Superannuation: Alternative Default Models

Submission to Productivity Commission

2 May 2017

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This report has been prepared in response to a call for submissions from the Productivity Commission following its draft report on Alternative Default Models for the superannuation industry.

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The submission was prepared and peer reviewed by the following consultants.

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2 May 2017

1. Executive Summary

1.1 About Rice Warner

Rice Warner was established in 1987 to support superannuation funds and businesses operating in the financial services industry. It is an Australian business, owned and controlled by its key executives.

Over the last three decades, it has built a strong reputation for insightful commentary. Its independence means clients can be sure the firm always acts in their best interest and provides unbiased advice. Clients include most large superannuation funds, as well as many other participants in the industry (service suppliers to funds, regulators and industry bodies).

Through its research and public policy activities, Rice Warner has built an unrivalled reputation for delivering a unique perspective across the superannuation, wealth management and life insurance industries.

1.2 Background

On 29 March 2017, the Productivity Commission ('Commission') released a draft report, ***Superannuation: Alternate Default Models.*** This report sets out four different models for allocating new entrants to superannuation into an appropriate default fund.

This report is part of Stage 2 of the three-part review of the superannuation system. Stage 1 sets out criteria for measuring efficiency and competition within the superannuation system. Stage 3 will use those criteria to compare the existing system against one or more of the four models proposed as alternate systems.

1.3 Focus of this submission

The purpose of Stage 2 is to identify an alternate default model that will then be compared against the current system in Stage 3 of the Inquiry.

We recognise that there are inefficiencies in the current superannuation system. However, we make no assertion that the best of the Commission models selected by us in this report is better than modifying the current system incrementally, to reduce inefficiencies and enhance competition. We acknowledge that the work should be deferred to Stage 3 of this inquiry.

Our submission considers:

- The criteria for selecting funds under any of the models.
- The relative merits of each of the four models.
- The merits of the Commission's proposal to restrict the new default models to people who do not yet have a superannuation account.

1.4 Criteria for selecting funds

We recommend some amendment to the broad criteria for assessing alternate default funds.

1.4.1 Life Insurance

Despite the poor value which many younger members have received, we believe life insurance remains a valuable benefit. We also consider that any default which excludes life insurance will lead to much of the population being uninsured. Unless there is a future trigger date to cover people (say, age 25), most will not take out cover themselves.

Consequently, we believe that life insurance should be one of the criteria for assessing an alternate default fund. We agree that the structure should try to overcome the issues we have identified about relative value.

1.4.2 Net returns

Our previous submission on *How to Assess the Competitiveness and Efficiency of the Superannuation System,* made several recommendations related to net investment returns. We agree that the industry should be measured on net returns. However, there are several issues to resolve:

- Measurement should be over long periods, whereas most past performance published in the media is short-term and mostly irrelevant.
- Industry benchmarking should be against passive listed portfolios. It is likely that a suitable portfolio will need to be developed for the Australian industry.
- Returns should be net of tax and investment fees. Administration fees can be measured separately.
- The performance of Choice members should be measured separately.
- Net returns are backward looking. Therefore, consider how to measure likely future investment returns without relying on past performance as a guide. Funds could assess the probability of achieving a ten year target by stochastic modelling. Members need to see these results to assess the veracity of the target.

We reiterate these recommendations and note that past performance can be used as a filter to eliminate poorly performing funds early in the tendering process, but is not suitable as a selection metric as past performance is backward looking and will not guarantee future performance.

We consider that a better metric is to measure the fund’s investment strategy and governance. This will be a better indicator of future performance.

1.4.3 Default funds for new entrants

There are several likely impacts of the proposal to set up alternate default funds for new entrants:

- A small number of superannuation funds (perhaps between four and ten) would manage the superannuation of new entrants.
- The successful funds would provide a simplified structure, including:
  - Potentially no life insurance.
  - A simplified investment structure with a leaning towards passive investments in listed securities.

- An administration fee below current industry funds, reflecting competition and reduced services.
- No intra-fund advice (as the members are unengaged).

- The number of Choice products would grow and it is possible they would become more expensive. Some of these products would be unsuitable for members.
- Unsuccessful funds will target young members and migrants and offer them access to their own default or Choice products (using life insurance and different investment strategies as levers). If these campaigns are successful, it will dilute the value of the funds which are successful in winning default members.
- The removal of new entrants will encourage unsuccessful funds to consider their future. We expect it will lead to more fund mergers.
- Large industry funds will develop specific campaigns to target Choice members.

