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



**April 2017**

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## 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 Superannuation: Alternative Default Models Draft Report.

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.

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## 1. Executive summary

Our response to the Draft Report has been framed with consideration of our original submission made in September 2016 to the Productivity Commission's request for input to the Issues Paper. That submission outlined a number of concerns about the proposal to conduct some form of competitive default fund selection process, including:

1. that outcomes may not actually be in the best interests of members, as they may miss out on additional benefits (i.e. superior insurance, or additional employer contributions) which they may qualify for under some existing models;
2. a periodic competitive process may encourage Trustees to focus on short term outcomes, when their focus should be long term;
3. the focus on lowest fees (which a competitive process implies), may result in inferior products (including insurance) and discounts qualitative factors;
4. the potentially significant impact on system stability if most unsuccessful Funds merged, contrary to one of the Commission's objectives;
5. the potentially significant reduction in competition that would ensue if there were significantly fewer Funds in the industry as a result of mergers, contrary to the Government's promotion of competition.

We are encouraged to see the acknowledgement in the Draft Report that existing default members should not be considered as part of any competitive process and should remain within their existing Fund unless an active choice is made. This addresses some of our concerns about points 4 and 5 above and any unintended consequences from the impact of the wholesale sales of assets needed to effect these rollovers.

However, we remain concerned that a fee based auction or multi criteria tender in particular are likely to disadvantage smaller Funds due to the costs which would be incurred in managing any bidding process and the requisite scaling up of capability in the event of "winning" a tender / auction.

We are similarly concerned that the exclusion of Insurance offerings from the assessment criteria, particularly given the chosen Fund will be likely to remain as a member's Fund for their working life, unless an active choice is made, will result in lower quality insurance offerings as this will not be a focus for Funds seeking to take part in this market. This has the potential to result in under-insurance of members and place an increased reliance on Government to support those who need to claim.

Our remaining comments are organised in response to the information requests and review findings where we feel we can add value.

Overall, we believe that rather than focussing on alternate default models that have not been proven to enhance member benefits, it would be wise to allow the changes that are currently proposed or recently implemented, to be allowed to operate to determine if further policy action is required / beneficial.

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## 2. Responses to Productivity Commission Findings and Recommendations

### DRAFT FINDING 1.1

Complementary policy action (including to extend genuine member choice to all employees) will be needed to deliver the full potential of member-driven competition under the alternative models developed in this Inquiry and also under current default arrangements.

It would be useful to see what complementary policy action is envisioned and how this would be implemented to fully appreciate and make effective comment on this finding.

### DRAFT FINDING 1.2

Where there is third-party involvement in the selection of a default product, there needs to be effective regulation or arrangements in place to ensure these third parties act in the best interests of members.

The proposal that transparency and declaration of conflicts occurs, is supported. However, any form of employer choice appears inconsistent with current arrangements, where employers are not allowed to provide advice, unless they have an AFSL. Employers may not want to make any active decision, and this model acknowledges that employees are not informed or engaged enough to make a choice themselves.

### DRAFT FINDING 3.1

The current arrangements where members can be defaulted to a new account on every change of job increases the proliferation of accounts. This materially adds to costs for members and reduces member balances at retirement.

### DRAFT RECOMMENDATION 3.1

To avoid perpetuating the legacy problems of the current system, any future alternative system for allocating members to default products should be premised on employees being assigned a default product only once, when they join the workforce.

The superannuation system has been subject to a high level of regulatory adjustment over its operation, particularly in the last decade. It would be helpful to the industry and members to have a period where these changes could be given time to take effect, to understand their impacts.

As noted in the Report, it should be expected that various legislated changes, not yet in operation, should reduce the number of instances where employees are defaulted into new accounts with a change in job. In particular, Single Touch Payroll proposals to pre-populate new employee documentation with the last known superannuation account

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should reduce the number of accounts a member holds and ensure any employee who does make a decision to open an account with a new Fund, has done so as a deliberate decision. The ATO SuperMatch2 tool should also ensure that new members to Funds are presented with the opportunity to consolidate their accounts if the member chooses.

