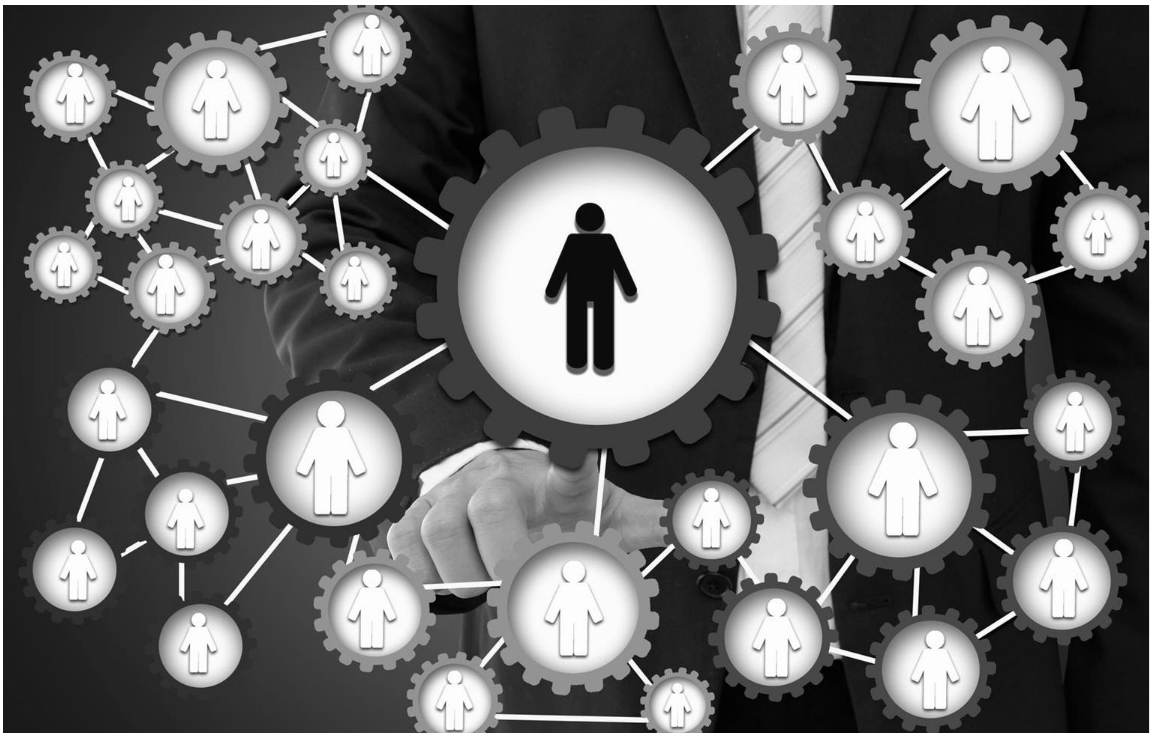
Superannuation: Alternative Default Models



Submission to the Productivity Commission

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This report has been prepared in response to a call for submissions from the Productivity Commission.

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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

The Productivity Commission ('Commission') has been asked to examine alternative models for a formal competitive process for allocating default members to superannuation products. Further, it will develop a workable model that could be implemented to replace the current default model.

The Commission has listed some Principles for designing a model, namely:

- **Best interests for members**, particularly by encouraging long-term investing and having a focus on expected after-tax returns net of fees.
- **Competition:**
  - Pressuring funds to be efficient.
  - Diversifying asset allocation.
  - Optimising long-term after-fee returns.
  - Facilitating new superannuation fund entrants to the market.
- **Feasibility** by ensuring the process is low-cost and easy to administer while minimising regulatory costs on industry.
- **Credibility and transparency** by making relevant information public, avoiding room for gaming the system and ensuring metrics are clear, simple, difficult to dispute and difficult to manipulate.
- **Regular assessment and accountability** by regularly reviewing the suitability of funds to continue to receive default members.
- **Fiscal implications** of the system in holding risks/costs for government including future Age Pension outlays.

1.3 Focus of this submission

In this submission, we argue that the structure of the current system can be improved, but that much of it does not need to be replaced. It would be far more productive to make some material changes to improve our superannuation structure to meet the Commission's objectives rather than replacing it completely with another system. A completely new system would carry significant risks both of transition and of destroying consumer confidence.