As the number of participating funds is limited to no more than 10 in three of the four models, there will be structural changes to market share. Most MySuper products would receive no new young members and, over time, more new members would be exercising Choice. This will have an impact on the structure of funds as there will be a large but gradual shift from default to Choice members. This may lead to a greater difference in product structure between default and Choice members within the same fund.

1.5 Assessment of alternative default models

We have considered the potential operation and likely outcomes of the proposed default models.

1.5.1 Elimination of Model 1

The Assisted Employee Choice model has many attractions. However, the fact that these changes are aimed at disengaged, generally younger, employees makes this model problematic. This is the group of consumers who are least likely to make decisions in relation to their superannuation. To build a system around helping them to make these decisions seems fraught with potential problems. Too many elements of the market would need to change to make this approach viable and there would then still be significant marketing to this group via the Choice system to make a choice away from the preferred solution.

See Section 4 (Model 1 – Assisted Employee Choice).

1.5.2 Elimination of Model 4

We do not believe that the Fee Based Auction will result in a sustainable market. It will probably result in lower fees initially, but this is likely to be due to reduced services rather than an improvement in efficiency. Over time, this model is also likely to lead to a significant reduction in providers, especially not-for-profit (mutual) providers, with increased systemic risk because the remaining providers are too large to fail.

See Section 7 (Model 4 – Fee based auction).

1.5.3 Elimination of Model 3

We are also not attracted to the Multi-criteria tender. There would be less likelihood of systemic risk from the elimination of providers, but the focus on fees will still likely dominate. Services will be reduced to support ever lower fees and the potential elimination of insurance is draconian. Not-for-profit providers will find it difficult to compete in this environment and are likely to be progressively eliminated over time. The likely increase in marketing of Choice products by providers who lose out on default members will also complicate the market and lead to higher costs overall.

See Section 6 (Model 3 – Multi-criteria tender)

1.5.4 Preference for Model 2

Our preference is for the Assisted Employer Choice (with employee protections) subject to the mooted employee protections being adequate. This approach is closest to the current approach so will cause the least confusion and disruption while focusing the market on efficiencies. The need for protections should not be underestimated if decisions are to be made in members' (employees') best interests. If this model is considered for further development, these protections must be clearly spelt out.

We recommend that Model 2 be adopted as the best of the four models set out by the Commission subject to detailed specification of the employee protections.

See Section 5 (Model 2 – Assisted employer choice (with employee protections)).

1.6 Other matters raised

We welcome the Commission's recognition of our recommendations to improve transparency in relation to fund mergers. Whichever model is adopted (be this an alternative model or an improved version of the current framework), we expect fund merger activity to increase. Transparency will improve outcomes and thereby overall market efficiency.

2. Criteria

In its Stage 1 Report[1], the Commission set out its own system-level objectives *for measuring competitiveness and efficiency.* These are:

- Competition in the superannuation system that drives efficient outcomes for members.
- Maximising net returns on contributions and balances over the long-term.
- Meeting member preferences and needs, in relation to information, products and risk management, over that member's lifetime.
- Providing insurance that meets members' needs at least cost.
- Complementing a stable financial system and not impeding long-term improvements in efficiency.

In addition to these system level objectives, the Commission has developed 22 objective criteria supported by 89 unique indicators.

Rice Warner responded to the Stage 1 report with its own submission wherein we commented on each of these objectives[2].

In its draft Stage 2 report, the Commission has specified that there is a market need for strong default funds which will apply to new entrants to the superannuation system. The issues faced by this cohort are:

- They are largely young people who are unengaged and do not actively choose a suitable fund.
- There is no structure for helping new entrants who are placed in an unsuitable fund.
- Fees tend to be high relative to the account balance.
- Insurance is not tailored to the needs of young people.
- Young people often end up with multiple accounts which duplicates their fees and insurance premiums.

The criteria used by the Commission for assessing the alternate default models differ in some areas from the Stage 1 objectives. They are:[3]

- **Member Benefits** – Does the model create incentives for funds to maximise long-term net returns and allocate members to products that meet their needs?
- **Competition** – Does the model encourage open participation (contestability) and rivalry between funds (competition) to drive innovation, cost reductions and more efficient long-term outcome for members?
- **Integrity** – Does the model promote a high-degree of integrity in the selection and delivery of default superannuation funds and the ongoing behaviour of superannuation funds more broadly?
- **Stability** – Is the model likely to create instability in the superannuation system that leads to significant systemic risks?