DRAFT RECOMMENDATION 3.2

The Australian Government should establish a centralised online service for members, employers and the Government that builds on existing functionality of myGov and Single Touch Payroll. The service should:

- allow members to register online their choice to open, close or consolidate accounts when they are submitting their Tax File Number on starting a new job
- facilitate the carryover of existing member accounts when members change jobs
- collect information about member choices (including on whether they are electing to open a default account) for their employer and the Government.

There should be universal participation in this process by employees and employers.

Achieving universal participation by employers and employees will require action from Government to compel all employees and retirees to create and maintain a MyGov account. In our view, any such system will still need to allow for employees to be informed of available options and to encourage a choice to be made based on the Funds available to them. Encouraging a review at the time of change of employment would promote more active engagement and participation by account holders in their retirement savings. It will be important for them to be aware of the differences between Funds and their offerings to ensure they are getting the most appropriate product.

DRAFT FINDING 3.2

There are strong grounds for requiring a fund that wins default status for contributions of new default members to extend the same fees and service terms to all its existing members of the default product.

Current MySuper legislation requires that all members of a MySuper product are treated equally. This finding is able to be met by existing Funds with current legislation in place. All new MySuper (ie. default) members are required currently to be subject to the same fees and have access to the same services as existing members. Any benefits offered to new members to join a Fund will need to be made available to all existing members. We do not believe a new model is required in order to achieve this finding.

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#### DRAFT FINDING 3.3

The default product in all models will focus on the accumulation stage and include investment, administration of member accounts and intrafund advice. It will be a simple and low-cost (but not conservative) product aimed at the needs of those who are disengaged from the system.

- A bundled insurance product will not be a factor in the selection of products and is best addressed through regulation and regulator oversight.
- Funds will primarily compete on long-term net investment returns and costs, subject to meeting a threshold quality of service, not on the quality or range of ancillary services per se.

Insurance offerings and quality of service are two of the key areas of differentiation in the current products on offer. The ability of a Fund to compete for default Fund status / accreditation through the auction based model, without having to consider its ability to adequately service its members or tailor its insurance offering to suit the needs of its members will likely result in a detriment to those members.

If the current suggested objectives of superannuation were to be implemented and insurance offerings were not part of the selection criteria for the Funds seeking to be selected to accept new default members, then the requirements for insurance to be considered by Trustees under the SIS Act should be reviewed to consider if it is still appropriate. We have serious concerns about such a proposal as the current system has resulted in a large portion of the workforce being covered, at least to some extent, for death, total and permanent disability and income protection insurance. Any removal of insurance from superannuation would be fraught with complications and risk, with the very real likelihood that many people would suffer events that they thought they were insured for, but in fact are not. In the absence of insurance being provided for within superannuation, further Government involvement and regulation will be required to ensure that employees have sufficient insurance coverage for these events.

#### DRAFT FINDING 3.5

The selection of eligible default products should be administered by a government body, and be subject to strong governance rules. The decision-making body must:

- have a strong focus on fund member interests
- have sufficient expertise to evaluate products
- be independent and free of real or perceived conflicts of interest
- have processes that are transparent and afford procedural fairness
- be accountable for its decisions.

There are a number of Government bodies already responsible for the regulation of superannuation funds. The creation of a new body to decide the selection of eligible default Funds is likely to add cost to the system for both Funds and the Government and ultimately for those who are meant to benefit from the system, the members. If a new

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default process is ultimately introduced, it is suggested that the Government consider charging an existing Government agency with this function.

DRAFT FINDING 5.1

Relative to the baseline, the assisted employee choice model would:

- significantly reduce the complexity employees face in choosing a product and lead to more employees choosing high-performing products that meet their needs, thereby increasing member benefits
- focus competition on product aspects of value to members, put downward pressure on fees (through greater product comparability) and likely curtail wasteful product proliferation
- better align funds' interests with those of members
- support a stable superannuation system
- have lower search costs for many employees and very low costs for employers, but with government and funds incurring additional costs associated with regulatory structures.

