
Deputy Chair
Productivity Commission
Locked Bag 2
Collins St East Melbourne
VIC 8003

28 April 2017

Subject: Mercer's response to the draft report on alternative default models

Dear Karen

Mercer is delighted to be able to make a submission in response to the Productivity Commission's Draft Report entitled *Superannuation: Alternative Default Models* released in March 2017.

This submission contains comments on the following topics:

- The state of the MySuper offerings
- The implications of current electronic developments
- Insurance matters
- The suggested once only default
- Our preferred option

1. The state of the MySuper offerings

The Draft Report suggests that a tender would likely help to facilitate some market consolidation and that there are currently a daunting number of 115 MySuper products (pages 7, 182). Whilst not disagreeing that there are too many MySuper products, we believe that your deliberations would be assisted by a better understanding of the current MySuper offerings. Using the December 2016 Quarterly MySuper Statistics from APRA, we can break down the listed 109 MySuper products into the following categories:

Type of MySuper	Total Number	Type of fund			
		Industry	Retail	Corporate	Public sector
Public offer*	67	33	26	1	7
Non-public offer	28	7	3	14	4
Large employer	14	2	12	0	0
Total	**109**	**42**	**41**	**15**	**11**

*Includes Material Goodwill public offer product

This table highlights that there are only 67 Public offer MySuper products. That is, there are many MySuper products where it may not be possible for an individual's future employer to continue to contribute to their previous superannuation fund. This table also highlights there are currently 42 non-public offer and large employer MySuper products where the trustees and/or employers have deliberately designed and developed their MySuper product for a niche market. Of course, whether they offer a good deal for the employees is a very different question but it should be recognised that these funds are not available to the general public or for the majority of employers to select as a default fund.

It is also worth considering the characteristics of these 67 Public offer MySuper products. The following table highlights their size and fund type.

Asset size	Total Number	Type of Fund			
		Industry	Retail	Corporate	Public sector
<$250 mill	7	0	7	0	0
$0.25-1 bill	12	4	6	0	2
$1-2 bill	13	6	6	0	1
$2-5 bill	17	14	1	0	2
$5-10 bill	10	3	5	1	1
$10-20 bill	1	1	0	0	0
>$20 bill	7	5	1	0	1
Total	**67**	**33**	**25**	**1**	**7**

It is interesting to note that there are only 18 MySuper products with assets currently in excess of $5 billion, which include two public sector funds and one corporate fund. Hence, in reality, it is feasible that the application of APRA's scale test together with a more stringent filter of MySuper products could reduce the number of MySuper Public offer products to around 20 funds within the next five years. This is not intended to suggest that funds with MySuper assets of less than $5 billion should not continue in circumstances where they provide real value to members.

The Draft Report strongly implies, but stops short of recommending, that the MySuper criteria should be strengthened along the lines set out for the assisted Employer Choice 'long list'. We note that page 215 suggests that MySuper products which do not meet these stronger criteria should not be permitted to continue to accept default contributions. This would effectively mean these products would lose MySuper status.

Mercer is supportive of strengthening the MySuper requirements to ensure a higher quality standard for funds eligible to receive default contributions, which may act to hasten the consolidation of the industry. As the Draft Report notes on page 200, APRA is also supportive of some strengthening of MySuper requirements.

The analysis above suggests that this would be likely to produce an outcome similar to, although not exactly the same as, the Commission's desire to have no more than ten default MySuper offerings (based on the maximum number of 'winners' under the multi-criteria tender and the maximum size of the shortlist under the Assisted Employee Choice model). Further this natural evolution within the industry, assisted by some prodding from the regulator under the strengthened standards, may be a more natural and less costly outcome than major reforms which introduce greater uncertainty, more disruption to existing funds and more political risk.

It should also be recognised that some large employers and the public sector may wish to continue to offer a MySuper product designed specifically for the benefit of their employees. These products may be tailored to suit their employees with particular insurance arrangements and/or additional benefits. Such products are generally highly competitive and should continue to be permitted.

