

28 April 2017

By email: super@pc.gov.au

Ms Karen Chester
Deputy Chair
Productivity Commission
Canberra ACT 2600

Dear Ms Chester,

Re: Superannuation: Alternative Default Models – Productivity Commission Draft Report

Thank you for the opportunity to make a submission on the Productivity Commission's draft report into alternative default models for the Australian superannuation system. Deloitte Touche Tohmatsu (Deloitte) strongly supports any efforts being made by the Government and the Productivity Commission to improve our superannuation system which will ultimately result in a higher level of confidence and improved retirement outcomes for the 12 million Australians who have accounts in the system.

Deloitte is a major provider of superannuation advisory services to employers and the trustees of all forms of superannuation funds. The services we provide that are relevant to this submission include:

- a. Benchmarking;
- b. Administration, asset consultant and insurance reviews; and
- c. Tender management including default fund selection for employers.

We believe the work we carry out in these areas places us in a unique position to comment on market competitiveness from an unbiased perspective.

In this submission we particularly want to comment on the proposed default models and in particular:

- a. Whether a short-list of products needs to be further refined and defined in light of the MySuper licencing regime operated by APRA;
- b. The concept of a lifetime default fund for employees entering the workforce for the first time;
- c. The potential of a negative impact resulting from market concentration should an auction system as proposed in the Report be introduced; and
- d. The current state of fund mergers and what action, if any, should be taken to further encourage mergers.

The current System

Under the current system employees generally fall into one of three categories:

- a. Award employees for whom an employer must select a default fund under the relevant Modern Award but at the same time the employee is given choice to select any complying superannuation fund into which their employer pays the Superannuation Guarantee contributions on the employee's behalf.
- b. Employees covered by an Enterprise Bargaining agreement whereby, in most cases, the employer and body representing the employees (usually a trade union) agree a default fund into which Superannuation Guarantee contributions are paid and the employee is not given any choice or alternative options.
- c. Non award employees who can be offered any complying fund with a MySuper licence as the default option.

The role of APRA

The important common thread between each of these classes of employee is that the default fund offered must hold a MySuper licence. There are approximately 130 such funds covering retail, corporate, non-exempt public sector and industry funds. These funds are generally held to a high level of governance and operational standards in that they are assessed by APRA on a 12-18 month cycle. In our experience APRA examines all aspects of these funds including investment performance, administration and life insurance. It has been clear to Deloitte that APRA has recently "raised the bar" and as such is demanding an increasingly higher standard and performance from these funds. Where APRA feels that a particular fund does not meet the standards it has power to either revoke the MySuper licence or encourage the trustee of the fund to consider merger options.

Under Draft Finding 3.5 of the Report the Commission recommends that "the selection of eligible default products should be administered by a government body and be subject to strong governance rules". We believe such a body exists with APRA insofar as it assesses funds as to whether or not they should hold a MySuper licence and that the establishment of any new body would simply add an unnecessary additional level of bureaucracy which would not add any value to the members' best interest.

We have already seen the Fair Work Commission encounter numerous issues in selecting default funds under Modern Awards and we see no reason why an independent body would succeed where the Fair Work Commission has not.

Should APRA be appointed as the body determining whether funds should be eligible to be default funds, by way of holding a MySuper licence, we recommend:

- a. The assessment process take part on an annual basis to ensure the on-going appropriateness of the default funds;
- b. APRA be given sufficient powers to remove a fund's default fund status; and
- c. Funds have available to them a simplified appeals process (not the Administration Appeals Tribunal) in order to challenge an adverse assessment by APRA.

We believe that the default fund assessment process should be structured with an "early warning" system where, in the case where the assessment body determines that the fund may be at risk of losing its default fund status, the fund is allowed a period to improve in the areas of deficiency. The fund would work under the guidance of the assessment body during this period, further supporting our

view that the assessment body should be APRA as such a relationship between APRA and funds already exists.

Lifetime choice

We agree with the Commission's Draft Finding 3.1 that "where members can be defaulted to a new account on every change of job increases the proliferation of accounts." This is clearly evidenced by research Deloitte has carried out which shows the average 25 year old has 3-4 superannuation accounts, each with, in our view, inadequate balances.

It should be noted, however, that having multiple accounts, where the account balance is large enough is not necessarily a negative as multiple accounts can provide diversification in investment style and advisers.

Our concern is that the proposed lifetime choice, while minimising annual administration fees paid by members, will not, in our view, promote member engagement. We believe that fund members need to be educated on the choices they make and effectively forced to make a decision on the fund into which their Superannuation Guarantee contributions will be paid. A lifetime choice model will, in our view, guarantee less engagement as a member could be potentially a member of an under-performing fund throughout their working life.