Relatively low levels of financial literacy across the workforce are likely to still result in an element of guesswork by many employees in selecting a Fund from the approved list. Also, it is considered probable that even under this proposed system of forcing a selection to be made, many employees will not make a selection. The proposed default selection of an Eligible Rollover Fund will offer a very basic product with minimal services and no insurance, and likely a conservative investment profile, which may deliver lower long term returns than existing default products.

The proposed additional level of accreditation would also add another layer of cost, which would ultimately be borne by members.

DRAFT FINDING 6.1

Relative to the baseline, the fee-based auction model would:

- promote member benefits by exerting downward pressure on fees
- focus competition on, and elevate transparency of, member fees
- likely assist integrity due to its simplicity and accountability mechanisms
- be unlikely to compromise long-term stability because the model as designed would not lead to excessive concentration of funds or volatile movement of members and assets
- have slightly lower system-wide costs, mainly due to lower search costs for members.

This model evidences the ongoing pre-occupation with fees, and the exclusive focus on quantitative outcomes to the exclusion of qualitative considerations. While it is recognised fee levels are important, we consider net outcomes and access to quality services to be of

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equal or greater importance. As outlined in our previous submission, we consider that the provision of high levels of personalised service, including access to advice, results in members making more informed decisions, contributing to better retirement outcomes. Lowest cost is likely to result in low levels of service, with consequent member impacts.

Again, our previous submission highlighted that extreme caution should be applied in transplanting policy settings adopted in some overseas countries, given the very significant differences in the structure of the industries and regulatory settings between jurisdictions.

It is also doubtful that successful Funds would necessarily have the capacity to absorb the significant numbers of new members, given the numbers quoted in the Report.

DRAFT FINDING 7.1

Relative to the baseline, the multi-criteria tender model would:

- promote member benefits by focusing competition on member satisfaction and long-term net returns
- focus competition on aspects of performance that matter to members, and more generally through the winning bid providing a market-wide performance benchmark
- create risks for integrity due to its vulnerability to subjective judgments, yet on the other hand promote integrity through stronger accountability mechanisms
- not create any material risks to stability, since it is unlikely to lead to excessive concentration or volatile movement of members and assets
- have slightly lower system-wide costs, mainly due to lower search costs for members.

This model contemplates a complex and multi layered process to seek default fund status. It is likely that small Funds will be at a disadvantage given the resources and costs which will likely be needed to submit proposals.

Also, as outlined above, such a model may encourage an inappropriate focus on short term outcomes.

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#### DRAFT Finding 8.1

Relative to the baseline, assisted employer choice (with employee protections) — employing both a light filter for mandatory minimum standards and a heavy filter for a preferred default list — would:

- enhance member benefits by increasing the likelihood of members being placed in higher quality products, and reducing the likelihood of them being in a poor product
- promote healthy competition by presenting product providers with incentives to perform strongly against the preferred list selection criteria or compete for corporate tenders and facilitating greater comparability, but there would still be some scope for unhealthy and wasteful marketing to employers
- increase the potential for agency problems given the involvement of employers, although the risk to the integrity of the system would lie primarily in the appointment process for the preferred default list selection panel
- create few stability concerns
- reduce search costs for employees, while increasing search costs for employers and regulatory costs for funds and government.

Our view is that the use of an auction or tender based model as contemplated in draft finding 6.1 and 7.1 is unlikely to provide significant benefits to members in the long term. Unless there were reforms to the current regulatory environment, it would appear that only 'public offer' funds would be able to fully compete in these options, further limiting competition. While an auction based on fees may provide some short term gains in fees, as described in the draft report's review of the Chilean system, there is a real risk of Funds bidding at unsustainable levels and returns being adversely affected in the medium to long term as Funds remove cost to compete to "win" the auctions.

