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RETAIL EMPLOYEES SUPERANNUATION PTY LIMITED AS TRUSTEE FOR THE RETAIL EMPLOYEES SUPERANNUATION TRUST

SUBMISSION

SUPERANNUATION ALTERNATIVE DEFAULT MODELS: PRODUCTIVITY COMMISSION ISSUES PAPER

1. Introduction

The Retail Employees Superannuation Trust (REST) is open to all Australians and is one of the largest superannuation funds by membership in Australia. It has around 1.9 million members with more than \$39bn of funds under management. In addition, REST receives contributions from over 160,000 employers, from the smallest employers in the economy to some of the largest, with widely distributed workforces.

REST was originally set up as a superannuation fund for workers in the retail and fast food industries in 1988. REST's membership comprises mainly younger retail workers with an average age of 31.5. About 22 per cent of REST members are part-time and casual workers with a majority of female workers. 97 % of REST's members are in the default REST MySuper product and this represents 85% of REST's total funds under management.

REST's long history in operating a superannuation fund and its scale in terms of members, employers and funds under management, together with its young demographic of members, high proportion of part-time and casual workers as members and high number of default members, places REST in a relatively unique position to comment on what works and would not work for default fund models.

REST's creation (as well as other industry funds) arose out of an industrial accord entitlement whereby a 3 % productivity pay increase was forgone in lieu of superannuation contributions to be made by employers for their employees. This arrangement was documented in the precursor to the modern industrial awards. In 1992, compulsory employer contributions in awards were further enhanced by the implementation of the superannuation guarantee legislation. Notwithstanding the implementation of the superannuation guarantee legislation, superannuation originated as an industrial entitlement in Awards and has been an integral part of Awards for the last 30 years. Apart from naming eligible default funds, the Awards include a number of other superannuation obligations such as the making of superannuation guarantee payments, signing up employees into the default fund, making payroll deductions for voluntary contributions of members and the frequency of making superannuation contribution payments. To take one of these aspects out of the Award, ie the named default fund provisions is contrary to the history of Awards in dealing with employee entitlements, including superannuation.

Given that over 97% of REST's members are in the default REST Super MySuper product, including those employees who are covered by the Modern Awards or Enterprise Bargaining Agreements (EBAs), the existing model is one which already uses the best elements of the proposed default fund allocation models.

The administrative model is already reflected in the Fair Work Commission's (FWC) role regarding the selection of default funds. Elements of the market based and active choice approaches are also present. For example, the proposed process for being listed as a default fund after consideration by an Expert Panel has features of the market based model and modern awards generally allow members to choose a fund if they wish. Further, market based competitive activity is extensive within funds through the selection of service providers, not least of which include the tendering of

administration and insurance providers. Trustees are also bound to meet the legislative requirements of MySuper in relation to maintaining the best interests of members and promotion of their financial interests in relation to superannuation funds.

The FWC (and its precursors) regulates superannuation in Modern Awards and for REST, this model has worked well for 28 years. As stated above, most of REST's members are default members as they are very young, often in their first job in the retail industry and often disengaged about superannuation matters given that for them, retirement is some 50 years away. With such large numbers of default members, it is important that any default selection model works well and is not inefficient, costly or confusing, both for the employees, their employers and the funds themselves. The existing system has worked well, and has put members' best interests as the key focus in its default allocation design.

REST believes that the introduction of any of the proposed models on a stand-alone basis would create major transitional issues, great uncertainty, increased costs and inefficiencies for members, employers and funds. The elements of the proposed models are already present in the current system and any development of allocation models should be incorporated into the current system rather than devising new models.

Any further changes to this existing model, as well as the existing EBA model, raise very large impacts for employers, employer representative groups, employee representatives, financial markets, the broader community and, most importantly, members.

2. Executive summary

- The best elements of each of the proposed models are already found in the current default model.
- If any of the proposed models were developed alone, without inclusion in the existing system, then the transitional issues would create uncertainty, lack of stability and be fundamentally flawed from a costs, efficiency and complexity perspective.
- The impact of the proposed models (on a stand-alone basis) on employees also do not adequately protect members' interests and increase potential risks in terms of lost benefits (e.g. insurance), reduced returns (asset allocation and active v passive management.)
- The proposed models (on a stand-alone basis) put an emphasis on a short term investment approach which is at odds with superannuation as a long term product.
- The proposed models if developed on a stand-alone basis have quite different implications, particularly if a long-term focus is taken.
- Employers would face increased compliance costs with any change of current models in relation to offering multiple default superannuation funds within their workforce.
- The proposed models would require significant change to existing legislation as well as to well-established trust law principles.
- The five criteria which the PC proposes to assess the alternative models against are too narrow and largely restricted to cost effectiveness as the main criteria.
- MySuper criteria should not be the only prudential criterion for selection of default funds. The imposition of additional criteria over and above a MySuper authorisation is notably absent from the Issues Paper. This point was reinforced by the 2012 PC report which required criteria greater than MySuper compliance as a minimum for consideration for default fund selection.
- While the terms of reference concentrate on efficiency and competitiveness, there is no recognition that benefits of competition cannot be achieved without some costs. In particular,

