

Superannuation: Alternative Default Models – Draft Report

Productivity Commission

1 May 2017

Table of Contents

About the Law Council of Australia	3
Acknowledgement	4
Executive Summary	5
Detailed submission	7
1. Summary of Draft Report.....	7
2. Development of alternative models	8
2.1 Proposed additional criteria overlaps with the requirements of MySuper legislation	8
2.2 Significant impact on viability and ability to ever be selected if initially excluded.....	9
3. Submission on the issues of having an Expert Panel.....	10
3.1 Assessment criteria.....	10
3.2 Importance of insurance	11
3.3 Consideration of retirement income products and the impact of the Models on their development	11
3.4 Query the ability of an Expert Panel to properly assess funds.....	11
3.5 Taking on the role of a ratings agency or financial adviser	12
3.6 Possibility of litigation and liability.....	12
3.7 Conflicts of interest	13
3.8 Government Affiliation	14
3.9 'Moral expectation' on the Government	14
3.10 Application to defined benefit funds	14
3.11 Application to non-public offer and public sector superannuation funds.....	15
3.12 Transitional issues	15
4. Assisted choice models - Model 1 (employee choice) and Model 2 (employer choice).....	15
5. Submission on the tender/auction model – Model 3 (tender) and Model 4 (fee- based auction)	16
6. Draft recommendation 3.3 – Formal Framework for Trustee assessment of fund merger proposals.	17
Contact.....	18

About the Law Council of Australia

The Law Council of Australia exists to represent the legal profession at the national level, to speak on behalf of its Constituent Bodies on national issues, and to promote the administration of justice, access to justice and general improvement of the law.

The Law Council advises governments, courts and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community. The Law Council also represents the Australian legal profession overseas, and maintains close relationships with legal professional bodies throughout the world.

The Law Council was established in 1933, and represents 16 Australian State and Territory law societies and bar associations and the Law Firms Australia, which are known collectively as the Council's Constituent Bodies. The Law Council's Constituent Bodies are:

- Australian Capital Territory Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Bar
- Law Firms Australia
- The Victorian Bar Inc
- Western Australian Bar Association

Through this representation, the Law Council effectively acts on behalf of more than 60,000 lawyers across Australia.

The Law Council is governed by a board of 23 Directors – one from each of the constituent bodies and six elected Executive members. The Directors meet quarterly to set objectives, policy and priorities for the Law Council. Between the meetings of Directors, policies and governance responsibility for the Law Council is exercised by the elected Executive members, led by the President who normally serves a 12 month term. The Council's six Executive members are nominated and elected by the board of Directors.

Members of the 2017 Executive as at 1 January 2017 are:

- Ms Fiona McLeod SC, President
- Mr Morry Bailes, President-Elect
- Mr Arthur Moses SC, Treasurer
- Ms Pauline Wright, Executive Member
- Mr Konrad de Kerloy, Executive Member
- Mr Geoff Bowyer, Executive Member

The Secretariat serves the Law Council nationally and is based in Canberra.

Acknowledgement

This submission has been prepared by the Superannuation Committee (**the Committee**), which is a committee of the Legal Practice Section of the Law Council of Australia.

The Committee's objectives are to ensure that the law relating to superannuation in Australia is sound, equitable and demonstrably clear. The Committee makes submissions and provides comments on the legal aspects of virtually all proposed legislation, circulars, policy papers and other regulatory instruments which affect superannuation funds.

Executive Summary

The Committee welcomes the opportunity to comment on the Productivity Commission's Draft Report, *Superannuation: Alternative Default Models* (**Draft Report**). The Draft Report includes comments on matters which are outside of the Committee's remit. As such, the Committee's response is confined to the very limited range of questions which the Committee considers touch upon questions of law. The Committee has also included comments regarding the practical implications of some proposals, based on Committee members' experience with the superannuation industry.

