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Superannuation
Productivity Commission
Locked Bag 2, Collins Street East
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Dear Productivity Commission,

AFA Submission – Consultation: Superannuation: Assessing Efficiency and Competitiveness

The Association of Financial Advisers Limited (**AFA**) has served the financial advice industry for over 70 years. Our objective is to achieve *Great Advice for More Australians* and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

The Board of the AFA is elected by the Membership and all Directors are practicing financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians reach their potential through building, managing and protecting wealth.

Introduction

The AFA welcomes the opportunity to make a submission in response to the Productivity Commission's Draft Report on Superannuation: Assessing Efficiency and Competitiveness.

We note the Productivity Commission's concern about the superannuation system. We agree with the two key issues that have been identified in this report with respect to duplicate accounts and underperforming funds. The issue of duplicate accounts is one that has developed over many years and is deep-seated in terms of the many attributes that cause such an outcome. We accept that a fundamental change across many dimensions is needed to address this.

The issue of underperformance is one that we are very conscious of. We acknowledge the Productivity Commission's contribution on this issue via this report. As has been recognised, there are some known reasons for underperformance, including high fees and inappropriate asset allocation. There are no doubt other less obvious reasons that also assist to better explain the reasons for relative under or over-performance by some funds. In some cases, this

underperformance is short term and in other cases it is longer term. We believe that it is an area that requires significantly more qualitative research that looks at specific case studies in a greater level of detail. We do need to be very conscious that past performance is no predictor of future performance, however it is certainly an important indicator of capability and if it can't be readily explained by the experts then it will be impossible for consumers to understand.

Some of the recommendations made by the Productivity Commission will contribute to an increase in the cost of running superannuation funds. Where these reforms involve changes to the underlying computer systems, this will be particularly expensive, and these costs will inevitably flow back to members. It is therefore essential that a cost benefit methodology is applied with respect to the final recommendations.

We also believe that it is important to ensure that consumers have confidence in the superannuation system and that further changes that are made to the overall superannuation system do not result in a further loss of confidence and declined levels of disengagement. This represents a fine balance and each element of a reform package should deliver a material benefit and not superficial benefits.

We are aware of the issues with the level of financial literacy and the low level of engagement that members have in their superannuation. We think that it is critical that steps are taken to encourage engagement and to promote the benefits of financial advice to assist members to better understand their position and how to get the best out of their superannuation.

We have concerns about the complexity of the reporting of fees by superannuation funds. In our view this has become too complex and will only serve to confuse members. More needs to be done to make this information comparable and easy to understand.

We have recently made a submission to the Senate Economics Committee on the Protecting Your Superannuation Package Bill and will repeat some of those comments in this submission.

Response to Information Requests and Recommendations Raised in the Draft Paper

Information Request 2.1 – Are the assumptions underpinning the Commission's benchmark portfolios sound? If not, how should they be revised, and what evidence would support any revisions?

No response.

Information Request 2.2 – Aside from administration fees, asset allocation and tax, what other factors might explain differences in investment performance against benchmark portfolios of the superannuation system, as well as segments such as for-profit and not-for-profit? What evidence is available to test the influence of such factors?

One factor that we are aware of is the impact of a reliable steady flow of new money coming into the superannuation fund. The ability to rely upon future inflows enables the fund to have more flexibility in the level of cash that is held, and the avoidance of costs related to the adjustment of the portfolio in order to meet cashflow needs. A steady reliable flow of new money also allows the fund to make investments that are longer term and less liquid. We believe that this can be an important contributor to performance.

Superannuation funds in a position of net cash outflow are in a very difficult position, with a reduced ability to implement investment decisions and a need to undertake more trading activity than may

be desired. This will drive up costs and potentially result in the payment of additional tax on any realised gains. The impact of this on the performance of a super fund should be the subject of further research.

Other potential factors include the hedging strategy for international equities, tactical asset allocation decisions, the difference between single and multi-manager strategies and the timing or frequency of revaluing unlisted assets.

The AFA does not have access to evidence on this.

Information Request 4.1 – Should life-cycle products continue to be allowed as part of MySuper? If so, do they require re-design to better cater for the varying circumstances of members nearing retirement, and how should this be achieved? What information is needed on members to develop a product better suited to managing sequencing risk?