increasing competition may lead to increases in marketing and distribution costs, which was acknowledged by the PC in their report of 2012.

- The PC notes in its report of 2012 that, “as trustees become reluctant to increase their expenses, including investment management expenses, this could lead to a “race to the bottom” in terms of performance. The criteria proposed by the Issues Paper appear to be favouring this approach, contrary to the previous report.
- The proposed models would introduce new agency issues that mean they would be even less aligned to the interests of members than the current system.
- The current system is underpinned by trust law and legislation which impose strong obligations on the trustees of all funds acting in the best interests of members and for default funds promoting members’ financial interests.
- An over-emphasis on fees and costs being a key criterion for selection of super funds impedes optimal investment and performance outcomes. For instance an active management approach may incur more expenses however the investment returns may be higher and the net position of members, superior. For example REST’s approach has delivered excellent net returns for members and REST Super’s Core Strategy investment option (the MySuper investment option) has outperformed similar options of super funds surveyed over the last 10 years.¹
- The current system is efficient and competitive and already has a mechanism for opening it up to further competition via the FWC. There is also extensive competition outside the boundaries of the FWC including choice of fund, corporate tenders, provision of services and SMSFs. For all of the reasons above, as further detailed in this paper, the work that the PC is now undertaking should target refining and augmenting the current system rather than replacing it. This would align well with, and complement, the extensive work done and conclusions reached by the PC in 2012.

3. Process

The best elements of each of the proposed models are already found in the current default model.

For instance, Trustees are already bound to meet the legislative requirements of MySuper in relation to maintaining the best interests of members and promotion of their financial interests.

The administrative model is already reflected in the Fair Work Commission’s (FWC) role regarding the selection of default funds. Elements of the market based and active choice approaches are also present. For example, the proposed process for being listed as a default fund after consideration by an Expert Panel has features of the market based model and modern awards generally allow members to choose a fund if they wish. Further, market based competitive activity is extensive within funds through the selection of service providers, not least of which include in relation to the current use of filters regarding selection of funds by the FWC, as well as the tendering of administration and insurance providers.

Any new model should not be developed in isolation from the existing system. Rather, any new model should target refining and augmenting the existing system, not replacing it. Quite apart from the merits of the existing system, any move to a new system would, through the transition process, create uncertainty, lack of stability and be fundamentally flawed from a costs, efficiency and complexity perspective for members, employers and funds. This would all be for little or no benefit.

REST notes that if any of the models proposed were implemented in isolation and separately from the current system, then they would depart radically from the previous model where the FWC proposed the use of an expert panel to conduct reviews of the Awards to select and determine default funds having regard to prescribed criteria and allocate 2-15 funds for each Award. These funds would be drawn from a limited pool that had been approved for listing on the FWC Default Fund List as the

¹ SuperRatings Fund Crediting Rate Survey – SR 50 Balanced (60-76) Index, September 2016

outcome of Stage 1. The funds would be named on each individual Award as the only approved funds to which future default super contributions could be made for employees covered by that Award. We note that Stage 1 has now been stalled because the Government has not appointed additional members to the expert panel.

While the scope of the Terms of Reference is broader than the Terms of Reference for the 2012 PC report, the 2012 report determined a number of principles that are no less valid today and are unaffected by the broader scope. For example, the 2012 report did in fact cover a variety of possible roles for the FWC.

In the 2012 PC report the PC held that the processes once settled would not be reviewed again until 2023. We note that this has not occurred with the new default models being suggested.

4. Comparison to current requirements: REST and its Modern Awards and EBAs

The Award which covers most of REST's members is the General Retail Industry Award, 2010, whereby REST is one of five named default superannuation funds. Under this Award, employers can pay mandatory superannuation guarantee contributions to REST, or to another named superannuation fund, or a member's own choice of fund or to another super fund under the grandfathering default positions.