We suggest a preferable variation to this model would involve:

- a. An employee being allocated a notional lifetime default fund upon commencement of employment in their first job.
- b. Upon changing jobs the employee would be required to acknowledge, in writing, that they wished to continue with their lifetime default fund rather than the default fund offered by the employer.
- c. If the employee chose the new employer default fund they would be required to confirm, in writing, whether they wanted their accounts consolidated or to be maintained in two separate funds.
- d. It would be a requirement on the employer to make the default offer and use best endeavours to obtain the written consents.
- e. Failure of an employee to complete any forms, after reasonable efforts by the employer, would result in the lifetime default fund being maintained.
- f. If the ATO, as the appropriate government agency, did not receive the consent forms it would be required, once it was aware of the change of employment through the taxation system, to notify the employee of their rights to select any complying fund and to consolidate accounts if so desired.

In our view, this process would promote member engagement and reduce the risk of a member remaining in an under-performing fund, through bringing the choice of fund front-of-mind upon commencing a new job.

The Auction System

Sections 6 and 7 of the Report consider the merits of an auction system in order to arrive at a short-list of default funds. While we appreciate that the Commission is attempting to arrive at a system which reduces costs and increases efficiency we are concerned about the potential for adverse market concentration that an auction system might cause.

In the current environment most industry funds still rely on new entrants to maintain a positive cash flow at a time where the majority of members, upon retirement, do not roll their accumulated benefits into a pension product due to the relatively small size of their balances. In an era of unprecedented levels of household debt we are seeing members of funds using a large portion of their superannuation, upon retirement, to extinguish this debt and invest any cash remaining in non-superannuation products where the quantum of the investment will mean that tax is not paid, leaving these monies in much the same position as they would have been had they been left in superannuation.

As a result funds are generally not yet retaining the majority of members through their period of retirement. Without new entrants many of these funds would not be cash flow positive.

Under the proposed auction system those funds which are not selected to be the short-listed default funds would, in many cases, be forced to wind up or merge. While this outcome may be a positive result from some perspectives we are concerned that the ultimate outcome would be a market of only those funds which are selected under the auction system. The same outcome might also apply to certain classes of service providers such as administrators and group life insurers.

In recent times we have seen the intense scrutiny the banking system has come under with allegations of lack of competition with many smaller financial institutions such as credit unions withdrawing from the market and we would be concerned if the same result occurred in the superannuation industry. Deloitte strongly supports the concept and practice of competition. We are concerned with any changes to the current superannuation environment that in any way diminishes or restricts competition between funds.

We are also concerned with any auction process which is heavily weighted toward costs alone. We believe that such a system would result in services or governance practices being sacrificed in order to meet cost expectations.

Fund mergers

In Information Request 3.3 you ask for comment about fund mergers and what action, if any, that should be taken to make fund mergers occur.

While Deloitte agrees that in some circumstances there is a strong argument for smaller funds to merge we do not agree with funds being forced to merge.

The decision of two industry funds to merge is a complex one which is influenced by a number of factors which might include efficiency gains, cost reductions and economies of scale however we have not seen an argument or evidence that confirms smaller funds (which we define as being in the \$500 million to \$2 billion range) cannot be as efficient or as competitive as larger funds.

Deloitte works with a number of these funds in the areas of consulting and audit and we have found that:

- a. They use the large service providers such as the major administrators and insurers which give them similar economies as larger funds;
- b. They tend to operate under strict budgets which results in very little non-essential expenditure that might be seen elsewhere;
- c. Smaller funds tend to be more “nimble” when it comes to changing service providers or moving investment objectives; and
- d. They do not attempt to be “all things to all people”. Most of these smaller funds offer a limited range of investment options and simplified insurance arrangements however we believe this meets the needs of most members and we must be aware that the Choice of Fund

legislation still gives the members the chance to select another fund if they believe their current fund is not meeting their needs.

Therefore while smaller funds cannot match the large funds in all areas of competition they can compete well in most areas (particularly in insurance and investment performance) and on this basis we do not support compulsory mergers based on size alone. Market, membership and regulatory forces (particularly given our discussion of the role of APRA above) will ultimately force less competitive funds to re-assess their positions and, if necessary, merge. Superannuation, like most other industries, benefits from healthy competition between both large and small participants. Other industries with appropriate levels of competition result in poor performers being forced out regardless of size. Differentiating funds solely on size does not, in our view, does not result in the best outcomes.

Conclusion

In summary we strongly support the concept of a competitive superannuation system which will drive superior outcomes for members. There is competition between funds at all levels although changes to the default system as it currently exists could enhance competition if done correctly. There is a strong push to remove superannuation from Modern Awards which could, in our view, provide for further healthy competition provided we do not make changes or introduce legislation which unnecessarily forces smaller and mid-sized funds from the market purely on size and is not linked to performance outcomes.

The market should provide the choice and variety demanded by fund members irrespective of fund size. The same level of competition should also be open to retail funds provided that there is full, transparent and consistent disclosure to members of their costs and that there are like-with-like comparisons of investment performance. We have a regulator in APRA which monitors and oversees all superannuation funds in Australia except SMSFs and we see no reason why APRA's role cannot be enhanced. The alternative of another independent arbitrator and an auction system has the potential to add costs and complexity without there being any net benefit to superannuation fund members.

Should further commentary be needed I can be contacted

Yours sincerely,

Russell Mason
Partner
Deloitte Touche Tohmatsu