[1] Productivity Commission – How to Assess the Competitiveness and Efficiency of the Superannuation System (Nov 2016)
[2] Rice Warner – Submission to Productivity Commission 19 September 2016 http://ricewarner.com/wp-content/uploads/2016/10/UPDATED-PC-SUBMISSION.pdf
[3] Productivity Commission – Superannuation: Alternative Default Models (draft report) March 2017 (p11)

- **System-wide costs** – Does the model minimise overall system-wide costs taking into account costs on members, employers, funds and governments?

Rice Warner accepts the broad assessment framework but suggests some modifications.

2.1 Insurance

2.1.1 Background

Insurance cover has long been an important feature of superannuation funds' benefit design for their members. It ensures that the long term financial provision represented by superannuation is not brought undone by premature death or disablement. The major advantages of insurance provision through superannuation include:

- Providing cover for a very large number of people who otherwise would have no insurance.
- Providing basic cover without the need for underwriting, which means many members receive insurance for which they would not be eligible in the retail life insurance market.
- Obtaining the lowest cost insurance for a large proportion of the population, both in terms of competitive premium rates due to bulk buying and low costs of putting cover in place because much of the cover is provided automatically to fund members without requiring any actions on their part.

We have for many years been helping employers select suitable default funds for their employees and superannuation funds obtaining suitable terms for their members. The quality and cost of the insurance programme has always been an important consideration for both employers and superannuation funds.

When we assist employers to transfer their fund into an industry fund or master trust, insurance is one of the key criteria evaluated as part of the offer.

When Superannuation Guarantee (SG) contributions commended in 1992 (at 3% of salary), the level of insurance offered by funds was modest - often the amount of death/TPD cover bought by fifty cents or one dollar per week. As the amount of SG contributions has increased, fund trustees have generally sought to provide an insurance programme that is relevant for their members. Affordability has been an important element of trustees' consideration in deciding on the appropriate insurance programme.

Most members joining superannuation cover are automatically granted a default level of insurance cover. This, together with the more generous levels of insurance provision now that SG contributions have increased to 9.5% per cent salary have:

- Provided a good basic level of insurance cover for members.
- Made a significant contribution to the levels of underinsurance in Australia.
- Limited the requirement for Government welfare to be made available to disabled superannuation fund members or the families of deceased members.

Default insurance cover within a superannuation environment has been the focus of recent media coverage in terms of affordability. It is however important to consider that:

- Trustees do take account of the cost to members in designing the insurance programme. They specifically consider the type and level of cover required at different ages.

- Without default insurance, the number of fund members with cover would be limited. In past cases, where a small number of funds had no default cover, the numbers of members with any insurance was usually less than 30% of the total membership. Clearly, providing mandatory insurance has expanded coverage through the population.

2.1.2 Underinsurance

Under the SGC system, there has been a significant increase in the amount of life insurance cover provided to superannuation fund members. The claims have made a significant contribution to society over the last ten years. Consequently, the life underinsurance gap has been significantly reduced, particularly for low income earners, over that period. Overwhelmingly, this has been driven by the provision of insurance as a part of default superannuation offerings.

Rice Warner has carried out several studies of underinsurance in Australia, taking account of group life insurance and individual retail policy insurance both within superannuation and outside superannuation. The first was carried out in 2005 and the latest in 2015. The 2005 study showed that the median insured death cover provided for 20% of the insured person's needs. By 2015, this had increased to 61% of basic death cover needs. In 2015, the percentages for disability cover were significantly less than those for death cover being 13% for TPD cover and 16% for disability income cover.

Progress to date has been facilitated by developments such as:

- Increased levels of default cover within superannuation.
- An increased focus on insurance by financial advisers and superannuation fund trustees.

The 2015 study also provided details of the amount of cover provided inside and outside superannuation. The percentages inside superannuation were:

- Death 75%
- TPD 86%
- Disability Income 59%

As at June 2016 there were 14,853,000 instances of life insurance provided by APRA regulated funds, or approximately half the number of accounts in APRA regulated funds. After allowing for duplicated accounts, some with insurance and some without, this translates to about 70% of superannuation fund members having death cover.

2.1.3 Typical insurance costs per member

To evaluate the impact of insurance premiums on retirement savings and affordability of cover, we have calculated insurance premiums as a percentage of salary in the first year of membership and then over the lifetime of membership in the fund. Secondly, the projected account balance at retirement age 65 is shown for three variations of each scenario, namely:

- No insurance
- Death and TPD cover
- Death and TPD, and income protection (IP) cover.

The retirement balances are in future dollars, i.e. dollars at retirement date.

One measure of affordability is to take insurance premiums as a percentage of income. Some funds benchmark 1% of salary over the lifetime of membership as being a reasonable level[4]. This corresponds to around 10% of the Superannuation Guarantee (SG) contribution which is considered reasonable, leaving a large portion of SG contributions to be invested for the member's retirement.