Accordingly, the General Retail Industry Award already offers choice beyond the named funds if a member chooses, as well as a suitable safety net as a default offering where a member does not choose. We note that the proposed models in the Issues Paper do not achieve the same balance of choice and safety net which is currently offered through the current Award arrangements which name REST.

Similarly, REST's largest employers have EBAs in place for their employees. These EBAs provide "better off" conditions than the relevant Modern Award. In some cases, the SG components specified in EBAs exceed the legislated minimum superannuation guarantee amount. Wages and other conditions of employment can also be more generous to workers than under Modern Awards.

5. MySuper should not be the only criteria

MySuper criteria should not be the only prudential criteria for selection of default funds. This point was reinforced by the 2012 PC report which proposed criteria greater than MySuper compliance as a minimum for consideration for default fund selection.

The imposition of additional criteria over and above a MySuper authorisation is notably absent from the Issues Paper. This point is important as requiring additional criteria over and above MySuper authorisation would have a material influence on the design of any new system and would tend to favour a system akin to the current system.

Superannuation funds which satisfy only the MySuper "tick the box" criteria but are not tailored to particular employees of industries must, by necessity, adopt a less relevant approach to specific memberships. These funds do not have the history of servicing the needs of a particular membership unlike the relevant industry funds, such as REST. They also do not have initial scale or may be unable to offer tailored benefits to employees of particular needs. Funds such as REST have tailored benefits, e.g. insurance and investments for our underlying demographic. Other MySuper products generally do not have such a focused approach given the diversity of their membership base and public offer status. As a result members, might not get the same targeted superannuation benefits.

6. Proposed models v existing system

There are key elements of the existing system which already use aspects of the administrative, market based and choice approach models.

For instance, the Administrative model comprises a centralised approach, whereby a Government body would decide which employees are to be placed into which products. This is already in place with the role of the FWC. Further development of this approach with the current system could be made as suggested by the 2012 PC report.

The 2012 PC report set out that the PC was commissioned to “design criteria for the selection of... default funds in Modern Awards by Fair Work Australia.” The 2012 report did in fact cover a variety of possible roles for the FWC. They included that the expert panel conduct ongoing assessments and undertake a periodic wholesale reassessment of the products listed in Modern Awards. This process was to apply at least for the medium term, given the uncertainty regarding the number, mix and quality of MySuper products offered from 2013. Also the PC recommended that the process should be reviewed in 2023 and this review should include consideration of the appropriateness of allowing employers to select any MySuper product as a default superannuation product.

A market based approach is already present in the system proposed by the PC in 2012. For example, the proposed process for being listed as a default fund after consideration by an Expert Panel has features of the market based model. Thus there is already a process in place whereby funds compete against each other. Further, market based competitive activity is extensive within funds through the selection of service providers, not least of which include the tendering of administration and insurance providers.

Active choice of superannuation funds for members) and for default funds (for employers) is also available in many Modern Awards and EBAs, so the benefits of competition are already present. The introduction of choice of fund was predicted to have significant positive impacts for members by many commentators, but the eventual take up by Australians has proved to be much lower than originally anticipated. The outcome was that employees either preferred to stay with their current super fund choices or were inactive and did not respond. Consequently the positive impacts did not eventuate or at least not even close to the degree first thought.

Recent Rice Warner research set out in their submission to the PC² showed that members who have not exercised choice of fund, ie default members, tend to have low balances, are younger and are more likely to be female and that the median balance for default members is under \$10,000. Given a majority of REST members would fit these criteria, REST notes that its membership would tend not to exercise choice, and accordingly this model may not be suitable for these members/employees.

7. Agency risk

There is the potential for significant agency issues whereby an employer may decide to choose a default fund based on other services unrelated to the provision of superannuation for its employees or offers of fee reduction by the default fund provider or the “bundling” of financial services which are attractive to the employer, rather than the member. It is also possible that they will nominate a fund based more on brand recognition unrelated to the relevance of the fund’s product and benefit design. Whilst many employers wish to do the best by their employees, this is not universal and the interests of employers and employees are not always aligned. The current system better promotes the interests of members without exacerbating this agency risk.

8. Criteria for assessing alternative models

The PC proposes to assess alternative models against five criteria. They are:

² *Superannuation Efficiency and Competitiveness*, submission to the Productivity Commission, Rice Warner, 19 September 2016, page 10.

- a) Members' best interests
- b) Competition
- c) Integrity
- d) Stability
- e) System-wide costs

8.1 REST's general comments on the proposed criteria

For all funds, the members' best interest criterion should be the overarching criterion for assessment of any model, and each of the four remaining criterion should be viewed through this lens.