The AFA supports the option for trustees to provide life-cycle products, however we believe that these products highlight one of the core issues with the MySuper regime. Under MySuper, everyone is in the same investment option, which means that the trustees need to make decisions on the basis of what they believe is in the best interest of members as a whole. Life-cycle products are designed on the basis of the assumption that as people get older they have a reduced appetite for risk. This may be a safe assumption for many and maybe even a majority of older members, however it certainly will not be the case for all members. Additionally, this often creates a false belief that individuals need to be cashed up at retirement whereas the reality is that funds need to continue to be invested for a significantly longer time. As a result, life-cycle products might be to the disadvantage of some members who would like to take more risk or retain their previous asset allocation. The other key consideration is that people are living longer, and they are spending more time in retirement. Thus, an increased exposure to growth assets is required in order to better enable the funds to last. There are many issues to consider in the determination of the best asset allocation for a fund, however this highlights the importance of choice options to complement the MySuper product. It also reinforces the need for financial advice as people approach retirement. We believe that superannuation funds should tailor messages to members at certain key trigger points (50, 55, 60) to encourage them to seek financial advice.

We do not believe that it is sensible for trustees to make decisions on the investment of the fund's assets on the basis of the impact of sequencing risk on the more mature members. It is difficult for them to take this into account when operating in the best interests of all members.

Information Request 7.1 – What are the main types and quantum of costs involved in fund mergers? How do these vary depending on the size of funds involved?

We are not in a position to discuss the cost of fund mergers; however, it is important to make the point that there are risks for individual members as a result of having their account moved as part of a merger. In particular, where they have previously received advice in terms of the choice of investment options or insurance cover, it is essential that these arrangements are not lost and that the new merged fund is aware of the existing adviser arrangement. There are also risks of their money being left uninvested during a transition period.

Information Request 7.2 – What evidence is there that funds are passing through economies of scale to members in the form of lower fees, or through other channels? Why has the pass-through of scale benefits occurred as it has?

No response.

Information Request 8.1 – What is the case for bundling life and total and permanent disability insurance together, as is done by some superannuation funds? Are there funds that offer these separately, and if so, do many members of these funds elect to have one type of cover but not the other?

There is a strong argument for providing life and TPD bundled together in the one insurance cover as it better caters for the insurance needs of members and it provides administrative simplicity and reduced decision making on the part of members. The AFA supports members having access to the flexibility to select one or the other or both. A number of funds do offer the option of either life and TPD or just life insurance. It is much less common for funds to offer stand-alone TPD insurance primarily due to the fact that the cost of stand-alone TPD is very close to the cost of Life and TPD combined. The value and cost effectiveness of combined cover is significant and provides clear benefits relative to stand alone cover. However, this is often a source of confusion for the average person who is not educated in this area.

The AFA does not have access to statistics on the use of different types of insurance cover.

Information Request 8.2 – What is the value for money case for income protection insurance being provided on an opt-out basis in MySuper products?

The legislation allows trustees to offer income protection on an opt-out basis. In reality less funds do provide income protection cover. The AFA believes that income protection is a cornerstone of every working Australian's financial security and whilst we might argue that income protection outside super is a better outcome for consumers, we do support the availability of it through superannuation funds.

Information Request 10.1 – Would a clearer division of responsibilities between APRA and ASIC (for superannuation) lead to better strategic conduct regulation and better regulator accountabilities? Is APRA best placed to specifically focus on ensuring high standards of system and fund performance, and ASIC to specifically focus on the conduct of trustees and the appropriateness of products (including for particular target markets)?

The AFA supports a clearer definition of responsibilities between APRA and ASIC and supports the proposed split.

Information Request 12.1 – Are there any material impediments to high-performing non-incumbent funds participating in a 'best in show' selection process? The Commission is particularly thinking about possible claims for participation by funds with no prior local track record but in-principle claims, such as foreign funds or a government-owned fund.

The AFA is concerned about the ability of super funds that are not on the top 10 list from actively competing for superannuation members and new inflows and that after a longer period of not being on the list it will be much more difficult to get back on the list. In part we believe that the advantages of being on the list in terms of the publicity and promotion that will result from this and the steady reliable flow of new money will create an unlevel playing field. These funds will have such an advantage and we suspect that it will only be where they fall over, that other funds will have a genuine opportunity to get on the list.