2. The implications of current electronic developments

We agree with your draft recommendation 3.2 that the existing functionality of myGov and Single Touch Payroll should continue to be developed. In particular, we believe that this service should enable:

- A new employee to select the fund that will receive their new employer's superannuation contributions, whether it be a fund with an existing account, the new employer's default fund or another fund, such as an SMSF
- More individuals to consolidate their accounts, as the information and functionality of this service becomes better known and utilised by the public

Together with the completed and pending enhancements of the SuperStream system, these developments will fundamentally change the Australian superannuation industry and are likely to reduce the proliferation of superannuation accounts which represents "one of the superannuation system's worst systemic failings" according to the Draft Report (page 9).

The development of Single Touch Payroll and the ongoing evolution of the myGov website are not incremental changes. They have the potential, indeed the likelihood, of fundamentally changing the selection of superannuation funds and encouraging the consolidation of accounts. As the Draft Report notes on page 85, “The electronic system would be a starting point for a more streamlined process.” We agree.

Therefore we recommend that the Government should enable the ATO to continue to enhance this development which will provide greater efficiency for employers and employees, whilst also encouraging the consolidation of member accounts. Hence, we believe that no further recommendations in respect of account consolidation should be made until these innovative processes have been fully operational and working for several years.

3. Insurance matters

Insurance cover represents an important part of the Australian superannuation industry. In fact, it has been considered so critical by previous Governments, that it is a compulsory part of MySuper products. However the Draft Report notes that “It should also be self-evident to funds and their advisers that the Government’s stated objective for the superannuation system does not envisage insurance as an essential element of the system” (page 81), thereby justifying in the Report a less important role for insurance. On the other hand, the Government has not changed the requirements for MySuper and the provision of death and disability cover remains a compulsory benefit in all MySuper products.

This compulsory provision of insurance does not suggest that the provision of insurance in super is perfect. As the Commission would be aware, an Insurance in Superannuation Working Group (ISWG), chaired by Jim Minto, has been established and is working across all the groups within the super industry. This cross-industry membership highlights the importance of the topic and the recognition within the industry that the insurance outcomes for members could be improved. Notwithstanding the work of the ISWG and the acceptance of some shortcomings, it must be recognised that insurance coverage through super funds means that millions of Australians now have some death or disability insurance.

We are therefore surprised that the alternative models would be evaluated on the quality of the superannuation product only, excluding insurance. That is, “the models do not involve comparing the quality or price of bundled insurance” (page 10) and that “a bundled insurance product will not be a factor in the selection of products and is best addressed through regulation and regulator oversight.” (Draft Finding 3.3) Whilst such an approach is a simplification of the product, we believe this framework does not recognise the value of insurance or the contrasting prices and benefits provided by insurance from different MySuper products.

There are significant differences in the prices and types of insurance provided by different MySuper products and the exclusion of this significant benefit from the evaluation of default MySuper products represents a major omission. The results could be that significantly more default members are not covered for particular needs in their industry (such as in the construction, mining or sporting industries) whereas in other cases, more default members may be paying for insurance that is not needed or paying premiums that are higher than would be available in another product, thereby eroding their retirement income savings.

For example, the insurance premiums in a predominantly white collar fund (such as one based in the public sector or finance industry) are likely to be much lower than funds with predominantly blue collar members. If the number of “approved funds” were to be fewer than ten, it is likely that some funds with very competitive insurance offerings may not be accepted as the proposed criteria exclude insurance. Such an outcome would not only mean that some individuals would be paying more for the same insurance but their ultimate retirement benefit may also be lower due to these extra costs.

We therefore urge the Commission to recognise that the provision of insurance matters to members and the evaluation of insurance should be part of any assessment of MySuper products.

4. The suggested “once only” default

Draft Recommendation 3.2 of the Draft Report suggests that to avoid problems with multiple accounts “any future alternative system for allocating members to default products should be premised on employees being assigned to default product only once.”