We do not believe any of the suggested models outlined, in particular the setting of arbitrary limits of 4 or 10 successful funds is likely to increase competition in the Industry in the long run or benefit members overall. If any variant on the proposals is ultimately introduced, we think the best result for members would allow for employees or employers to choose from any Fund which meets the minimum standards and criteria set, not limited to an arbitrary number of 'successful' Funds.

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### 3. Responses to Productivity Commission Information requests

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#### INFORMATION REQUEST 3.1

*The Commission is seeking comment from the industry on the effect on fund participation in the competitive process of moving to the first-timer pool of default members.*

- *Are there any funds that might choose not to participate due to the lower value of the pool, and what is the threshold minimum pool size (per fund) at which this might happen?*
  - *How would the move to a first-timer pool of default members affect the fees and product features that funds would offer when competing for new members?*
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We expect that there would be a number of Funds, particularly smaller Funds, who would choose not to participate in a competitive process for the first-timer pool. For a start, Funds which are not ‘public offer’ may not be able to accept all members from this pool. In addition, non ‘public offer’ Funds that are designed for industries that typically attract low numbers of new entrants to the workforce, may not compete, even if they could then accept only members within their industry, as their members will already have been allocated to a default fund through the first employment. There would likely be significant costs associated with the competitive process, both financially, and by distracting Funds from their primary purpose of managing retirement benefits for members.

We believe that a competitive process for the first-timer pool of default members would be likely to reduce fees for those members and the existing default members of the Funds that are successful. This is likely to be achieved by reducing the number and quality of features and services in the Funds, and in the case of the fee based auction model, reduce the focus on the quality of any service as well, with consequential negative impacts on member outcomes.

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#### INFORMATION REQUEST 3.2

*The Commission is seeking feedback on the merits and implementation issues of its proposal to improve transparency around fund merger activity.*

- *What (if any) complementary regulatory action would be needed to ensure that the framework is effective in promoting mergers and the exit of underperforming funds?*
  - *Are there any likely unintended consequences from introducing the proposed framework? To what extent and how could those unintended consequences be addressed through policy design?*
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The Draft Report suggests that promoting mergers is a goal of the Commission. However, it is noted that the Government’s terms of reference for the assessment of alternative default models, do not appear to address promotion of mergers at all.

Given the Report refers throughout the document to a goal of increasing competitive pressure, the suggestion that mergers is the preferred way to remove underperforming funds seems to be a significant diversion from the scope of this report, which is supposed to be assessing alternative default models.

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#### INFORMATION REQUEST 5.1

*In terms of a shortlist of superannuation products, what evidence is available on the size of the list that would best facilitate the majority of employees to choose a fund that meets their needs?*

*What specific information should be included alongside such a shortlist to help employees to choose between products? In what format should the information be presented? What evidence is there for how the metrics would assist employees to make decisions?*

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We strongly believe that insurance arrangements, as well as access to education and advice, should be included in any information made available to employees to assist in choosing the appropriate superannuation fund. The benefits to individual members in having appropriate and customised insurance cover should be considered by members in making a decision on choosing a Fund.

If some form of competitive selection process is ultimately introduced, we consider that any Funds which meet the relevant criteria should qualify, rather than the Government setting an arbitrary limit of 4 to 10 successful funds.

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#### INFORMATION REQUEST 7.1

*Which aspects of member services should be included in the tender criteria? Do default members value the same services as choice members?*

*How should default members be allocated across the set of winning products? Are there problems with sequentially allocating members into products with different investment strategies, fees and services, as is implied by this model? What role could a best-and-final-offer stage play in providing a select number of funds the opportunity to improve their offer?*

*Regarding transparency, are there any problems with only withholding information that can reasonably be shown to be commercially sensitive? What information would fall under this exemption?*

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Member services that should be considered are:

- Member Education / Advice
- Accuracy / timeliness of transaction processing
- Insurance Offerings

to assist default members in making an informed decision on the Fund which best meets their needs.