We are also concerned that funds outside the top 10 may be inclined to take unnecessary risks in the lead up to the determination of the new top 10 list in order to enhance their performance. There is a genuine risk that this model could drive dysfunctional behaviour in order to get a fund onto the list.

As long as there are rigorous and defined selection guidelines then we do not believe that there is any reason to reject an application from a foreign fund or a government fund. They would need to demonstrate that they have the capacity to meet the requirements, and this includes knowledge and capability to operate within the Australian legislative regime.

DRAFT RECOMMENDATION 1 - DEFAULTING ONLY ONCE FOR NEW WORKFORCE ENTRANTS

The AFA strongly supports the employees ability to choose a superannuation fund that meets their needs. In the absence of them making a choice, then we fully agree that they should not simply be defaulted into another new fund each time they change jobs. This means that they should be defaulted into a fund only once when they start work and then they can keep that fund when they move to a new employer or can choose a different fund if they wish. We agree that the best way to do this is some form of centralised IT solution that enables this to be achieved in a practical, cost-effective manner.

We equally recognise that this is a fundamental change to the current superannuation model, however we believe that a reform of the current system to better address the issue with duplicate accounts, and to provide more choice is worthy of further investigation and support.

We also support the proposed system solution enabling the consolidation of existing funds, however we have one hesitation with respect to the consolidation of accounts that might have a better insurance solution than the one they choose to move to. It is often difficult for the members of superannuation funds to understand the differences in insurance offers and therefore to make an informed choice of the best solution. Such a system solution for the selection of a fund needs to be supported by education and guidance to assist them to make such decisions.

We also put forward the idea that there should be some form of cooling off period that would allow members to retrace the change and recover the previous account in the event that they discovered that the move they had made was not in their best interest.

DRAFT RECOMMENDATION 2 - 'BEST IN SHOW' SHORTLIST FOR NEW MEMBERS

Whilst we support the simplicity of a 'best in show' top 10 list, we also recognise that there could be significant unintended consequences. We believe that the selection of a list of 10 at the exclusion of all others for a four year period is fraught with danger. In fact, a highly performing fund in one year could easily be an underperforming fund in the following year.

We also make the point that this model does not address the historical practice of employers negotiating enhanced product offers with superannuation funds that might involve a range of additional benefits for their employees including reduced fees, reduced rates on insurance premiums, higher automatic acceptance limits on insurance or other benefits such as financial education. In some cases, employers might also subsidise fees and insurance. We cannot see how the 'Best in Show' model that is based upon the overall market can take into account special offers that may be made available by particular employers to their employees. Under the proposal, if the employer fund is not on the top 10 list, then it seems that employees will not have access to the fund via the centralised system. We would like to see a solution where employees would still have the ability to select their employer fund from the system, subject to them having access to comparison information on the options that were available.

We are also concerned that the creation of a top 10 list will then lead to an overt advertising war, with the winner coming down to who has the best advertisements and does the most promotion and

has the best celebrity endorsements. The additional scale that comes with being on the top 10 list will provide significant competitive advantages.

Being on the top 10 list will be an incredible advantage to the funds as they will have a positive cashflow and confidence about future cashflow to better enable them to invest in systems and processes. Where trustees do not have the same level of confidence about future cashflows then they need to be more cautious in terms of retaining a cash buffer and more cautious about making longer term illiquid investments. This means that the 10 funds on the list will obtain a natural advantage over the other funds which will mean that a level playing field does not exist. As discussed above funds outside of the top 10 may be motivated to take excessive risk to enhance their chances of getting into the top 10 list.

We are keen to see a way for the funds that are not on the list being able to remain competitive. We have given thought to options such as a rotational basis of being on the list or there being a secondary list of highly recommended funds that members can get access to. We are certainly concerned about the prospect of there being a list of 10 funds and then the rest, with no differentiation between the fund that was ranked 11 and the worst fund.

What impact might the top 10 list have on the process of consolidation of super funds? Will a high performing fund be willing to merge with an underperforming fund, if their performance statistics becomes the combination of the two funds, and they need to incorporate the poor performing fund into the reported performance number?

