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To whom it may concern

Productivity Commission Draft Report: Superannuation Alternative Default Models

As one of Australia's leading professional services firms, we believe we are well placed to share our perspectives on the important issue of superannuation. Our firm's national superannuation practice has deep experience in the superannuation industry and across the financial services sector more broadly. We are committed to positively contributing to the Australian community and supporting and enabling initiatives such as your report that will strengthen the future prosperity of our country.

We believe the paper offers a comprehensive series of alternative default models which have been well thought through and in particular, the risks of each model have been clearly outlined and where possible, mitigated.

In particular, we agree that:

- New employees should be defaulted once only in their lifetime on commencing work and from then on they should exercise choice whenever appropriate. This will greatly reduce the number of unintended multiple accounts over time and encourage member engagement.
- There should be no impact on all existing default members, that is, the new arrangements should only apply to new employees entering the workforce, which is estimated at around 400,000 per year with around \$800 million in annual contributions.
- There should be some form of quality filter applied to any superannuation fund able to be considered a default product, where this quality filter is over and above the MySuper licence requirements.

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- Of the four default models:
 - We should work towards having the assisted employee choice model as the preferred solution in the longer term but in the shorter term we accept that new employees would find this decision difficult given the complexity of comparing superannuation products. Constant changes to superannuation rules have increased the perceived complexity of superannuation for many.
 - In the shorter term, our preferred model is the assisted employer choice model. This approach is very similar to the current arrangements, except that there will be a quality filter over the superannuation products that could form part of both the long and short list of default products.
- In our view the multi-criteria tender and fee-based auction models with sequential allocation of default members would be the least preferred models. Under both these arrangements:
 - There would be no scope for new employees to go into specific niche superannuation funds highly targeted to specific industries
 - It may be difficult in practice to avoid the tender/auction becoming a lowest cost exercise which ultimately could lead to sub-optimal investments and/or services
 - We would expect participating funds to dedicate significant resources to the tendering process which at some stage is likely to increase costs to members
 - This would be giving the selected products considerable credibility in the eyes of the public over any other superannuation funds, and this may result in less competition and higher barriers to entry for other superannuation funds
 - Given the importance of the tender/auction process, this may significantly increase the risk for the government of the day to exert influence on the selection of default products through the appointment of the expert group
 - This may also significantly increase the responsibility for the Government should one of these carefully selected funds fail or deliver sub-optimal investment returns.
- In regards to other proposals, we agree that:
 - An assessment every 4 years is reasonable, but if a fund falls out of the short list in the meantime, they do not have to transfer defaulted members (except if breach contract terms)
 - Fees in default fund should apply to all default members so the benefits are pushed through to all members
 - Primary competition should be on net investment returns and costs for a threshold level of services
 - There should be a government-run centralised online information service, with universal participation by employees and employers, to facilitate more efficient allocation of default members to products.

Other areas we offer further comments on are as follows:

- Decision making expert group
- Centralised clearing house
- Participation in competitive process (information request 3.1)
- Proposed merger proposals (information request 3.2)
- Comparative information requirements for assisted employee choice (information request 5.1)
- Last resort fund for assisted employee choice (information request 5.1)
- Bait and switch risks (information request 5.1)
- Assessment criteria and member services (information request 7.1)
- Employer assisted model and costs (information request 8.1).

Decision making expert group

In all models, it is envisaged that there would be an independent expert group appointed by the government to determine the shortlist of products for Models 1 and 2 and the results of the multi-criteria tender and fee-based auction for Models 3 and 4.

There is the risk that the government of the day could exert influence on the selection of the expert group.

Some suggestions to help mitigate this risk are as follows:

- We agree that this group should be independent of the regulators, however the Australian Government Actuary could be tasked with providing this group with the technical, evidenced based analysis required to inform their decision making
- We also believe that holding this group publicly accountable for their decisions would help mitigate this risk. The results of the decision making process should be made public following the selection and we see no commercial reasons why a summary of the assessment against all key criteria could not be made public.