The data for the projections was sourced from 21 funds, predominantly not-for-profit. Default premium costs were obtained from fund disclosure documents with average account balance and contribution data collected in respect of a 12-month period ending 30 June 2015. For the purposes of our modelling, the average salary and account balance data at each age has been aggregated across genders and occupational classes for all funds combined.

Table 1. Insurance premiums as a percentage of salary[5]

Occupation	Age next birthday on joining	Death and TPD cover only		Death, TPD and IP cover	
		First year	Average fund lifetime	First year	Average fund lifetime
		(%)			
White Collar	21	0.72	0.52	1.24	1.02
	26	0.55	0.51	0.89	1.02
	31	0.49	0.51	0.84	1.04
	36	0.50	0.51	0.90	1.08
	41	0.54	0.52	0.99	1.13
	46	0.58	0.54	1.09	1.22
	51	0.62	0.56	1.27	1.34
	56	0.65	0.57	1.48	1.46
	61	0.58	0.56	1.74	1.55
Heavy Manual	21	1.00	0.74	1.98	1.54
	26	0.75	0.72	1.37	1.52
	31	0.68	0.73	1.28	1.55
	36	0.72	0.74	1.37	1.61
	41	0.80	0.75	1.52	1.68
	46	0.85	0.78	1.66	1.81
	51	0.90	0.80	1.91	1.98
	56	0.93	0.80	2.18	2.14
	61	0.83	0.78	2.51	2.29

2.1.4 What insurance do young members need?

It is often stated that life insurance is of limited value to young members. It is true that default group life is not tailored to the individual needs of members so the value (i.e. level of cover to needs) will vary considerably between members. Some of the problems are:

[4] Rice Warner Affordability Study
[5] Rice Warner Affordability study

- Membership of multiple funds will usually provide multiple life insurance cover and duplicate premiums. Because of restrictions on some forms of insurance, like disability income insurance, this can result in the member having excess cover that will be restricted at claim.
- Young single people (without dependants) usually do not need life insurance.
- Young people (like older members) need income protection and the levels provided by superannuation funds are usually for short durations (up to two years).
- The young members in many funds subsidise older members.

These issues are recognised by funds and advisers such as Rice Warner. Benefit design work we have carried out for funds over recent years has had an emphasis on the types of cover, the levels of that cover, and the premium rates for that cover across the age spectrum. One example has a very low default level of cover for new entrants to a fund until the members' account balances rise above a threshold when the cover moves to a higher level.

Despite the relatively poor value which many younger members have received, we believe life insurance remains a valuable benefit. We also consider that any default which excludes life insurance will lead to much of the population being uncovered. Unless there is a future trigger date to cover people (say, age 25), most will not take out cover themselves.

Finally, not all new entrants are young people. Australia has a large migrant population and life insurance is a valuable benefit for these newcomers.

Consequently, we believe that life insurance should be one of the criteria used for assessing an alternate default fund. We agree that the structure should try to overcome the issues we have identified about relative value.

2.2 Net returns

Members can influence their own retirement benefit by making additional contributions and by choosing when to retire. If they defer retirement, they will receive more investment earnings, could make further contributions and will defer consumption of their retirement benefit.

Their superannuation fund can influence their retirement benefit by maximising the level of investment earnings allocated to the member and minimising the fees taken to pay for all services. The Commission seeks to improve member's retirement benefits by encouraging a system which focuses on maximising net returns.

Rice Warner discussed net returns in its submission to Stage 1 of this Inquiry[6]. This sets out many of the issues in evaluating this metric. The conundrum in measuring net returns is that fees are known but future investment performance is not. Nor can future investment performance be easily estimated. Further a fund's fees will be aggregated for many services broadly separated into investments, operations and financial advice.

Investment returns should be presented net of tax and all fees associated with the investment function. The fees for operations and member services should be measured as a separate metric. These services are largely homogenous and comparisons are meaningful.

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[6] Rice Warner – Submission to Productivity Commission 19 September 2016 http://ricewarner.com/wp-content/uploads/2016/10/UPDATED-PC-SUBMISSION.pdf

2.2.1 *Is past performance useful for evaluating funds?*

The extent to which a fund's ability to deliver member outcomes can be evaluated by their past investment performance is extremely limited. It is not meaningful to directly compare products based on this metric.

However, past performance can be used as an initial filter in the tendering process. Funds which have performed materially worse than the rest of the market over a reasonable investment horizon, such as ten years, can be eliminated early in the process. In other words, past performance is a good filter to eliminate poorly performing funds.