In general, REST holds that the above criteria as proposed in the Government's Terms of Reference are too narrow and it is questionable whether they cover all of the criteria set down in the Terms of Reference. Further the time horizon of assessment should be encouraging a long term rather than a short term approach.

REST's considers appropriate additional criteria should include:

- Appropriateness of the investment strategy of the default investment option of the fund in terms of risk and expected return
- Medium to long term net-of-costs investment performance of the default investment option;
- Amount of fees incurred by members
- Scale of the fund and the level of services provided to fund members
- Suitability and cost of insurance provided by the fund
- Governance of the fund
- Fees incurred and other impacts on members if they cease employment with an employer.

It is also important that the criteria are linked to the expectations of the specific type of members covered by the Modern Award or EBA and the default fund's ability to structure the benefits and services which are most appropriate to those members.

While REST believes that elements of the above criteria could be used for assessing funds, the most fundamental criterion is the ability to support and reflect the needs of the underlying core demographic of default members of the relevant fund.

To achieve the best possible retirement outcomes for those default members (which in REST's case are predominantly drawn from the retail industry) requires historical observation by the relevant fund and decisions made at all levels of the fund which support that core demographic of default members and application of scale to improve outcomes over the longer term.

REST believes that, there are fundamental differences in the way in which a default fund designs and executes the benefits to be derived from each product – even though they may be outwardly designed to be comparable through MySuper.

The nature and performance of a fund's My Super product will depend, in part, on the particular demographic of the fund that they are supposed to reflect. All superannuation trustees must take this into account when designing these products or they may not deliver what they intended to do - providing a secure retirement for members, security for dependants in the event of the member's death and security for members in the event of disablement.

By definition, those funds whose default members are predominantly drawn from the industries covered by the relevant Modern Awards are most capable of meeting the key criteria. This of course does not mean that these funds might necessarily meet all of the other criteria.

As an industry fund tailored to the needs of our members, REST has already designed the investment strategies, objectives, ancillary insurance and support services of the fund to meet the needs of retail employees that has delivered:

- Excellent investment returns over the medium/long term, e.g REST Super's Core Strategy (the MySuper investment option) has outperformed similar options of super funds surveyed over the last 10 years.³
- Low fees based on the average members' account balances, e.g. according to the Chant West fee survey as at 30 June 2016, REST is ranked in the top quartile of lowest fees on balances of \$50,000 for REST Super's Core Strategy (the MySuper investment option).
- Lifestage insurance, geared to the members' demographics
- Excellent governance and compliance
- Low cost flat fee advice which is free for the first super related question
- Stability and certainty in members' expected outcomes.
- Education relevant to members
- Communicating to members through their preferred digital channels.

Industry superannuation funds are best placed to be listed as default funds in relevant Awards as they have tailored benefits to meet the employee superannuation requirements of relevant industries. The selection criteria involves parties whereby the alignment with the outcomes of members is stronger than other models.

Other funds can *duplicate* products with the use of MySuper but they cannot reproduce REST's capability and focus on retail employees, particularly for default members.

Comments on each of the suggested criteria are below:

8.2 Members' best interests:

REST holds that the Government's Terms of Reference are too narrow and departs from the previous considerations of the PC in its report of 2012. The PC held that meeting the best interests of employees is the explicit overarching objective in any criteria for the selection and ongoing assessment of superannuation products for listing as default products in Modern Awards⁴. REST agrees with this view. However, there appears to be no mention of this overarching objective in the Issues Paper. Further another recommendation of the 2012 PC report was the promotion of "transparency" where "relevant information should be made publicly available and actual, perceived or potential conflicts of interest should be declared."⁵ There also does not appear to be any mention of the value of transparency in this Issues Paper.

Further the value of advice should be added as a criterion that is in the member's best interests. The PC in its report of 2012 found that "intra-fund advice that is advice relating to a member's existing interest in the fund and products offered by the fund) is important in equipping members with the skills and knowledge to make decisions about their superannuation."⁶

8.2.1 The value of insurance

We note the 2016 PC report states that the cost of insurance held through superannuation detracts from retirement balances and ultimately retirement incomes. Further, that "policy dictates that life and total and permanent disability insurance are bundled with superannuation on an opt-out basis in default products. Given this constraint, the Commission plans to assess whether

³ SuperRatings Fund Crediting Rate Survey – SR 50 Balanced (60-76) Index, September 2016