Centralised clearing house

It would be good to understand more about the role you envisage for a centralised clearing house. Do you envisage more than the basic clearing house function where employers remit all superannuation contributions directly to the clearing house, with the clearing house's only role being to get these contributions transferred into the relevant superannuation funds? If so, we would like to better understand how this interacts with a superannuation fund's existing administration functions and the significant work and costs incurred to date on SuperStream to achieve straight through processing of contributions (from employers to superannuation funds) and rollovers (between superannuation funds).

Participation in competitive process (information request 3.1)

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

In our view, niche industry funds and corporate funds would still choose to participate in the longer lists for employee and employer choice Models 1 and 2 but not the short list for these models or the market based assessments for Models 3 and 4, given they are not intended for widespread public membership.

We do not believe that the potentially limited size of the first-timer pool of default members (being around #400,000 per year) would discourage capable superannuation funds from being part of the competitive process, given the very significant competitive and marketing advantage that would be gained from being a short listed fund under any Model.

Proposed merger proposals (information request 3.2)

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

We agree with the objective of these proposals, which is to achieve more mergers in order to more quickly reduce the large tail of non-performing, unsustainable superannuation funds. However, we believe that there may be a better way of achieving this objective.

In our experience in this and other similar industries, there is a significant amount of informal discussions and internal work that is undertaken behind the scenes in assessing a range of potential merge candidates long before any parties enter into a more formal undertaking, such as agreeing a memorandum of understanding (MOU) with a selected fund. At the point of entering into a MOU, members and APRA would be advised and the detailed due diligence would commence.

This preliminary informal work is required to better understand the potential strategic, cultural and operational fit and therefore whether the significant costs and time involved in undertaking a detailed due diligence are worth incurring.

In our view, forcing trustees to disclose the nature of all these early and informal discussions would be counterproductive in that they would likely result in an avoidance of undertaking these important early informal discussions by Trustees.

Instead, we suggest that APRA should play a far more significant and important role in encouraging mergers through:

- Greater accountability for ensuring that non-performing unsustainable superannuation funds are merging
- Greater guidance on the management of key conflicts in relation to mergers
- Greater disclosure where planned mergers do not proceed.

APRA already has a mechanism in place, being the scale test, which is intended to encourage mergers where superannuation funds are not meeting members' interests. The success or otherwise of this mechanism should be assessed on a regular basis and changes made to it as required.

APRA could also provide greater guidance on how to manage conflicts of interest which can arise during mergers for example, by encouraging the selection of the merged entity CEO and Board positions to be held off until after the due diligence has been completed and merger agreed to.

In addition, following an MOU and public announcement of a planned merger, APRA should be required to be kept informed of the outcomes of the due diligence and if the merger is not going to proceed, APRA should be informed of the key reasons why this is the case.

Comparative information requirements for assisted employee choice (information request 5.1)

What specific information should be included alongside such a shortlist to help employees to choose between products?

Others specialist such as communication consultants may be better placed to answer this question, but we note that the MySuper Dashboard has considerably improved the ability to easily compare superannuation funds on key metrics. A continuation of this style of short-form and simple dashboard style reporting should be considered.

Last resort fund for assisted employee choice (information request 5.1)

What institutional arrangements would best suit a last-resort fund? Should it be managed by existing eligible rollover funds or the Future Fund?

We agree that a last resort fund is required for this model in the event that a new employee does not make a choice in time for their employer to remit SG contributions.

However, it would be essential that this was a simple, low cost product mandated to encourage people to transfer into an actively selected more suitable superannuation fund.

So essentially, this fund would be a temporary holding account only with clear direction “to do themselves out of a job” by reminding and encouraging its members to roll over as soon as possible into another fund that better suits their needs.

In our view, this mandate would be more easily met if the last resort product was run by a government agency. It would be difficult for a private sector to operate a fund which meets these objectives due to commercial considerations. For this reason, we believe that a private sector ERF is unsuitable.

There are two major functions required to operate any superannuation product, namely administration and investment. As the Future Fund is solely focussed on investments and does not have any experience or systems for superannuation administration we believe they would not be suited to administer this product. Instead, we would suggest either:

- A product administered by the ATO, possibly with the investment function undertaken by the Future Fund if required, or
- A product administered by an existing superannuation government agency, with the investment function done by either themselves or by the Future Fund.