DRAFT RECOMMENDATION 3 - INDEPENDENT EXPERT PANEL FOR 'BEST IN SHOW' SELECTION

We note that the superannuation industry has been dominated by intense rivalry and the subject of an ongoing battle of competing ideology. We believe that some of this competition has been inappropriate and detrimental to the interest of members and the confidence of consumers. The practical reality is that there are very big differences between some of the participants in the industry and that this reflects strong political differences. This opens up the genuine concern about the risk of the members of this expert panel being subject to bias.

We all want the people on this panel to be experts, however to become experts, they need to have had experience in the industry, which means that they will have worked within entities on one side of the market. We question whether the panel could be made up solely of people who are service providers to all sides of the industry? Therefore, the members of this panel will be seen to have an allegiance to the side that they previously worked in. It is difficult to see how this obstacle can be overcome. To be independent then they will need to no longer be in practice and therefore there is a risk that their knowledge will no longer be current.

We also believe that there is a potential issue in the members of the panel deciding the criteria that are to be used to select the funds and then using that criteria to select the funds. It might be better to separate the process of the selection of the criteria from the selection of the funds.

DRAFT RECOMMENDATION 4 - MYSUPER AUTHORISATION

The AFA supports the recommendation that the MySuper authorisation standard be increased.

We raise the question of the requirement to report annually to ASIC on the number of MySuper members who have chosen to switch to a choice fund. Is this because the Productivity Commission believes that we need to guard against this happening or whether they think that this is a warning trigger? As stated above, we support members having choice and if they choose to move from one

investment option to another then that is their choice. We are not convinced that there is any policy benefit in reporting this to APRA on an annual basis.

We note the proposal that funds who persistently underperform should have their MySuper authorisation revoked. We offer two points of feedback on this. For the application of this, the variance from the benchmark would need to be greater than the 0.25% referred to in the draft report. Secondly the consequences of the cancellation of the authorisation for members would be substantial and such decisions should always take the best interests of members into account.

DRAFT RECOMMENDATION 5 - REGULATION OF TRUSTEE BOARD DIRECTORS

The AFA supports measures to improve the level of governance on superannuation fund trustee boards. We support the idea of an annual assessment of performance and to ensure that a formal process is applied to the establishment of a skills matrix and public reporting of compliance with this matrix. We also support the proposal with respect to an external third-party evaluation of the performance of the board.

The AFA appreciates the importance of independent directors on the boards of superannuation fund trustees. We support measures to increase the level of independent directors on these boards.

DRAFT RECOMMENDATION 6 - REPORTING ON MERGER ACTIVITY

We recognise the issue behind this proposal, which is to ensure that merger decisions are made in the best interests of members. We are not convinced that this requirement will lead to more mergers or better outcomes in the merger process. We believe that there is a risk that less mergers will be considered as a result, since trustees will be too risk averse when it comes to the potential implications in deciding not to proceed with a merger. They may be less inclined to actively consider a merger if this needs to be reported to APRA.

We think that the Productivity Commission should give due consideration to other mechanisms to encourage mergers that are in the best interests of members.

DRAFT RECOMMENDATION - 7 CAPITAL GAINS TAX RELIEF FOR MERGERS

The AFA supports an environment that is encouraging of sensible mergers of superannuation funds to provide better scales of economy and as a mechanism to address underperformance. We certainly support super funds having permanent access to loss relief and asset rollover provisions. In our view this would better facilitate merger decisions that may be in the best interest of members.

DRAFT RECOMMENDATION 8 - CLEANING UP LOST ACCOUNTS

The AFA strongly supports practical solutions to reduce the number of duplicate and inactive accounts. Recommendation 8 should work to the benefit of consumers, however there are some particular risks that need to be carefully managed.

We agree that the inactive threshold should be reduced from 5 years. We note that the recent Protecting Your Superannuation Package reforms proposed by the Government include a 13 month inactive trigger. We believe that this is too short and that a two year timeframe is more sensible. We argue this on the grounds that some people who take maternity leave may extend beyond 12 months and that some people taking a break may also be away for longer. It is also important to take steps to reduce the number of people who have their funds move to the ATO against their wishes. Some consideration needs to be given to the cost and disruption involved in the transfer to the ATO and then the activity that is involved in these funds being recovered.