⁴ *Default Superannuation Funds in Modern Awards*, Productivity Commission Inquiry Report, No 60, 5 October, 2012, page 8

⁵ Ibid, page 8

⁶ Ibid, page 12

trustees are offering the most appropriate insurance for their members, and whether the costs of insurance are minimised for the type and level of cover provided.”⁷ The PC states that “the bundling of group insurance with superannuation is prima facie likely to lead to allocative inefficiency. Inefficiency could result from people being provided with insurance they do not need, or going without adequate insurance under the assumption that their level of cover within superannuation is sufficient.”⁸ The PC also acknowledges that various participants consider the provision of default insurance within superannuation to be an important mechanism to address “underinsurance” in society more broadly. REST agrees with the latter view. Members receive insurance tailored to their needs that they would otherwise not purchase. Further, group insurance is the only mechanism that provides access to insurance for many workers (e.g part-time/casual). This can only be done through scale. Alternative mechanisms would lead to a higher level of underinsurance and a greater burden on the Government and taxpayers. This is discussed further below.

In the 2012 PC report the Commission recognised that employees in different occupations and different Awards have different characteristics and face varying risks, thus requiring different kinds of insurance. The PC recommended that the selection and ongoing assessment of default superannuation products for listing in Modern Awards should include consideration of the appropriateness of the MySuper product’s insurance offerings for employees who derive their default superannuation product in accordance with a given Modern Award.⁹ The 2012 PC report recognised the value of tailored insurance, rather than whether or not insurance should be offered on a group life basis at all.

Further, the value of group life insurance was recognised through the Stronger Super reforms whereby insurance was made mandatory for MySuper products, as well as allowing flexibility between different groups of members to differentiate insurance offerings. If insurance was de-linked from MySuper and superannuation in general, there would be widespread impacts for members and the Australian economy with increased health costs.

The PC’s approach to assess the value of insurance through “loss ratios”¹⁰ where the value is calculated as total claims divided by total premiums does not recognise other less quantitative measures of assessing the value of insurance. For instance, some members will never make a claim but enjoy “peace of mind” in that they have a risk mitigation strategy in place in case they are injured or become ill and cannot work. Any insurance that an individual takes out is reflective of this in that they know that they have a safety net in case they need it. This is a qualitative benefit.

ASIC also commented on the value of “loss ratios”¹¹ noting that “measures in any one year are of little interpretative value, as year-to-year measures will depend significantly on the pricing cycle, the timing of significant events, and time lags between when claims are made and premiums paid out. It may also be difficult to get consistent data and data may not be comparable across members and funds.”

REST holds the view that the provision of default insurance within superannuation is an important mechanism to address levels of “underinsurance” across the community and Australia, in general. For REST members, there is an allocative efficiency whereby the insurance needs of retail employees are tailored to those employees, including opt outs and extensive disclosure about the type and design of insurance. Further a key advantage of REST is that its members are largely from a homogenous industry. Therefore, the premium rates are priced accordingly. The large membership provides significant scale for the insurer, which results in lower premiums and higher automatic acceptance limits. This is an example of insurance providing allocative efficiencies according to the market segmentation of retail industry employees under the current

⁷ *How to Assess the Competitiveness and Efficiency of the Superannuation System*, Productivity Commission Draft Report, August, 2016, page 8.

⁸ *Ibid*, page 69.

⁹ *How to assess the Competitiveness and Efficiency of the Superannuation System*, Productivity Commission Draft Report, August, 2016, page 151.

¹⁰ *Ibid*, page 151

¹¹ *Life Insurance Claims: An industry review*, ASIC, October 2016, page 8.

system.

Market segmentation of insurance can also occur for not for profit funds. Those profit to member funds with group life insurance typically address the underinsurance of Australians, providing it at a lower cost than insurance offered outside of superannuation. Further those persons who would not be able to obtain insurance because of their low incomes can obtain cover provided on a group basis rather than being individually underwritten. It is also important to note the availability of cover. One defining feature of REST's current insurance offering is that default and voluntary insurance cover is provided for both part time and casual members for death, TPD and income protection cover which our members may not obtain elsewhere.