Whilst we recognise that the proliferation of multiple accounts for some individuals is not a desirable feature of the system, it is important to note that the statement on page 67 that “an employee … would get a new account every time they change jobs and do not actively choose a product” is incorrect. There are many instances where an individual changing jobs remains within the same industry (which is not uncommon) and is defaulted into their existing superannuation fund. In previous years, this may have resulted in the establishment of a new account within the same fund but funds are now required to consolidate multiple accounts for the same individual, where it is in the member’s interest to do so.

It is also worth noting that there are many instances where it is impractical for an individual to be defaulted into their previous product. These include where:

- The previous default account was within a defined benefit fund. Although defined benefit funds are gradually disappearing, there remain some open defined benefit funds. These include UniSuper, Emergency Services (in Victoria) and the Uniting Church.

- The previous default fund may have been a non-public offer fund or a fund offered by a large employer (see above tables). In these cases, it is unlikely that the new employer will be able to contribute to the previous fund. Hence a second default account will be needed.
- The previous default fund was in the public sector and, in some cases, these funds are not public offer. Hence the new employer is not able to contribute to such funds.

Whilst the above comments provide examples of where the individual's previous superannuation fund is unable to accept contributions from the future employer, it is equally important to note that in some instances, it would be sub-optimal for the new employer to contribute to the previous fund. Such an outcome would mean that the benefits provided to the individual would be reduced or less suitable (or more expensive) than the new employer's default arrangements.

Let's consider some examples. It is likely that the first employment for many individuals would be a part time role in the hospitality, retail, building, tertiary education or sporting industries. Each of these industries has particular characteristics which are reflected in the current superannuation arrangements. These characteristics may affect the default offerings in many ways including the insurance offerings, the forms of communication to members and the investment strategy.

However that does not mean that these features are appropriate for the individual when they join the full time workforce some years later. For example:

- The new employer's default fund may include a higher level of contribution, subsidised costs or better insurance
- The individual may need a higher default level of insurance due to the increased risks in their occupation or industry e.g. in the mining industry funds may provide higher default levels due to the difficulty and cost of obtaining personal cover for those in high risk occupations or, design their super offering allowing for insurance provided outside super
- The services offered to the member may now be inappropriate due to different locations

In short, the in-built assumption in the Draft Report that the individual's first superannuation fund will be appropriate or the "best" available for an individual who does not make a choice throughout their working career cannot be justified.

The first-timer pool approach could also have a significant negative effect on the competition exerted in the superannuation market by large employers – we make further comment on this issue in our comments on Model 2 in the following section.

The Draft Report has recognised some of these issues, commenting on page 71:

> *There may also be potential adverse effects for employees who, in the absence of other actions would remain in their default fund for many years. Under the current arrangements, being asked to select a product on changing jobs is an opportunity for employees to review the suitability and performance of their existing superannuation product. However, retaining the existing turnover default arrangements is an indirect way of encouraging members to engage with their superannuation, and current evidence indicates that members rarely review their product when changing jobs, in any case.*

We think the Commission is underestimating the impact that myGov/Single Touch Payroll functionality will have on member engagement. We believe this functionality will lead to a much more active workforce in terms of making a choice to retain an existing fund when joining a new employer, or to accept the new employer default and to consolidate their existing accounts into their new account. The lack of a simple method of doing this has been the major impediment in the past.

We therefore recommend that the Commission remove the 'first timer pool' recommendation and replace it with a greater commitment to the approach based on Single Touch Payroll and the myGov website. Such an approach will encourage members to use their previous fund whilst also recognising that the new employer's default offering may provide better benefits or be more suitable.

5. Our preferred option

The Draft Report presents four alternative options with Models 1 and 2 based on an administrative approach and Models 3 and 4 based on a market approach. Our preference is for a development of Model 2 for the following reasons:

Model 1 – Assisted employee choice

Whilst we are strong advocates of choice, we recognise that many individuals, particularly in the early years of their employment, are disinterested in superannuation and are unlikely to make a choice even if there is a restricted shortlist of 4-10 MySuper products.

Therefore it is inevitable that a last-resort fund would be required. Such an outcome is likely to produce lower investment returns and/or reduced insurance cover for many of these members. In effect, this last-resort fund is likely to replace the current default funds for many employees.