The Committee's views can be summarised as follows:

1. The Committee does not consider that it is necessary or desirable for a MySuper product to be assessed against any additional factors in order to be a default fund. This is because:
 - (a) the proposed additional criteria overlap with the legislative requirements of all MySuper products and their imposition would effectively duplicate the Australian Prudential Regulatory Authority's (**APRA**) role in assessing funds that are authorised to accept Superannuation Guarantee contributions;
 - (b) recent and ongoing consolidation within the superannuation industry, and the legislative requirement for MySuper products to have sufficient scale, is likely to result in a considerable reduction in the number of funds, simplifying the default fund selection process for employees and employers; and
 - (c) a process that selects default funds will, over the medium to longer term, have a significant impact on the viability of a fund which is not selected, thus reducing competition.
2. If a MySuper product is to be assessed against any additional factors in order to be a default fund (assuming that these would be along the lines outlined in the Draft Report):
 - (a) The Committee submits that the evaluation of the alternative models ought to include consideration of:
 - (i) the ability of the Model to provide suitable and quality insurance to members at an affordable price and the impact on a fund's ability to establish or maintain the scale needed to provide affordable insurance; and
 - (ii) given the objective the Government has set for superannuation, the ability of the Model to provide suitable and quality retirement income or longevity products and the impact on a fund's ability to establish or maintain the scale needed to viably develop and offer such retirement income or longevity products..
 - (b) The Commission should consider how defined benefit funds would be accommodated within each of the models and the potential impact on members of those funds if they are excluded.
 - (c) The Commission should consider how non-public offer superannuation funds and public sector funds could be accommodated within each of the models.

- (d) Consideration should also be given to the implications of fund changes in the interim between Expert Panel reviews.
- (e) The Committee queries whether an Expert Panel could ever accurately assess funds against these factors, given:
 - (i) the high level nature of those factors;
 - (ii) the need for expert input and access of information to understand the peculiarities or appropriate characteristics of the relevant industry;
 - (iii) the number of funds that are likely to seek default fund status and the corresponding workload involved in making assessments for each; and
 - (iv) the significant volume and specialised nature of the information required (and that is likely to be provided) to the Expert Panel to assess each fund's application.

The Committee also notes that APRA is currently responsible for undertaking similar assessments, and is only able to carry out that responsibility utilising dedicated resources committed to the task on an on-going basis. The Committee queries whether it is realistic to expect that the Expert Panel will be provided with a similar level of resourcing to enable it to carry out corresponding work.

- (f) Consistent with the principles of transparency and accountability, the Expert Panel's assessment ought to be published. Consideration also needs to be given to:
 - (i) the possibility of a fund trustee seeking judicial review of the Expert Panel's decision;
 - (ii) potential exposure to legal actions (in the form of individual or class actions) against the Expert Panel for compensation to:
 - (A) a fund as a result of a MySuper product not being recommended or selected by the Expert Panel following an error made in the assessment process;
 - (B) a fund that has suffered a loss as a result of something published by the Expert Panel that is incorrect; or
 - (C) employers or employees for loss suffered as a result of contributing to MySuper products selected by the Expert Panel; and
 - (iii) what action would be taken against a Fund that has provided misleading information to the Expert Panel or otherwise misrepresented its credentials.
- (g) Ordinarily, the assessment of a fund against factors such as the ones set out in the Draft Report is carried out for an employer or an employee by a qualified licensed financial adviser (who will be subject to statutory and general law duties). Under each of the alternative models, the Expert Panel would in effect take on the role ordinarily conducted by a ratings agency or even a financial adviser and create its own approved 'default MySuper' product list (much like a financial adviser's approved product list).