Insurance through Group super is typically on an automatic acceptance limit basis, where up to a certain limit, the insurance is accepted without the requirement for underwriting. Retail advised life insurance always requires underwriting. Thus, insurance cover is often available to people in a Group super scheme who may not be able to access that insurance through a retail advised arrangement due to their state of health or family history, or it may be subject to premium loadings or policy exclusions. For this reason, for people who have had a deterioration in their health, they may choose to hold onto an old inactive account to continue their existing insurance arrangement. This is a strategy that financial advisers often recommend, to ensure that their clients have access to insurance that is cost effective. They would typically keep a small balance in that account in order to cover the cost of the insurance premiums. This is a deliberate strategy; and it is important that these proposed changes will not put the insurance of these members at risk in the event that they are incorrectly deemed to be lost or inactive. It is important that measures are put in place to protect these people who have intentionally elected to retain their insurance in an inactive account, including through timely notification to their financial adviser. These accounts should have a record that they are to be excluded from this regime and it should be possible for the financial adviser to notify the fund of this. Provisions should also be put in place to enable the re-instatement of this insurance should an unintended transfer to the ATO occur.

We note that there are undoubtedly still many superannuation accounts for people where the trustees do not have the member's TFN. In these circumstances, there is an increased risk that the member will never recover the funds. This risk needs to be addressed.

As the return applied to the account by the ATO will be limited to the Consumer Price Index, there is a risk that money left with the ATO for a longer period of time will be at a material disadvantage. We also recognise the risk that the automatic transfers of super balances by the ATO could result in funds being transferred to the wrong person by mistake. We ask the question of who will take liability for such an event?

We recognise the objective of consolidating client money into an active account, however we note that the client may have more than one active account if they have multiple jobs and that there is a risk of a member's funds being auto-consolidated into a worse performing fund. Some additional controls may be necessary to address these risks.

DRAFT RECOMMENDATION 9 - A MEMBER-FRIENDLY DASHBOARD FOR ALL PRODUCTS

The AFA supports clear and concise reporting for members through tools such as the dashboard. It is important to be careful about suggesting that choice funds can readily sit within the one regime. Many choice members hold multiple investment options and a direct comparison to a single MySuper product may be problematic. It is important to ensure that the timeframe for this is realistic in order to avoid unnecessary costs.

Whilst we support public disclosure, we are concerned that the complexity of having all product dashboards on the one single website may be overwhelming for consumers unless there was some mechanism for simplification and summarising. There would be significant risks of unintended consequences from the incorrect interpretation of information on this website and it would need to be carefully considered.

DRAFT RECOMMENDATION 10 - DELIVERING DASHBOARDS TO MEMBERS

As discussed previously, we support full disclosure to members. In the case of an adviser recommending that a client move their funds from a MySuper product to a single (or multiple) choice investment option, then there is a requirement of full disclosure under the product replacement

requirements. In this case it may be the staff of the financial adviser who actually arrange the transfer, and the member will be relying upon the advice of their financial adviser.

Our other input on this is that this proposal may be costly for some funds to do when they are working with legacy systems. It may be that funds need to have a range of options to achieve this objective so that they are not forced to go down a costly systems change route.

DRAFT RECOMMENDATION 11 - GUIDANCE FOR PRE-RETIREES

Whilst we would support this proposal, we believe that retirement is such a complex and challenging process that the majority of people navigating retirement should seek personal financial advice. They might obtain that from an adviser within their superannuation fund or otherwise from a financial advice business. There is no substitute for quality advice and whilst being directed to useful reading is beneficial, only a very limited number of people will be able to do this without expert guidance.

We also make the point that people need to start preparing for retirement much earlier than 55, and therefore this proactive education program should start at 50, rather than 55.

DRAFT RECOMMENDATION 12 - EXIT FEES AT COST-RECOVERY LEVELS

We support the proposal to limit exit fees to a cost recovery level. We note that the Government has gone significantly further in the Protecting Your Superannuation Package Bill by seeking to ban all exit fees and to apply it to all superannuation funds and not just new accounts which is what the Productivity Commission has recommended.

We do not support the government’s proposal to completely ban exit fees as this will penalise the remaining members as they will need to recover the cost of processing withdrawals. We support the proposal to limit these fees to a cost recovery basis, which we believe will deliver an equitable outcome.