The lack of a good default MySuper product under this option for individuals who do not make a choice is a major disadvantage and for this reason we do not support Model 1.

Model 2 – Assisted employer choice

We endorse the principles of this option as it aims to provide benefits to defaulting members in two ways:

1. For employees of larger employers who have been able to negotiate favourable arrangements, these additional benefits flow directly to them
2. For employees of other employers who are less engaged, a stronger filter would be applied to develop 'preferred default' MySuper products, thereby ensuring stronger performing products, or products better aligned to members' needs, are offered.

However we are concerned that the first timer pool approach could mean that the benefits currently achievable by large employers will disappear, as it could destroy the ability of these employers to negotiate favourable arrangements. At present, when an employer chooses a new default fund it applies not only to new employees but also to the future contributions for all existing default employees and it is standard practice for their existing balances in the previous default fund to be successor fund transferred to the new fund, thereby avoiding any duplication of accounts issue. This approach gives large employers considerable bulk purchasing power, because the winning fund picks up all the existing default employees and their balances, as well as the new default employees.

Contrast this with the potential position under the 'first timer pool approach. Even for a large employer, the number of first timers entering their workforce could be quite small, so that if existing default employees did not also move to the new default fund, the employer may essentially have no bulk purchasing power.

This outcome would have a very adverse effect on competition, effectively removing the segment of the market where competition is at its fiercest. Employers would have much reduced (at best) ability to negotiate favourable arrangements and their employees would be worse off as a result.

In order to maintain effective competition under the first timer model, a mechanism would be needed so that when any employer changes the employer default fund for new default members, it is also able to do so for the employer's existing default fund members (so triggering a transfer of the existing default fund balances to the new default fund). For example, when an employer chooses a new default fund:

- the new fund trustee could be required to tell all previous default fund members about the new default fund; and
- unless the member notifies the trustee they don't want to move, their future contributions and their existing account balance will be automatically moved to the new default fund chosen by employer.

With the modification outlined above, we believe the Model 2 dual approach would enable willing employers to negotiate better deals for their employees whilst also reducing the pressure on other employers through the application of the stronger filter.

This modification (facilitating the transfer of the existing default fund member contributions and balances to a new employer default fund) would also be desirable if another default allocation model is adopted, to avoid existing default employees being potentially left in an underperforming fund when the employer had negotiated and adopted a superior ongoing product.

It is acknowledged that a principal-agent issue exists; however, the existence of the stronger filter for the second list reduces this problem considerably. It should also be recognised that through the ongoing evolution of the myGov website, more and more employees will become aware they can use myGov to check their current superannuation funds and balances, as well as consolidate accounts, and, in time select the fund for their employer contributions. This is also likely to significantly increase the number of members exercising choice, which will reduce the impact of the employer's decision regarding the default fund.

Nevertheless, we would support strengthening the prohibitions on offering incentives to employers when making default fund decisions to allay any concerns about incentives inappropriately influencing such decisions.

However one aspect of this proposed model that we strongly disagree with is the exclusion of products with life-cycle investment strategies from the 'preferred default' MySuper product list. There is no explanation of why this is the case. We assume this is because life-cycle investment strategies make comparisons more difficult, because we believe that the Commission is aware of the strong reasons why life-cycle strategies are particularly appropriate for default products aimed at disengaged members.

One suggestion made at an industry forum we attended was that there was no need for a life-cycle product because the first timer pool would in the main be young people. However we note that:

- On page 206 of the draft report it is noted that "young people…. would typically benefit from higher risk investments" ; and
- The product must also apply to all of a fund's existing default members, and hence must be suitable across all age bands.

In our view, the better focus on managing risk and member outcomes that comes with a lifecycle approach should make it the obvious choice. Looking forward, these strategies also have the potential to evolve towards individualised paths which would promote greater member engagement, which should be a desirable outcome.