2.2.2 *How do we measure Net Returns?*

As we cannot use past investment performance, we need a metric that will help us estimate relative levels of future performance.

We know that there is a correlation between risk and investment return. However, the largest investment risks for superannuation members are in investing in assets which have a lower expected return in the long-term. Volatility of returns is not their biggest risk as funds need not sell assets when market values are low.

We survey investment managers and asset consultants each year to ascertain their view on long term returns. The results show that growth assets have a higher expected return but with a higher volatility – i.e. a wider range of potential outcomes over the medium to long term.

Table 2. Expected Long Term Investment Returns – Rice Warner Survey 2017

Asset Class	Expected return (% p.a.)	Expected volatility (%)
Australian Equity	8.2	17.0
Emerging Markets Equity	10.0	20.5
International Equity (Hedged)	7.7	16.6
International Equity (Unhedged)	8.0	15.5
Private Equity	9.0	19.9
Australian Fixed Interest	2.9	4.8
High Yield Debt	6.0	10.3
Inflation-linked Bonds	2.6	6.2
International Bonds	2.8	4.0
Direct Property	6.6	10.0
International Property	6.9	16.6
Listed Property	6.6	15.9
Mortgage/Loans	5.4	7.7
Hedge Funds	6.0	9.2
Infrastructure	7.3	11.3
AWOTE	3.0	2.0
Cash	3.3	1.0
CPI	2.5	1.2

It is possible to use a fund's asset allocation and provide an estimation of relative long-term performance. This can be done by undertaking a projection to retirement using a stochastic model based on public information gathered from the funds.

The results can only be an estimate since:

- The current asset allocation can change over time.
- Passive investments will be cheaper and it is subjective whether to allow higher performance for active management on listed securities.
- Unlisted assets should provide an illiquidity premium but this will be negated if funds pay too much for assets.

Nonetheless, the stochastic modelling can provide a good assessment of the probability of an investment strategy within a fund achieving a specified benchmark return – e.g. CPI + 3% pa. This can be helpful when comparing funds or when comparing investment options within a fund.

3. Default funds for new entrants

The Commission's idea to establish new default funds for new entrants to the superannuation system is an interesting concept. We have considered what changes would occur in the industry were this change to be adopted.

There are several likely impacts:

- A small number of superannuation funds (perhaps between four and ten depending on the model) would manage the superannuation of new entrants.
- The successful funds would provide a simplified structure, including
  - No life insurance.
  - A simplified investment structure with a leaning towards passive investments in listed securities.
  - An administration fee below current industry fund levels, reflecting competition and reduced services.
  - No intra-fund advice (as the members are unengaged) – also a cost saving.
- The successful funds could have Choice products with more services for a higher fee and a different investment strategy.
- Some successful funds might invest in conservative investments to preserve capital. This is a similar strategy to the NEST fund in the UK – but it does negate the early years of compound interest on growth assets.
- Unsuccessful funds will target young members and migrants and offer them access to their own default or choice products (using life insurance and different investment strategies as levers). If these campaigns are successful, it will dilute the value of the funds which are successful in winning default members.
- Some unsuccessful retail funds might decide to withdraw from MySuper over time and to offer more expensive Choice products. This will be a strategy to protect profit margins.
- The removal of new entrants will encourage unsuccessful funds to consider their future. We expect it will lead to more fund mergers.
- Large industry funds will develop specific campaigns to target Choice members.

3.1 Impact of new structure

We consider that the structure for new entrants will lead to more targeting of these members – encouraging them to make a Choice decision. This will lead to many young people exercising a choice of fund much earlier than would normally occur. On balance, these decisions will be positive as it will reduce the number of unengaged members.

There is a risk that many members will be pressured into inappropriate Choice products with the default fund being a 'loss leader' to garner new customers. There are already examples of this behaviour visible in the market today.

3.2 Small number of participating funds

Under 3 of the 4 models, the number of funds is limited as show in Table 3.

Table 3. Number of allowed funds under each model

Model	No. of funds
Model 1	4 to 10
Model 2	not stated
Model 3	5 to 10
Model 4	1 to 5

The small number of funds reflects:

- The difficulties consumers have selecting from a large number of choices.
- The desire to provide a reasonable flow of members to each successful fund.

The practical outcome of these lists is that the majority of MySuper products would have no new young members and, over time, most new members would be exercising Choice. This has an impact on the structure of funds as there will be a large but gradual shift from default to Choice members. This may lead to a greater difference in product structure between default and Choice members within the same fund.

3.3 Impact on Choice members

The changes being considered are considerable and they will take away a captive source of business for MySuper funds. We expect this will lead to significantly increased marketing activity by funds which will lead to a greater number of Choice members and, by definition, a larger cohort of engaged members.