- (h) Rather than being overseen by the Australian Government, an independent statutory body would be a more suitable alternative to oversee the Expert Panel.
 - (i) Even if the Expert Panel was exempted from liability, consideration needs to be given to the 'moral expectation' created that the Government will make good any losses borne by an employer or employee who contributed to a MySuper product selected by the Expert Panel.
 - (j) Consideration needs to be given to the legislation that would need to be put in place to ensure that the Expert Panel applies the criteria consistently with other Commonwealth legislation (i.e. the *Corporations Act 2001* (Cth) (**Corporations Act**)) and is excluded from the requirement to hold an Australian Financial Services (**AFS**) licence as required by other financial advisers.
3. To operate at its best, the Expert Panel needs to consist of members with up to date knowledge and expertise on the workings of the superannuation industry and the relevant issues to incoming members. However, it is also important that each member of the Expert Panel is not hindered in their performance on the panel by conflicts.
 4. The Committee also considers that the Commission would need to consider the effect of funds being excluded as preferred funds under each of the models, including:
 - (a) the impact on the cash flows of otherwise good funds that for whatever reason were not selected under that model, and the on-going viability of those funds;
 - (b) the impact over the medium to long term (say 5 to 15 years) on remaining members of funds that are not selected; and
 - (c) the effect on decision-making by funds in relation to longer term investments (such as infrastructure) where there must be some level of certainty regarding expected contribution in-flows and out-flows, particularly under Models 3 and 4.
 5. The Committee does not consider that it is necessary or desirable for the Commission to adopt Draft Recommendation 3.3 on the basis that the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**) already provides adequate protection to members and the Committee is not aware of any evidence that would suggest such additional measures beyond this are warranted.

Detailed submission

1. Summary of Draft Report

The Draft Report, attempts to identify alternative default superannuation models that could be implemented by the Government if deemed desirable following the Commission's future review of the efficiency and competitiveness of the superannuation system.

The Commission has identified the following four alternative default models:

- (a) **Model 1 - Assisted employee choice:** employees are provided with a short-list of 4 to 10 accredited products for selection;

- (b) **Model 2 - Assisted employer choice:** employers are provided with two shortlists imposing either a light or heavy filter depending on the employer's desired level of involvement;
- (c) **Model 3 - Multi-criteria tender:** funds will submit tenders that consider multiple criteria to compete for list inclusion; and
- (d) **Model 4 - Fee-based auction:** funds will compete in a fee-based auction to win a position on the list available to new default members.

The four models can be grouped as assisted-choice models (Models 1 and 2) and the tender/auction models (Models 3 and 4).

Each of the proposed models would apply only to new default members entering the workforce who do not choose a fund for themselves (**new default members**). Unless a new default member chooses a different fund the default fund will remain with the member as they change jobs to eliminate multiple accounts.

All models involve a selection body (which we shall call the **Expert Panel**) which will be overseen by the Australian Government.

2. Development of alternative models

2.1 Proposed additional criteria overlaps with the requirements of MySuper legislation

The Draft Report states that the Commission is not tasked in its inquiry with forming a view on the merits of the current default arrangements, nor whether alternative models are better or worse than the current default arrangements. While the Committee accepts that this is not a specified task of the Commission, the task of identifying an alternative model must implicitly include an assessment of whether that model is worthy of being an alternative of the current default arrangements – that is, whether the potential model is good enough to be an alternative to the current model.

Under the current model, superannuation funds must have an APRA-authorised MySuper product to receive Superannuation Guarantee contributions. Funds currently undertake an extensive process to construct MySuper products and obtain APRA authorisation to operate a MySuper product.

Currently there are only 109 MySuper products,¹ excluding MySuper products established only for specific employers, there are only 95 generic MySuper products available. APRA has indicated that new MySuper authorisations will be difficult to obtain and, therefore, this number is not expected to increase and is more likely to decrease with fund mergers and APRA's campaign to merge funds that do not deliver value due to scale. The reduction in the number of funds is likely to simplify the default fund selection process for both employees and employers.

As noted in the summary above, the Committee is strongly of the view that the legislative and prudential requirements applying to MySuper products will provide a sufficient basis for the selection and ongoing assessment of a superannuation fund to be a default fund.

These requirements are the result of significant work by members of the Cooper Review, the Government's Stronger Super Working Groups, the Treasury and APRA. They have been

¹ See APRA, *Quarterly MySuper Statistics* report, December 2016 edition (issued 21 February 2017).

designed to ensure that each MySuper product contains features which are suitable for the majority of employees who do not wish to exercise choice.

In addition, each trustee offering a MySuper product must comply with the “enhanced trustee obligations” and APRA’s Prudential Standards.