We believe that there should be due consideration to the option of limiting exit fees to a cost recovery basis for legacy products as some of these fees can be particularly significant and as a direct result they work against people consolidating their superannuation and moving from higher fee legacy products to more competitive modern products. Setting the exit fees at a cost recovery level as opposed to a complete ban will remove the risk of the remaining members subsidising the departing members.

DRAFT RECOMMENDATION 13 - DISCLOSURE OF TRAILING COMMISSIONS

The AFA supports the disclosure of trail commissions on superannuation products.

It is important to note that trail commission cannot be paid on new superannuation business since 1 July 2013 and also trail commission cannot be paid on MySuper products or group super arrangements. Trail commission can only be paid on choice members where the product was taken out prior to 1 July 2013. Thus, this is very much a minority of superannuation members. It is also important to recognise that many clients on trail commission arrangements are still receiving ongoing service from their financial adviser. If the trail commission was cancelled, then the adviser would need to agree with the client to put in place an ongoing fee arrangement for services to continue.

We recognise that commissions may also be in existence on individual insurance arrangements that superannuation members hold. Ongoing servicing commission on insurance is intended to pay for

regular reviews of insurance needs and to assist clients at the time of an insurance claim. Financial advisers do not typically charge for assisting clients with making an insurance claim. The cost of this is covered by the servicing commissions that advisers receive across their full client book.

We are concerned that the Productivity Commission are probably incorrectly assuming that no service is being provided for the trail commissions that are being paid. We therefore believe that the message that is provided to members in annual statements needs to be balanced. We question the proposal for a blunt statement that commissions are illegal for new members. The message should not be drafted on the basis that the clients are getting no benefit from this arrangement with a financial adviser. Potentially it could encourage them to talk to their financial adviser to confirm that their arrangement is still appropriate.

It is also important for the Productivity Commission to understand that where a trail commission is turned off, the payment is retained by the product provider and not passed back to the client. We also believe that it is important for the Productivity Commission to understand that there may be a range of reasons that prevent a client from being moved from a trail commission paying product to a modern product. These reasons include exit fees, Capital Gains tax issues, deeming treatment (for income stream products) and potential complications in obtaining replacement insurance where their health may have declined. We would be willing to provide the Productivity Commission with more background on grandfathered trail commissions arrangements if this was beneficial.

DRAFT RECOMMENDATION 14 - OPT-IN INSURANCE FOR MEMBERS UNDER 25

We strongly disagree with the proposition that people under the age of 25 do not need insurance. Some people under the age of 25 with no dependents and no debt may have less need for life (death) insurance, however what will happen to them if they suffer an illness or have an accident that prevents them from ever working again? For those with a family, what happens to their spouse and children if the primary income earner dies or is no longer able to work? Our members deal with insurance claims for this group of young Australians on a regular basis. For those who experience a life insurance event, having insurance leaves them in a significantly better position as opposed to relying on Centrelink benefits.

It is important to note that insurance for younger people is not expensive. A 24 year old male can get $200,000 of death cover and $100,000 of TPD for less than $200 per year.

Whilst it is possible to argue that these younger people should be able to make the decision on whether they want insurance, the practical reality is that the majority of young people don’t appreciate the importance of insurance, and don’t expect that they will need it. Even when they have significant debts and dependents they are never drawn to thinking about the consequences of suffering a serious illness or injury. No matter how much marketing is done, it will not change this apathy towards insurance. It is also the case that they don’t appreciate that their greatest asset, in most cases, is their future income producing capacity, and that this is something that they can insure. The practical reality is that very few young people will voluntarily take up insurance when it is on an opt-in basis. It is most likely that those who have already experienced a health issue or have a family history of health issues are more likely to opt-in, which will increase the risk within the life insurance pool.

The apparent view put forward in this recommendation that people under the age of 25 are less likely to need insurance and therefore they should be removed from the insurance pool, fails to take into account that still a large number of people under the age of 25 experience insurance events. Secondly, it fails to take into consideration that if you take a large number of people out of the insurance pool then it increases the cost of premiums for everyone left in the pool. This is due to the fact that the fixed costs of the insurance business need to be apportioned over a lesser number of

members and also those removed from the pool might represent lower risks. In fact, the impact is compounded by the reality that those who choose to opt-in are more likely to be the people who are at increased risk of making a claim.