The consequences of the change are difficult to evaluate. However, it is likely that:

- More young people will become engaged and will join other funds as Choice members.
- The costs of Choice products might grow above the cost of MySuper (even within the same trust fund) due to marketing costs. Hence, more members will pay higher fees.
- More work will be done on tailoring investment and insurance strategies in a more competitive environment.
- There will be more people in SMSFs, perhaps from much younger ages than at present. However, the overall impact on this segment is likely to be relatively small.

4. Model 1 – Assisted Employee Choice

Under Model 1 – Assisted Employee Choice, there would be a non-mandatory product shortlist to nudge members towards a small set of good products and a set of protections to help employees to choose from a broader set of products.

- Only four to ten funds would be selected for the shortlist by an independent government body.
- There would be a fund of last resort for employees who do not make a choice.
- Additional product accreditation would be used to strengthen no frills options for employees.

We note that although reducing the list to avoid 'choice overload' is desirable, four funds is too few. Australian banks have such an oligopoly and there is little competition on price for retail banking products.

We would support Assisted Employee Choice with some suggested amendments as given in Section 4.3 (Recommendations for Assisted Employee Choice). However, it is not our preferred option.

4.1 Positive outcomes of model 1

The positive outcomes of the Assisted Employee Choice model include:

- Removal of multiple accounts for future entrants.
- Reduction in levels of unnecessary life insurance.
- Minimum standards for funds chosen by young members.
- Lower fees through a commoditised product structure with lower transactions (fewer rollovers and fewer queries or activities by members).
- The shift in market share between funds will be gradual – this model is unlikely to cause a sudden shock to the system.

4.2 Negative impacts of model 1

The drawbacks of the Assisted Employee Choice model include:

- We perceive the potential removal of life insurance as draconian; it would be better to tailor insurance to young member needs.
- Competition for young members will grow; costs of marketing for the industry will rise.
  - The marketing of unsuitable Choice products will increase. This may well include an increase in intermediation for the default fund as a mechanism to gather customers for Choice products later.
  - Marketing efforts may result in decisions being made on 'brand' rather than value as consumers find it difficult to understand and assess value in superannuation. Advertising and promotion will expand to build these brands.
- Many members would choose outside the preferred product list – particularly if they get advice from family and friends, or are directed by marketing.
- The industry will still need a 'fund of last resort.'

4.3 Recommendations for Assisted Employee Choice Model

We would be comfortable with this option if it was refined as follows:

- As most members entering the funds will be young, the asset allocation should reflect that they cannot access their benefits for up to 50 years. The asset allocation should be constrained to ensure it is suitable. This control could potentially be principle based rather than prescriptive – e.g. the asset allocations must be capable of delivering a return of CPI + 3% p.a. over rolling 10 year periods with a probability of 75% or greater.
- It would be a refinement to limit this option to those under age 25 and allow older members to join funds as they do currently.
- Members should be encouraged to review their superannuation when they attain age 25.
- Modest life insurance should be introduced but tailored to member needs. For example, no life (death) insurance for single persons. The cover can potentially be arranged on a total cost basis to cover death and disablement. Singles would have higher disablement cover and no death cover which would switch to a mixture of death and disablement cover should they have a spouse (as widely defined).
- The fund of last resort should be replaced by controlled allocation to the participating funds of those who do not make decisions. An approach could be to use month of birth to select the fund. This would spread the membership rather than favouring a specific fund which would otherwise have an unfair brand advantage. It would also save creating a new fund that would only receive highly disengaged members.
- Young members should be able to move to any MySuper product at will. There will, however, need to be protections in relation to movements to Choice funds. The current protections on fund switching at least must continue, but more protections are probably needed. There are examples in the market of providers of small business e-commerce solutions which provide cloud-based Human Resource services free of charge. The employer pays nothing for these services. The provider, however, earns its income by offering financial and other products, including superannuation, to employees both when they join the employer and later. The product suppliers pay a fee or commissions to be included on the service. It is possible that the superannuation funds offered to new employees might not include any MySuper products.

5. Model 2 – Assisted employer choice (with employee protections)

Under this Model, employers would select a default fund for all their employees. There would be a long list akin to a MySuper list filtered to eliminate unsuitable funds. The number of approved funds on this list is not stipulated. The report (Table 5.3) lists the criteria amongst which is an emphasis on solid long- term investment performance (measured over periods of at least 5 years).

A short list of quality products would be selected based on investment performance and other product features. Further, the performance would be constantly monitored to ensure there is no lengthy under-performance. Funds will also need to demonstrate that (lack of) fund scale is not an impediment to performance.