There are many impediments to making the current system efficient and we suggest ways to remove some of them.

Some of the inefficiencies are:

- Young people are unengaged and many don't get value from their superannuation. Their life insurance may also be of little value to many of them. Lack of engagement means younger members are especially likely to remain in the default investment and insurance options of their default fund, even if their specific needs would be better served by selecting different options.
- There are too many superannuation funds which provide similar MySuper products with little differentiation; many are ***relatively*** inefficient.
- There is no mechanism for identifying and then winding up an inefficient fund.
- There are too many superannuation accounts.
- Too many Australians are restricted from accessing Choice due to awards and Enterprise Bargaining Agreements (EBAs).
- Some funds have poor investment strategies.

1.4 Recommendations

1.4.1 Young People

We consider that, from a determined date, say July 2017, the SG contributions for all Australians under age 25, who are obtaining superannuation for the first time, should be placed with the ATO for record-keeping (or an appropriate entity selected by a tender process) and the contributions should be invested with the Future Fund (or an alternate investment process).

There would be no insurance on these accounts.

Members who want to choose a superannuation fund can opt out at any time and have their accumulated contributions rolled into that fund.

At age 25, members would choose a fund or have their benefit transferred to their employer's default fund.

1.4.2 Fund Mergers

Improved mechanisms are needed to encourage funds to merge where this is in the best interests of members. We recommend that these include:

- Establishing a consistent framework for funds to approach other funds with merger proposals.
- Formal requirements to consider whether merger proposals are in the best interests of members.
- Requiring that a Board notify APRA and its members when an approach for a merger is received and rejected. The notification should include details of the approach and the reasons for the rejection.
- Empowering members to vote on merger proposals.

1.5 Rice Warner Consultants

This report was prepared and peer reviewed for the Productivity Commission by the following consultants.

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14 November 2016

2. Structure of Australian system

2.1 Structure

The structure of Australian superannuation is often described as a three-pillar system. The pillars are:

- A means-tested Age Pension which currently provides about 28.9% of average weekly earnings to a single pensioner and about 43.6% to a married retiree couple.
- A mandatory 9.5% of wages (which is scheduled to increase gradually to 12% by 2025) usually allocated to a defined contribution plan.
- Voluntary contributions which are subject to Budgetary changes from time to time. The limits applying from July 2017 (subject to the final stages of the legislation process) are:
  - pre-tax up to $25,000 a year for those aged less than 65 (inclusive of the mandatory 9.5% of wages)
  - post tax, up to $100,000 a year for those aged less than 65 who have total superannuation less than $1.6 million.

2.2 MySuper funds

All employers must pay Superannuation Guarantee contributions for their employees into a MySuper default fund. Those employees who have Choice may elect a different fund.

In selecting a default fund, most employers are bound by Industrial Awards or EBAs. Many of these arrangements are restrictive and that has allowed many funds to grow large through distribution monopolies, giving them a guaranteed flow of default members and their contributions.

One advantage of the current system is that several large funds have been able to invest long-term based on solid cash flows. They have also been able to keep fees down through low distribution costs. However, there is no mechanism for replacing them were they to be inefficient.

2.3 Choice

All members can choose different investment strategies within a fund and they can all choose any fund for a pension when they retire.

About 80% of employees are also able to choose their own fund. This could be any regulated superannuation entity or an SMSF.

2.4 Size of market

Although the number of superannuation funds has dropped considerably in the last 20 years, most commentators consider that there are still too many. The large number of funds has not led to significant diversity of products and the small size of many funds is inefficient. For example, there are about 125 funds that are less than $1 billion in size. We note that some large funds are also inefficient as a result of charging excessive fees or having a poor investment process.

There is no method for culling inefficient funds, even when it is clear that it would be in the members' best interests. If such a mechanism could be set up, the existing system would be improved dramatically.

3. Young People

3.1 Issues

Almost all young people are unengaged and have little interest in their superannuation. The value of their superannuation is often eroded through:

- Holding multiple accounts as they tend not to consolidate their super when they change jobs.
- Having high fees relative to their small account balances.
- Paying premiums for life insurance which is excessive relative to their needs at the time.

3.2 Multiple Accounts

As soon as someone enters the workforce, they will be placed into a superannuation fund by their first employer. They become default members and most will stay like that until they change jobs. At that stage, they need to make a decision between using the nominated default fund of their new employer, staying with their existing fund or choosing another fund. Often, they change funds to the default fund of the new employer but do not consolidate accounts.