AIA Australia issued a report in early June 2018 indicating that they had paid out $84 million on 1,200 claims for members under the age of 25 since 2015. This included payments for death, Total and Permanent Disability (TPD) and Income Protection. Across the entire industry this is likely to be a very material number.

Some important statistics that we are aware of provides an insight into the number of children born to parents who are under the age of 25:

- In 2016, 23% of births were to mothers under the age of 25.
- In 2016, 12% of births were to fathers under the age of 25.

What will happen to the surviving spouse and the children of people who die or have a TPD event who are under the age of 25 and have no insurance?

Another important point made by AIA Australia is that almost half of the full-time workers under the age of 25 are in blue collar jobs, where the risks are much greater. There needs to be consideration of the fact that some occupations have much higher levels of risk and therefore have greater need for insurance. Mental health is an issue that impacts many young people, along with those with inactive accounts (as addressed in Recommendation 15 below). If someone suffers a TPD event, then typically their income prospects will disappear and often their costs will increase. Who is going to support these people for the rest of their lives? When it comes to TPD, it is worth realising that this is potentially more important for people under the age of 25 as they will have less existing financial resources and will often need to live with their illness/injury for much longer.

Group superannuation insurance is typically offered on an automatic acceptance basis, where new members get automatic cover up to a certain limit when they join the fund. This is the means by which the insurer manages the anti-selection risk. Where people decline the insurance or are excluded from the insurance arrangements and they decide to come back in at a later point, then this is typically done on the basis of underwriting. This is the mechanism for insurers to avoid people deliberately seeking insurance or upgrading their insurance when they are aware of a health issue that generates greater risk. Insurers would need to consider in detail how they were going to cater for the inclusion of people who reach the age of 25. This will open up many questions that they will need to consider in order to avoid taking on unreasonable risks without the ability to charge the appropriate premiums or to exclude certain policy conditions.

We strongly caution the Productivity Commission on this proposal and suggest that any benefit will be offset by premium increases for the remaining members and that the disadvantage that it will cause for those younger people who experience a life insurance event is a more important consideration.

DRAFT RECOMMENDATION 15 - CEASE INSURANCE ON ACCOUNTS WITHOUT CONTRIBUTIONS

As discussed above in response to Recommendation 8, it is a common strategy for financial advisers to recommend to clients to hold onto an inactive superannuation fund in order to continue to pay for insurance through that fund. They may have moved to a new fund in terms of ongoing contributions, but want to retain the previous fund for insurance purposes. It could be that their previous fund offered underwritten insurance that better met their needs, or was on better terms or rates. The new fund may not offer the same level of insurance under automatic acceptance limits. As discussed

above it may also be that their health has deteriorated, and they may not be able to get insurance in their new fund or be subject to premium loadings or policy exclusions.

It may also be the case that the member has deliberately chosen not to have insurance through their new fund. We do not believe that their existing insurance should be turned off without getting their consent and without checking whether they have insurance elsewhere.

Thus, there are very good reasons why someone may want to hold onto insurance in an account that is no longer receiving contributions. We have fundamental concerns about whether the process of notification will ensure that all clients in this situation are in a position to respond and confirm that they wish to hold onto their insurance. This risk of failure to respond may become an issue where the member has moved address and has not notified their super fund. We would also suggest that where a financial adviser is recorded by the superannuation fund that any notification goes to them as well, so that they can intervene to ensure that the insurance is not turned off incorrectly.

We also believe that this is appropriate to raise the reports that have been prepared by independent experts such as KPMG and Rice Warner with respect to the Protecting Your Superannuation Package Bill. KPMG have predicted that the changes proposed by the Government could lead to a 50% reduction in the total level of insurance cover and a 26% increase in the cost of premiums for those who retain cover. The recommendations made by the Productivity Commission would have some impact upon the cost of insurance for remaining members, however probably less than the 26% predicted by KPMG with respect to the Government's budget proposal.

It would be disastrous for these members to experience a life insurance event after having their insurance turned off due to their account not receiving contributions for 13 months. Situations like this which reflect the issues in the current default superannuation system, should not cause the turning off of life insurance cover for people who need protection.

Ideally members of funds would get financial advice before such major changes are made to their superannuation arrangements so that they understand their insurance needs (i.e. debt and dependents etc) and what options they have available to meet those needs.