Employers would probably choose from the short list but they would be free to pick a fund from the long list. However, there would be stronger rules than currently exist in the provisions of the SIS Act to stop inducement of employers.

Finally, large companies would still be able to negotiate their own terms if they can acquire something better than the short-listed offers.

Under this scenario, there would continue to be a link between the new entrants' first employer and the fund.

5.1 Positive outcomes of Model 2

The positive outcomes of this Model are similar to other models, namely:

- Removal of multiple accounts for future entrants.
- Reduction in levels of unnecessary life insurance.
- Minimum standards of funds for young members.
- Employers are more likely to select a suitable fund than an individual.
- The shift in market share between funds will be gradual – there won't be a sudden shock to the system.

Other positives:

- As the majority of new members are young, the asset allocation should reflect that they cannot access funds for up to 50 years. We agree that a single diversified strategy would be chosen (but argue that many lifecycle products are unsuitable).
- Less emphasis on past investment performance.
- Same service standards as MySuper products.
- Life insurance is more likely to be a feature of the products offered.

5.2 Negative impacts of Model 2

The negatives are:

- Employers will be confused between the two types of filter (mandatory light filter to eliminate unsuitable funds) followed by a strong filter to select preferred products.

- There is a significant risk that employers could choose a default fund in support of their own business agenda rather than the best interests of members. One of the reasons for establishing compulsory superannuation in its current form was because members' interests were not always paramount to employers. The Commission has indicated that suitable controls will be needed to limit or eliminate this behaviour, but no details have been provided on what these controls might be.
- Fewer opportunities for new funds to enter the market.
- Competition for young members will grow and costs of marketing for the industry will rise. Brand will also be very important under this option so expenditure on brand building will increase.
- It will be necessary to review the filtered list periodically and decide what to do when a fund is dropped off.

5.3 Recommendations for model 2

We are comfortable with this option for the following reasons:

- Investment strategy will be a key determinant.
- Most funds will use their own MySuper product as the vehicle. This will minimise disruption.
- The approach is the most similar to the current approach which will also limit disruptions.

Our comfort, however, is subject to a proper set of controls being implemented to ensure default funds are only selected in members' best interests.

Meanwhile, the following points still apply:

- It would be a refinement to limit this option to those under age 25 and allow older members to join funds as they do currently.
- Members should be encouraged to review their superannuation when they attain age 25.
- Modest life insurance should be introduced but tailored to member needs. For example, no life insurance for single persons.
- Young members should be able to move to any MySuper product at will. There will, however, need to be protections in relation to movements to Choice funds as discussed in Section 4.3 (Recommendations for Assisted Employee Choice).

6. Model 3 – Multi-criteria tender

Under this Model, a tender would be held centrally to select five to ten funds. Once funds have met minimum criteria for governance and transparency, they will be assessed on multiple characteristics:

- Past performance on net returns and member satisfaction.
- Investment strategy.
- Quality of member services, engagement and intra-fund advice.
- Fee levels and transparency.
- Innovation in unspecified areas.

Again, the judge would be a government-appointed selection body which would have to follow pre-determined criteria.

There would then be a performance monitoring and enforcement stage.

Under this scenario, there would be no link between the new entrant's first employer and this fund.

6.1 Positive outcomes of Model 3

The positive outcomes of this Model are similar to other models, namely:

- Removal of multiple accounts for future entrants.
- Reduction in levels of unnecessary life insurance.
- Minimum standards of funds chosen by young members.
- Opportunities for new funds to enter the market.
- The shift in market share between funds will be gradual – there won't be a sudden shock to the system.
- Existing funds will be less threatened by this structure as the winning funds are less likely to provide products tailored to the young.

6.2 Negative impacts of Model 3

The negatives are:

- This option will have a disproportionate focus on fees. Business models will be built around reducing fees rather than improving member outcomes.
- Members will be allocated randomly so will have no link to their new employer's fund.
- Past performance will count even though this is no indicator of future performance – and it may be irrelevant to this cohort.
- As most members are young, the asset allocation should reflect that they cannot access funds for up to 50 years. The allowable asset allocation would need to be constrained to ensure it is suitable.
- Service standards might be cut to suit the fees paid.