De-linking insurance from superannuation would result in the Australian health system taking a heavier burden of paying for those uninsured members. Even if insurance was not de-linked from superannuation, there would be impacts upon REST members if any of the alternate models were implemented. REST operates one of the largest insurance pools in the southern hemisphere. As a result, REST is able to offer cheaper insurance because of the benefits of scale. Larger membership groups provide larger pools which provide actuaries with higher certainty of the outcome of total claims. This yields lower risk premiums. The administration of group life plans also benefits from scale because it, too, has a large fixed cost component. The administration component of premium rates will therefore also fall with increasing membership, or rise with decreasing membership. Premium rates therefore reduce with scale, all other things being equal. However, any changes to the current model will cause a reduced membership which will erode this pool and could potentially affect REST's future experience. This will impact on the remaining members in terms of premium rates, cover and ancillary benefits.

8.2.2 The value of innovation

The current system is encouraging innovation and this has a key role in achieving efficiencies. REST notes that the role and effects of innovation in terms of achieving efficiencies should be more prevalent in the proposed framework.

Innovation can include improvements in services and in the modes of delivery of products and services. One perspective would be to capture innovation as a source of competition, and the value and benefit of innovation to members.

Dynamic efficiency occurs when innovation and technological change increase the overall benefits that could be achieved in a competitive and efficient system. This can mean:

- **Better forms of product distribution via digital delivery:**

Despite regulatory constraints, there have been recent changes by ASIC (RG 221 *Facilitating Digital Financial Services Disclosures*, issued 29 March, 2016) in relation to product disclosure innovation by facilitating default digital delivery of financial services disclosure and by removing barriers and encouraging the use of innovative Product Disclosure Statements, Financial Services Guides and Statements of Advice.

Allowing for a more efficient, digital form of distribution also takes away regulatory blockages from the regime operating efficiently where members can now choose the most appropriate, effective and efficient method of communication.

These new regulatory settings have achieved for super (and other financial products) cheaper, more efficient digital disclosure and messaging, and reduced market inefficiencies in the form of postal costs and preparation of paper documents (which may reach millions of dollars depending on the number of members who need to be sent superannuation disclosure material by post).

The removal of these barriers by ASIC also provided incentives for superannuation product providers to develop more innovative disclosure that is cheaper and better able

to meet member's expectations. In particular, where a superannuation fund has a majority of young members, using digital distribution methods achieves a dynamic efficiency where funds are communicating to members in a way that they prefer and are much more likely to become more engaged. This is a particular challenge for superannuation as younger members are characteristically "disengaged" given that their retirement is decades away. REST has recently launched digital periodic statements which are sent to members via SMS and email. This has resulted in lower costs in terms of distribution of the statements as well as increased engagement with members.

Greater innovation in superannuation products, including interactive web-based disclosures, applications, videos, games and audio presentations in disclosure leads to better quality communication to members.

- **Better product development**

Innovations such as "apps" or applications whereby members can check their superannuation balances on their mobiles as well as other transactions, test very favourably with these younger members. It leads to dynamic efficiencies of increasing member satisfaction and trust with super, presenting information that is more likely to be acted upon, as opposed to non-digital approaches which may not achieve the same engagement and is more costly. Information that is in a form that is able to be acted upon by members is much more efficient in terms of achieving a fund's objectives of communicating with members about their own superannuation.

Innovative products such as mobile applications offering electronic retirement calculators, ability to make electronic contributions, showing insurance details in the application all add to the application operating as a "one stop shop" for superannuation, increasing efficiencies through member self-service. Similar efficiencies are achieved with on-line joining and transactions which many super funds now offer.

- **Better member engagement**

While innovative products can achieve better member engagement, other tools such as robo-advice can enhance this engagement. Many super funds now enable fund members to access digital advice through the fund's website. Some funds have found that offering advice through different channels achieves a greater engagement with members which assists them with an improved retirement outcome.

- **Better administration**

From a fund perspective, robo-advice and self-administration processes also create back office efficiencies which reduces the need for manual processes and increases data speed. Funds are also able to use their scale so that the large funds, with their national presence, can provide affordable access to quality financial advice.

Cloud computing also allows funds and their administrators and other service providers to store, process and access data more efficiently. Some super funds are able to house servers located overseas which offers a cheaper solution to administration, subject to the fund being able to ensure that the cloud provider complies with the regulatory requirements regarding cloud computing.

8.3 Competition

While the terms of reference concentrate on efficiency and competitiveness, there is no recognition that benefits of competition cannot be achieved without some costs. In particular, increasing competition may lead to increases in marketing and distribution costs, which was acknowledged by the PC in their report of 2012.

The PC refers to cost reduction as fostering competition between funds. However focus on costs alone

does not address the context of value and benefits to members. While the intention of the PC is to introduce competition and efficiency, the proposed models would introduce new costs when compared to the previous distribution method and these costs would outweigh the benefits.