DRAFT RECOMMENDATION 16 - INSURANCE BALANCE EROSION TRADE-OFFS

Whilst we support this proposal we also strongly suggest that this needs to be presented as a balanced message. We are concerned that there is an overriding ideological view on insurance that is impacting upon the clarity of the message. Some of the recent recommendations with respect to life insurance appear to come from the ideological view that it is better to save a larger number of people a smaller amount of money, rather than protect a smaller number of people in the event of a life changing insurance event. This is the opposite of the underlying principle of insurance.

As the impact on those who experience a life insurance event without cover is such a significantly detrimental outcome, we think the balance should be more in the direction of accepting a small cost for the benefit of those who really need it. If these changes to under 25 year old members and inactive accounts were implemented there would be a number of people who would be significantly disadvantaged, and they would not accept the justification that this reform was going to save a small amount of money for other members.

DRAFT RECOMMENDATION 17 - INSURANCE CODE TO BE A MYSUPER CONDITION

In our view this is a problematic recommendation, as the Productivity Commission, amongst others have called for further changes to the Insurance in Superannuation Voluntary Code of Practice. Can

superannuation funds support this recommendation if they don't know what changes are likely to be made?

We recognise that this recommendation is seen as a way of making the code mandatory, however this will only work for superannuation product providers who have MySuper funds. We think that other solutions need to be considered to have this Code of Practice more universally adopted. We also understand that the take-up of the Code of Practice has already been very positive, so this may not be such an important issue.

DRAFT RECOMMENDATION 18 - INSURANCE CODE TASKFORCE

We have previously expressed our concerns with the Code of Practice in that we did not agree with the proposals to limit the cost of insurance cover to 1% of salary, particularly when the members may be in high risk occupations. We have also challenged the proposals with respect to turning off insurance for inactive accounts. Our concern is that the people who are calling for greater change do not fully appreciate the importance of insurance or the consequences of people not having enough insurance. In this respect we do not agree with the assumption that the Code of Practice necessarily needs to be strengthened.

We also question this being driven by the regulators without adequate industry participation.

DRAFT RECOMMENDATION 19 - INDEPENDENT REVIEW OF INSURANCE IN SUPER

We would support a detailed review of insurance in superannuation provided that it was undertaken by people with genuine industry expertise. The definition of the scope of such an inquiry would need to be carefully considered in order to ensure that the focus was on the effectiveness of the broader system and the outcomes at both an individual level and an economy wide level.

The Parliamentary Joint Committee on Corporations and Financial Services undertook a lengthy inquiry into life insurance, however we were very disappointed in their final report and do not believe that they addressed one of the core objectives of assessing the relative benefits and risk of the three channels of retail advised, direct and group insurance.

DRAFT RECOMMENDATION 20 - AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

The AFA supports the proposals with respect to APRA, although noting that we have previously expressed some reservations with respect to the implementation of the outcomes test.

We also make the point that the issue of legacy products requires deeper consideration. As discussed above this needs to be investigated in terms of the potential obstacles at the individual member level and at the overall fund level.

DRAFT RECOMMENDATION 21 AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

We broadly support the ASIC recommendations, subject to the fact that we expressed reservations about the potential intervention of regulators in fund merger issues. We also note that Recommendation 6 suggested that the disclosure of potential mergers at the point of a memorandum of understanding should be notified to APRA, yet Recommendation 21 proposes that failed mergers be investigated by ASIC.

DRAFT RECOMMENDATION 22 SUPERANNUATION DATA WORKING GROUP

We support this proposal to establish a superannuation data working group, however we highlight the importance of having industry representation. The challenge, without industry representation is that some proposals may be impractical and that this is only going to be understood with the benefit of industry contributions. Since all costs are eventually passed through to members, reforms need to be sensible and add value above the cost to implement and maintain.

Concluding Remarks

This report represents the outcome of a major review and includes many wide-ranging recommendations for reform. We support the broad thrust of the reforms and the objective of improving member outcomes in the superannuation industry. We believe that there are some significant consequences of the recommendations and we believe that with some recommendations, further analysis and investigation is required.

The AFA welcomes the opportunity to contribute to this review. If you have any questions, then please contact us

Yours faithfully

Philip Kewin
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Association of Financial Advisers Ltd