The Committee notes that the potential criteria which are considered in the Draft Report are all matters which have been carefully considered in the design of the MySuper requirements. As a result, an assessment of funds as against the additional criteria proposed for listing as a default fund in the Draft Report would effectively require the Expert Panel to attempt to carry out work already required to be carried out by APRA (but with potentially more difficulty in doing so – see our comments in section O below).

On one view, the potential criteria will not only duplicate, but appears to make redundant, the MySuper regime and authorisation process.

APRA collects and publishes quarterly information on its website in relation to MySuper products (on a product by product basis), including:

- the profile, return target and asset allocation targets and ranges for MySuper products with a lifecycle stages investment strategy;
- the fees charged broken up into Administration fees, Activity fees and Investment fees;
- the costs incurred including disclosed insurance premiums; and
- representative member investment performance for MySuper products with a single investment strategy and with a lifecycle stages investment strategy.

The Committee submits that both the APRA MySuper authorisation process and the current default model, promote healthy (price and performance) competition amongst MySuper products and it is against this base that alternative default models must be based.

In the Committee’s view, the additional criteria identified by the Commission would not demonstrably add to the protection of the interests of employees over and above the protections afforded by the MySuper legislation.

2.2 Significant impact on viability and ability to ever be selected if initially excluded

It is understood that the overwhelming majority of employees in Australia do not exercise fund choice and, as a result, are in a default fund.

The Draft Report estimates that there are approximately 400,000 new default members each year. Therefore, in a 5 to 15 year period, a MySuper product that has not been selected would be potentially excluded from accessing the default superannuation contributions of between 2 million to 6 million new default members. Given that the Australian workforce consists of approximately only 12 million people,² the exclusion of a MySuper product has the potential to significantly impact the MySuper product cash inflows and its ongoing viability.

² See Australian Bureau of Statistics, Labour Force as at March 2017 <<http://www.abs.gov.au/ausstats/abs@.nsf/mf/6202.0>>.

At the very least, a reduction in cash flow resulting from a MySuper product's exclusion is likely to make it harder for it to meet the proposed criteria to be recommended or selected by the Expert Panel in future.

In either of these cases, competition within the industry is likely to be detrimentally affected.

3. Submission on the issues of having an Expert Panel

3.1 Assessment criteria

Each of the alternative models identified require a selecting body called the Expert Panel (which will be overseen by the Australian Government) to select either the accredited products (in Models 1 and 2) or the winning tenderer (in Models 3 and 4).

The Draft Report does not specify the assessment criteria against which the Expert Panel will conduct its accreditation or tender process other than the following high level descriptions:

- (a) for Model 1: that the shortlist is to be made up of selected products that are deemed to be 'good' using the heavy filter that would be applied for Model 2;
- (b) for Model 2: there would be two lists:
 - (i) the first made up of products that meet a light filter i.e. 'mandatory minimum standards' to protect member's interests akin to a strengthened MySuper authorisation process (with a stronger emphasis on minimum performance standards); and
 - (ii) the second made up of products that meet a heavy filter i.e. stricter criteria in relation to investment performance and other product features (similar to the tender criteria for Model 3);
- (c) for Model 3: a set of minimum criteria to pre-qualify, followed by a tender against the following criteria: past performance on net returns, member satisfaction, investment strategy, quality of member services, engagement and intra fund advice, fee levels and transparency and innovation in unspecified areas; and
- (d) for Model 4: a set of minimum criteria to pre-qualify, aimed at assessing the fund's integrity and capacity to handle the expected member inflows and the level of member and investment services, followed by a tender determined by reference to the overall fee charged by the fund.

In the absence of more detailed and specific sub-criteria making up these criteria, it seems to the Committee that the criteria for assessing funds is high level and subjective making it difficult to evaluate their viability.

For example, the Draft Report indicates that the product accreditation will be a strengthened version of MySuper. The Committee questions what these extra requirements will entail and how these will significantly benefit member interests.