In addition, choice of superannuation funds (for members) and for default funds (for employers) is still available in many Modern Awards, so the benefits of competition are already present.

The proposed allocative models do not deliver any advantages perceived to be delivered by competition and in fact create further uncertainty and ineffective default selection, particularly if financial literacy is low and advice is not available. The sign of an efficient default fund selection process takes into account these matters, so that the outcome of a good retirement is possible.

As discussed in our innovation section, innovation is also a source of competition. Improvements and innovation in services, particularly digital innovations increase efficiencies in terms of delivery of products and services.

8.3.1 Extensive existing competition

There is also extensive competition outside the boundaries of the above including corporate tenders, the provision of services to funds and SMSFs. Annually the value of corporate tenders comprise 2-3% of the estimated \$215bn corporate fund market (including retail employer master trusts, standalone corporate plans and industry fund corporate segments). SMSFs are over a quarter of the overall funds under management market and growing.

8.3.2 “Race to the Bottom”

The PC notes in its report of 2012 that, “as trustees become reluctant to increase their expenses, including investment management expenses, this could lead to a “race to the bottom” in terms of performance. The criteria proposed by the Issues Paper appears to be favouring this approach, contrary to the previous report.

Any over emphasis on fees and costs being a key criterion for selection of super funds to increase competition also impedes optimal investment and performance outcomes. For instance, an active management approach may incur more expenses but the investment returns tend to be higher’ which benefits members. REST has an active investment management approach whereby we seek to capture market opportunities and manage downside risk. For all investment options, this involves regularly reviewing the exposures to major sectors and markets within asset classes and appointing active investment managers to manage the underlying investments where we believe the expected benefits exceed the costs of active management. This approach has delivered excellent net returns for members and REST Super’s Core Strategy investment option (the MySuper investment option) has outperformed similar options of super funds surveyed over the last 10 years.¹²

Any over emphasis on lower investment management costs favours a short term investment philosophy requiring greater liquidity requirements and the adoption of a cheaper passive indexing strategy with the prospect of lower returns. It is likely that in circumstances where the risks of a loss of members and assets and/or lower future cash flows were higher, funds would potentially be more reluctant to allocate capital to investments that are less liquid and/or require a long investment time frame. Lower allocations by funds to these sectors, a risk most pronounced with respect to unlisted assets, could have a detrimental impact on business costs, productivity and innovation and therefore employment and growth in the Australian economy as more costly capital is required to be sourced off-shore or via less traditional avenues. Further, if funds are less certain about the stability of their membership size, assets and future growth, there may be an unwillingness to allocate to the listed equity market, and in particular to the mid and small cap sectors where there is less liquidity. This in

¹² SuperRatings Fund Crediting Rate Survey – SR 50 Balanced (60-76) Index, September 2016

turn could place upward pressure on the cost of capital of Australian listed companies, thereby reducing business investment, employment and growth. It also creates a mismatch in the investment horizon and the longer-term nature of a member's superannuation, detrimentally impacting member benefits with lower net investment returns.

8.4 Integrity

The PC defines this criterion as, "Minimising the scope for the allocation process to be manipulated (or "gamed")." However, the PC should acknowledge and take into account the current strict governance arrangements already in place for superannuation trustees and funds. For instance, superannuation trustees are bound by the general law and extensive regulatory requirements, including trust law, superannuation law, APRA prudential standards and guides and their internal policies and processes which prescribe good governance. Managing conflicts of interest, in particular is a matter which is key to superannuation trustees and funds.

Governance requirements already prescribe that trustees exercise care, skill and diligence, prohibitions on related party transactions, accountability and reporting to members and putting members' best interests at the forefront of considerations.

These considerations were also recognised in the PC's 2012 report¹³ when the PC said that "default superannuation arrangements are subject to significant principal-agent relationships. The role of governance arrangements is to limit the ability of agents to act in a manner contrary to the interests of the principals, to ensure the interests of the principals override other interests, and to promote overall transparency and confidence in the compulsory superannuation system."

REST holds that existing laws, trust law and regulatory requirements are already in place to regulate any conflicts of interests arising which should include regulation of 'gaming'.

8.5 Stability

To ensure a stable superannuation system, the criteria must take into account the needs of default members, employers as well as the community. Default members require low cost, simple products which deliver stable returns and are tailored to their particular needs and expectations. For employers, they require certainty, efficiency, administrative ease and not being required to act as "defacto trustee" by choosing a suitable default fund, which may not be in their employees' best interests.