Bait and switch risks (information request 5.1)

Under a system of active employee choice, what would be the costs and benefits of prohibiting funds or related parties from offering prospective members a short-term benefit that is unrelated to the superannuation product? What specific form should any such prohibitions take?

All of the proposed models have their risks and these are well discussed in the report, particularly, the risks of member inducement under Model 1, the principal-agent risks under Model 2 as well as the risks of higher marketing costs under both options and the risks of lowest cost, not necessarily better investments under Models 3 and 4.

One other potential risk is the risk of bait and switch.

We would expect that any provider offering a default product would also have other choice products. It is possible that a provider could be very successful at designing a low cost default product but then expend significant effort, inducements and/or pressure in moving people into the more expensive choice products. They alone would have the contact details for all members in the default product and could easily target these members.

It is difficult to know how this could be limited through specific controls on inducements but we feel this should be considered. We also note that the FOFA best interest test has some relevance here but whether this is in itself sufficient should be considered.

In addition, you may also want to require regular reporting by these providers on movements from the default into related provider products.

Assessment criteria and Member services (information request 7.1)

We agree with the key assessment criteria put forward being:

- Past performance on net returns and independent surveys of member satisfaction
- Investment strategy and governance
- The quality of member services, engagement and advice
- Fee levels and transparency
- Innovation in other areas.

We would also suggest that governance and risk management frameworks be added for consideration.

Which aspects of member services should be included in the tender criteria?

We agree that the key services to be included should be the basic services required for investment, administration of member accounts and intra-fund advice, which would incorporate information on the superannuation system and general financial advice (for example, online calculators and guides on managing transition risk prior to retirement) as outlined on pages 78 and 79.

Are there problems with sequentially allocating members into products with different investment strategies, fees and services, as is implied by this model?

Not that we can see.

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

We see no commercial reasons why the information provided for an assessment against all key criteria should not be publicly available.

Employer assisted model and costs (information request 8.1)

Which types of employers prefer to retain a role in default product selection? To what extent are default products or corporate fund offerings considered important benefits offered to prospective employees in competitive labour markets?

Larger employers often have their own corporate superannuation scheme as these are specifically designed with their employee needs in mind, for example around appropriate insurance covers. When employers have their own superannuation funds it is because they believe there are additional benefits from having these funds for employees in a competitive labour market.

What are the main drivers of costs to employers in selecting default products on behalf of their employees? Would a shortlist of preferred default products make this task easier for employers?

For employers who do not have their own superannuation arrangement, the main cost is the process of selecting a suitable fund for their employees as this would typically involve external consultants, especially where there may be niche requirements for example, employers in mining or health sectors.

Would a dual-list approach, allowing employers to select a product from one of two lists, provide them with sufficient flexibility to select tailored default products that best meet the needs of their employees?

Yes.

Having a long list for the employer assisted Model 2 enables large employers to have their own corporate superannuation fund or the relevant industry fund on the list from which they can then choose as their default.

Having a short list enables smaller employers to select a fund which would be a “good” fund without having to incur any additional selection related costs.

Conclusion

In conclusion, we congratulate you on a well-considered and comprehensive approach to this review which is reflected in this Draft Report.

Even if these models are never adopted, we believe that as a result of this review there are three key changes that should be enacted regardless and these are:

- New employees should only ever be defaulted once in their lifetime on commencing work to reduce the number of unintended multiple accounts over time and encourage member engagement



- There should be some form of quality filter applied to any superannuation fund able to be considered a default product, whether the current Fair Work based approach is retained or any other model adopted
- APRA should play a far more significant role in ensuring non-performing unsustainable superannuation funds are successfully merged into other superannuation funds.

We understand that the third stage of reviewing the efficiency and competitiveness of the superannuation system, which is due to commence July 2017, will be an important input into the determination of not just the final model but also the key criteria on which products should be judged

We would welcome the opportunity to participate in any further workshops or consultative meetings to further discuss our views. Please contact me

Kind regards

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