Table 1 shows the number of pre-retirement members under 25 relative to the rest of the pre-retirees.

Table 1. Number of pre-retirement members by age and gender ('000)

Age group	Members			Accounts			Estimated average accounts per member
	Male	Female	Total	Male	Female	Total	
15 - 19	459	481	940	525	542	1,067	1.14
20 - 24	833	759	1,592	1,426	1,326	2,752	1.73
25 - 29	955	825	1,780	1,911	1,758	3,669	2.06
30 - 34	970	806	1,776	1,910	1,736	3,646	2.05
35 - 39	866	730	1,596	1,883	1,749	3,632	2.28
40 - 44	887	787	1,674	1,677	1,589	3,266	1.95
45 - 49	818	759	1,577	1,489	1,440	2,929	1.86
50 - 54	808	757	1,565	1,338	1,299	2,637	1.68
55 - 59	730	667	1,397	1,076	1,028	2,104	1.51
60 - 64	543	444	987	709	645	1,354	1.37
Total	**7,869**	**7,015**	**14,884**	**13,944**	**13,112**	**27,056**	**1.82**

Source: Rice Warner Superannuation Market Projections Report 2015

It can be seen that young people hold far too many accounts. While a few may be held deliberately (to diversify between investment options and/or increase insurance cover) the large majority of the 1.3 million excess accounts held by those under age 25 are wasteful.

Poor behaviour by young people continues as they move through more jobs. Multiple accounts grow further between ages 15 and 40 until more of the population becomes engaged.

The position has improved since the ATO began to collect 'lost accounts'. From January 2017, lost accounts up to $6,000 in value will be transferred to the ATO. These accounts pay a nominal interest (CPI) so they are not very effective as a long-term savings mechanism.

In practice, the lost accounts held by the ATO are not invested but the money goes into consolidated revenue as income. The projected impact is shown in Table 2.

Table 2. Projected impact of ATO Lost Super Rules (includes over 25s)

Year	Assets transferred to ATO ($M)	Accounts transferred to ATO ('000)
2015-16	188.2	1,059
2016-17	279.0	918

Source: Rice Warner Superannuation Market Projections Report 2015

3.3 Fees

Young people are starting their careers so they don't have a lot of superannuation. Consequently, the fees they pay are relatively large. This is exacerbated if they work part-time (and have lower levels of contribution), and have high levels of insurance cover and multiple accounts. Many will not have high balances by the time they are age 25.

The total administration fees paid by those under age 25 is more than $400 million a year and it is questionable whether, as a cohort, they achieve value for money.

3.4 Life insurance

Young people pay life insurance premiums of about $175 million a year. The majority of those who die under age 25 do so without dependants – anecdotally, the usual beneficiaries are the members' mothers. When this happens, there is a tax of 15% on the benefit. The combination of the original tax on concessional contributions plus the tax on the benefit means the benefit is not efficient.

Based on the measured incidence rate of claims in our *Group Claims Experience Study 2015* and number of members in our *Superannuation Market Projections Report 2015* we would expect the following number of claims for under 25s as set out in Table 3 (these are indicative only and actual claims may vary).

Our *Super Insights* statistics show an average Death and TPD sum insured would be $140,000. Note that not all funds offer default income protection cover – so the actual number of claims will be lower than in Table 3. Where cover is provided the typical sum insured would be 75% of salary for a benefit period of two years.

Table 3. Expected number of claims for under 25s – year to June 2016

Type	Expected No of Claims
Death	706
TPD	181
Income Protection	5,667

3.5 Better structure for young members

We know that almost all young people have little interest in retirement. There are too many immediate issues for them to consider, including budgeting to spend less than they earn. Consequently, is there a better way of holding their superannuation until they are ready to engage and participate actively?

One option would be for the ATO to collect all the contributions for young people (say, those under age 25). Alternately, the administration could be tendered to a private-sector entity. These could be invested in bulk by an entity such as the Future Fund. An advantage is that there would be a single account for all members irrespective of the number of employers they have.

The contributions could be invested in a growth portfolio to give higher returns than rather than simply receiving a CPI return.

There would be no insurance benefits under this arrangement.