REST believes that the current system is a stable system in that it promotes certainty and trust from the community. REST also knows from experience that the community has a low tolerance for any changes to superannuation laws. Our observation is that there tends to be a decrease in voluntary contributions to the fund upon each new legislative development impacting superannuation. This decrease is a sign from our members that their levels of trust, participation and engagement have declined given the uncertainty of the application of new developments.

For the community, as discussed, the impact of superannuation investments for the long term in capital/debt markets and infrastructure projects generally have flow on effects to the community in terms of new capital works and projects that provide benefits to all members of society, as well as being able to support broad community initiatives such as financial literacy programs and low cost accessible financial advice.

8.6 System-wide costs

The proposed allocation models on a stand-alone basis have the potential to increase the costs of providing the superannuation services by reduction of scale. If membership was to decrease, operating expenses would rise. Members remaining in the fund would need to bear these additional

¹³ *Default Superannuation Funds in Modern Awards*, Productivity Commission Inquiry Report, No 60, 5 October, 2012, page 92

costs. Scale impacts include potentially higher fees for members leaving for another fund and changes to insurance.

A reduction in a fund's membership would erode the fund's insurance pool. REST operates one of the largest insurance pools in the southern hemisphere. A reduced membership would erode this pool and could potentially affect REST's future competitiveness. This would impact on the remaining members in terms of premium rates, cover and ancillary benefits and could potentially affect the fund's future competitiveness. A member leaving the fund may experience reduced or ineligible insurance benefits under another fund. If an allocated default fund was to lose its default status, the members might be required to change funds which would result in a loss of an existing insurance benefit. As discussed previously, if this cover was not offered through superannuation, these members would not be able to get cover anywhere else or at least at an affordable price. This places a heavier burden on the government to provide uninsured medical services which has cost impacts upon the community and health system.

The loss of default status for a fund would also lead to employee and employer confusion as well as additional costs for funds, members and employers.

8.6.1 Issues for employers in relation to choosing default funds

For employers, the transitional issues arising from changes of a default fund would introduce more "red tape" for them and the requirements to direct their energies not just to their business but spend considerable effort from their human resources and finance teams to make sure appropriate default fund arrangements are in place for their employees.

The difficulties of a system where employers select an individual product from a long list is that despite innovations in the industry in regard to clearing houses, there are higher costs in terms of time and money spent in administration of a process which previously was unnecessary. For this reason, most employers offer a single default fund. Major retail employers have flagged that changes to the default fund selection would cause substantial inconvenience, be it the need for system configuration or the distribution of disclosure material to employees and associated material to all work locations, as well as liaising with additional parties for contribution reconciliations and insurance claims. This has flow on implications to the benefits of members and efficiency. There is:

- Less engagement, support and education of employees. An employer may have multiple default employees who get quite different outcomes (because of different default funds) despite being otherwise quite similar. The employer is less likely to support education and support services from each and every super provider. From a super fund point of view, there will be the loss of scale at a workplace meaning it is more costly to service and potentially uneconomic,
- Slowing down of insurance claims processing times from an employer having to deal with multiple benefit designs, providers and different claims processes. There is considerable work to be done to address efficiency in the insurance market while acknowledging that the Australian group insurance system is one of the most efficient globally.

Ultimately, employers would prefer to leave the responsibility for selecting default superannuation funds to those for whom it is core business. If this were to change, employers would need to make a choice of default fund which would provide them with an onerous and potentially challengeable duty of care to select the appropriate fund.

Employers are not necessarily qualified to make such decisions and it is possible that many employers would select a fund which is not geared to their employees' expectations – to the detriment of their employees. REST believes that employers would not want to be in the position where the selected funds are not tailored to the relevant demographics of the industry their employees work in. These employers may also find themselves acting as "defacto advisers" whereby they must choose the default fund and then be possibly challenged for their choices by their employees. If the fund is subsequently shown to be not suitable for their employees, then this may create disharmony in the workplace.

If the employer is in the retail sector and does not choose REST, it may still have a significant number of employees using REST. We expect many will already be members of REST when they began their careers and they will not perceive a need to change just because the new employer has a different default fund. Ultimately, a new system could result in employers having multiple default funds for its workforce. This could result in potentially significant variations in member insurance coverage, costs and fee levels, as well as investment risk and return strategies and outcomes within the same workforce and over numerous workplaces. Differing insurance offerings for employees with the same employer would put a “moral hazard” decision making process on the employer who would be at risk of not making the appropriate default fund choice in relation to death, TPD and IP insurance.