- As many leading funds are effectively mutual organisations, any error in setting fees will be passed onto other members. This model could, over time, therefore eliminate mutual organisations in favour of those who can rely on shareholder capital. This would reduce competition over time and potentially lead to an oligopoly similar to the banking industry.
- It is likely that some leading funds will not participate in the tender but they will market aggressively to young members to join them under Choice (unengaged members could be attracted by matters other than value for money). There are already examples of App-based marketing of expensive funds to younger consumers.
- Potential removal of life insurance is draconian; better to tailor to young member needs.
- Competition for young members will grow; costs of marketing for the industry will rise.
- The marketing of unsuitable Choice products will increase. Even the successful tenderers will shift members to Choice to lock them in against the possibility of losing the next auction.
- On renewal of the contract, what happens to members of an unsuccessful fund? If they do not move, the new fund would be reliant on new market entrants and the market will become increasingly fragmented. If they do move, the previous provider could well face ruin.

6.3 Recommendations for Model 3

There are some elements of the proposal that are attractive:

- Investment strategy will be a key determinant.
- Most funds will use their own MySuper product as the vehicle. This will minimise disruption.

These attractions do not overcome the negatives and, consequently, Rice Warner is not attracted to this option.

Should it be adopted, the following points still apply:

- It would be a refinement to limit this option to those under age 25 and allow older members to join funds as they do currently.
- Members should be encouraged to review their superannuation when they attain age 25.
- Modest life insurance should be introduced but tailored to member needs. For example, no life (death) insurance for single persons.
- Young members should be able to move to any MySuper product at will. There will, however, need to be protections in relation to movements to Choice funds as discussed in Section 4.3 (Recommendations for Assisted Employee Choice).

7. Model 4 – Fee-based auction

Model 4 – the fee based auction is the most controversial option put forward. The auction would be based on fees (both investment and administration) and one to five products would then be selected. Secondary consideration would be given to minimum criteria for the investment strategy and some additional features.

7.1 Positive outcomes of Model 4

The positive outcomes of this Model are:

- Removal of multiple accounts for future entrants.
- Reduction in levels of unnecessary life insurance.
- Minimum standards of funds chosen by young members.
- Opportunities for new funds to enter the market.
- The shift in market share between funds will be gradual – there won't be a sudden shock to the system.

7.2 Negative impacts of Model 3

The negatives are:

- This option will have a focus on fees rather than net returns – it could well lead to poor outcomes. As most members are young, the asset allocation should reflect that they cannot access funds for up to 50 years. The asset allocation would need to be structured to ensure it is suitable.
- Service standards might be cut to suit the fees paid.
- As many leading funds are effectively mutual organisations, any error in setting fees will be passed onto other members. This model could, over time, therefore eliminate mutual organisations in favour of those who can rely on shareholder capital. This would reduce competition over time and potentially lead to an oligopoly similar to the banking industry.
- It is likely that some leading funds will not participate in the auction, but they will market aggressively to young members to join them under Choice (unengaged members could be attracted by matters other than value for money). There are already examples of App-based marketing of expensive funds to younger consumers.
- Potential removal of life insurance is draconian; better to tailor to young member needs.
- Competition for young members will grow; costs of marketing for the industry will rise.
- The marketing of unsuitable Choice products will increase.
- On renewal of the auction, what happens to members of an unsuccessful fund?

We are uncomfortable with this option for the following reasons:

- There will be a mass disruption should a successful fund not be reappointed after the end of the period (say four years). What then happens to existing members – do they move to another fund or do they remain in a fund which is unsuccessful.
- We are not convinced that the leading funds will set the right investment strategy as they will focus on reducing costs.

7.3 Recommendations for Model 4

Meanwhile, the following points still apply:

- It would be a refinement to limit this option to those under age 25 and allow older members to join funds as they do currently.
- Members should be encouraged to review their superannuation when they attain age 25.
- Modest life insurance should be introduced but tailored to member needs. For example, no life insurance for single persons.
- Young members should be able to move to any MySuper product at will. However, there will need to be protections in relation to movements to Choice funds as discussed in Section 4.3 (Recommendations for Assisted Employee Choice).

Rice Warner does not support the fee based auction.

We believe that an excessive focus on fees will result in an unacceptable reduction in member services, including the provision of insurance and will lead to a reduction in investment focus which will negatively affect investment returns. Loss leading to win new business could create systemic risks.

At the end of each term, the auction system will then require that either:

- Existing members be transferred to the new provider at a large administrative expense.
- Existing members remain with the previous auction winner which will be, by definition, a sub-standard fund.

Neither of these situations is optimal. We note that difficulties in managing accounts in unsuccessful funds have been a major factor in the increasing public dissatisfaction with the system in Chile.

This Model has the potential to introduce significant systemic risk to the system by reducing the number of providers and potential providers over time who will become too big to fail. We will have the service of a Telstra and the pricing of a bank – how will that benefit members?