We consider that any young employee should be allowed to opt out of this arrangement at any time and join their employer's default fund or choose a fund of their own. However, we would expect that few would do this unless they had dependants and wanted insurance cover.

At age 25, employees would be asked to select a fund for their future contributions. If they did not make an election, they would be placed in their employer's default fund as a new member. A small number would not have employment and their benefit would be retained until they opted out or found employment.

This new structure might appear to harm some funds which attract a large number of young members. This includes HOSTPLUS which operates in the hospitality industry and REST which operates in the retail industry. However, there is large turnover of these young members and holding large numbers of small accounts from unengaged members is not efficient for fund, administrator and member alike. These funds and others which attract young members would still gain engaged members under Choice and be allocated large numbers of members when they turn age 25.

4. Consolidation

4.1 Is size important?

Size is important for MySuper. It is clear that the largest funds have significant advantages over small funds, including but not limited to:

- Lower fees for members due to the benefits of scale.
- Better governance structures.
- Access to unlisted investment opportunities.
- Better range of services for members, including provision of financial advice.

There is little practical differentiation between MySuper products apart from investment strategies. Consequently, some of the smaller funds could benefit from the advantages of larger funds were they to merge with them.

We consider that a MySuper fund should be part of a trust fund (including Choice members and retirement accounts) with assets exceeding $2 billion and/or active members exceeding 50,000. Ideally, the fund should have positive cash flow as this will provide the liquidity to ensure it has a long-term investment strategy.

There are 151 funds with assets below $2 billion (34 of which have no assets disclosed) in the APRA Fund Level Profiles (June 2015).

Table 4. Distribution of funds below $1 billion

Size ($m)	Number of Funds	Mean No. accounts	Avg. Member Balance
0 - 100	33	9,638	4,509
100 - 200	11	9,141	14,808
200 - 300	10	2,390	109,024
300 - 400	8	3,220	112,121
400 - 500	8	14,274	31,790
500 - 600	8	135,800	4,135
600 - 700	4	8,118	81,298
700 - 800	5	13,387	55,216
800 - 900	7	84,384	10,063
900 – 1,000	3	7,283	130,859
1,000 - 2,000	20	122,804	12,181
Total < $2 billion	**117**	**41,341**	**33,284**
Total no data	**34**	**-**	**-**

Smaller funds can exist for Choice where the benefits can be tailored to meet the requirements of specific groups of members, such as those wanting a more aggressive investment strategy or funds with a defined benefit structure.

Similarly, scale is important for retirement as subscale funds are unlikely to provide enough product choices to allow members to select something appropriate for their own circumstances and needs. It is also the case that members exercising choice can make decisions for reasons other than price or net returns.

4.2 Encouraging mergers

There is no requirement for any inefficient fund to merge with another. In theory, APRA has a scale test[1] but it is rarely (if ever) applied.

We are aware that a much greater number of approaches to merge have been made by funds than have proceeded to completion even where there was a reasonable case made that both sets of members would benefit from the merger. Clearly Boards can reject approaches, but the lack of transparency regarding merger proposals appears to be hindering the process.

There do not appear to be any issues with funds formulating and presenting proposals to other funds. The issue appears to be with the processes by which those proposals are considered and how decisions are reached in the best interests of members. The process would be enhanced by a formal framework for approaches and the consideration of those approaches.

Our recommendation is that a system with some of the features of the system applying to listed companies should be considered in relation to transparency. A structure which the Commission could consider could be:

- Establishing a consistent framework for funds to approach other funds with merger proposals.
- Specific provisions that a Board receiving a proposal must formally consider that proposal in the best interests of members (there might need to be supporting provisions to ensure that trivial or vexatious proposals are prevented).
- Notification to APRA by the Board when an approach is rejected. This notification should include details of the approach and the reasons for the rejection (Boards currently notify APRA of accepted approaches).
- Notification to fund members by the Board when an approach is rejected. This notification should include clear reasons for the rejection (Boards currently notify members of accepted approaches).
- Provisions requiring the Board to take a proposal to a vote of members in specific circumstances – for example, should a suitor make revised approaches that seek to overcome the reasons for rejection given by the Board.

[1] Section 29VN (b) of the *Superannuation Industry Supervision Act 1993*
http://www.austlii.edu.au/au/legis/cth/consol_act/sia1993473/s29vn.html