We further note that Table 3.1 indicates that both the UK and Sweden defaults are life cycle products and Table B.1 shows that the Chile default also is age based – so three of the four overseas default systems examined in Appendix B have age-based investment strategies, with the exception (KiwiSaver) currently having a low risk default.

Hence there is strong international support for life cycle default investment strategies.

The exclusion of life cycle products raises the concern that the emphasis on homogeneous, easily comparable products and low cost is likely to act as a significant barrier and disincentive to innovation. The Draft Report notes on page 207 that “innovation, especially in investment strategy, matters” but it is difficult to see how funds wanting to achieve default status are not more likely to be rewarded for cutting costs than for investing in innovation, particularly in regard to innovations in investment strategy which will take some years to bear fruit.

Further, while we agree long-term net returns are key, it is important to avoid the historical investment return performance criteria for the preferred list precluding the eligibility of a new MySuper product without a long performance history. In this regard we are pleased to see that the Commission proposes to allow satisfactory performance history to be evidenced by reference to other products either in Australia or overseas.

If this is not possible, it is hard to see how the eligible product list will not effectively be restricted to survivors of the current pool of MySuper products, with those with lifecycle products effectively locked out of the race .

Lastly:

- as per our earlier comments, we recommend that the default insurance terms and conditions should be included in the assessment criteria
- the filter should avoid incentivising funds to focus on cost minimisation rather than maximising net long-term returns to members (refer further comments under Model 4 below).

Model 3 – Multi criteria tender

As noted in the Draft Report, this is similar to the New Zealand model for the selection of its default providers. However, the Australian superannuation market is much more developed than the NZ market with many more nuances and variations. This means that the development of appropriate and multiple criteria that cover a variety of situations and conditions will be extremely difficult.

It’s also worth noting the NZ model has nine providers for a population that is around 20 per cent of the Australian population. This suggests that the selection of up to ten providers may be too small a number, given the varieties within the Australian population.

Model 4 – Fee based auction

We do not support an auction based on fees only. Of course, fees are important but there are several aspects to the provision of superannuation throughout an individual’s lifetime. There is a significant danger in this option of a “race to the bottom”, notwithstanding the pre-qualification stage to ensure that participants meet minimum standards.

According to the Draft Report, members’ best interests are met where long-term net returns are maximised and employees are allocated to the products that best suit their needs. The focus should be on net long-term returns to members, not on lowest costs. As the report acknowledges:

> *“…. competition on fees could increase incentives for funds to adopt a low-cost passive approach to investment. Funds would have incentives to passively manage within an asset class (such as tracking an equity index instead of actively choosing listed equities), and to avoid or limit exposure to higher cost asset classes (such as illiquid investment opportunities like infrastructure and unlisted property). These incentives would be strengthened by the inclusion of investment fees in the bidding metric.”*

We strongly agree that a fee-based auction would be a major disincentive for funds to invest in assets classes such as private equity and alternative assets, as well as active management, due to their higher costs. However these classes can provide important diversification benefits (as well as illiquidity premiums in some instances) that can contribute to higher risk-adjusted net returns.

With a fee auction, trustees would have a conflict between seeking to maximise long-term net returns (by investing in higher cost asset classes) and improving the sustainability of their fund (by reducing investment costs to give them the best chance of success in the auction and thus a share of new default members).

This approach also runs the real risk that there would be a very small number of participants, as occurred in Chile, such that the desired level of competition would not be achieved.

Conclusion

We believe that of the options proposed, Model 2 is to be preferred. We support a stronger filter for MySuper products based on clear and publicised criteria. This is likely to lead to a reduced number of funds offering MySuper products, greater efficiency within the industry and improved outcomes for members.

Importantly, Model 2 (with the modifications we have proposed) would enable large employers to maintain their involvement which normally leads to better superannuation benefits for their employees.

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 $150 billion in funds under administration locally and provide services to over 2.4 million superannuation members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 224,000 members and more than $21 billion in assets under management.

We would be delighted to meet with you and your team to discuss our submission and related matters. Please contact me by email if you would like to arrange a discussion.

Yours sincerely

Dr David Knox
Senior Partner