3.2 Importance of insurance

The Draft Report states that the alternative models will be evaluated on the quality of their default superannuation product only and not on the quality or price of insurance which is currently bundled with default superannuation as a 'regulatory add-on'.

One of the requirements of a MySuper product is that it must provide insured death and permanent incapacity benefits on an opt-out basis³. This recognises that the provision of death and permanent incapacity benefits forms part of the sole purpose of superannuation funds⁴ and that these are significant and valued benefits for members.

In the Committee's view, insurance provided through superannuation is more than just a 'regulatory add-on' – it is a benefit that is valued by members, particularly in high risk occupations (including blue collar occupations and more recently occupations with higher incidences of mental illness) where the cost of obtaining that insurance outside of a group policy is considerably more. The Committee submits that the evaluation of the alternative models ought to include consideration of the ability of the model to provide suitable and quality insurance to members at an affordable price, as part of the delivery of retirement incomes to them and their dependants.

3.3 Consideration of retirement income products and the impact of the Models on their development

The primary objective of the superannuation system is to provide income in retirement to substitute or supplement the age pension. Given this, the Committee submits that the evaluation of the alternative models should also include consideration of the ability of the model to provide suitable and quality retirement income or longevity products to members as part of the delivery of retirement outcomes to them.

Further, if a fund is not recommended or selected, the resulting reduction in cash flow to that fund is likely to make it harder for the fund to establish or maintain the scale needed to viably develop and offer such retirement income or longevity products.

3.4 Query the ability of an Expert Panel to properly assess funds

The Committee not only questions whether the imposition of a further assessment would provide any benefit or value to employees, but also questions whether the Expert Panel would be in a position to accurately assess funds against the high level criteria identified.

Each of the criteria identified is high level in nature and inherently subjective and, therefore, difficult to assess. In addition, any assessment will require the Expert Panel to:

- (a) understand the complexity and specificity of individual employee/default member needs. This includes their current and future age demographic, attitudes, risk appetite, occupational risk and retirement goals;
- (b) objectively assess the features of funds including: its investments, methodology, investment management style, investment risk profile, cost and fee structure, policy terms, corporate governance structures and long-term strategy; and
- (c) assess the funds against their understanding of the superannuation industry.

³ See SIS Act s 68AA.

⁴ See SIS Act s 62.

The Expert Panel's aim will be to make a thorough assessment of funds by creating a simple and accessible selection process for employees and employers.

Given the significance of a MySuper product not being recommended or selected by the Expert Panel, it is likely that the Expert Panel will receive applications from the majority of funds that are capable of accepting default contributions and that the amount of information required (and that is likely to be provided) to the Expert Panel to assess each fund's application will be voluminous.

This raises the question of whether the Expert Panel will have the resources to be able to make an accurate assessment of each criterion. The Committee notes that APRA is currently responsible for undertaking similar assessments and is only able to carry out that responsibility utilising dedicated resources committed to the task on an on-going basis.

Consideration will also need to be given to the time that will be allowed to the Expert Panel to conduct such an assessment within the expected timeframe.

3.5 Taking on the role of a ratings agency or financial adviser

Ordinarily, the assessment of a fund against factors such as the ones set out in the Draft Report, are carried out for an employer or employee by a qualified licensed financial adviser (who is subject to the requirements of the Corporations Act).

While the details of these criteria are not articulated in the Draft Report, it seems to the Committee that under each of the alternative models, the Expert Panel would in effect take on the role ordinarily conducted by a ratings agency or even a financial adviser in creating a list of funds that meet specified criteria as to the suitability or appropriateness of that MySuper product. Put another way, the Expert Panel will be asked to create an approved 'default MySuper' product list (much like a financial adviser's approved product list).

The Committee questions whether it is appropriate for a Government agency to take on this role given the commercial nature of the assessment required to be made and the potential for liability to which the agency may be exposed in relation to such assessments.

Consideration needs to be given to the legislation that would need to be put in place to ensure that the Expert Panel applies the criteria consistently with other Commonwealth legislation (i.e. the Corporations Act). For example, the legislation would, in the Committee's view, need to address whether the Expert Panel will be subject to any particular duties in relation to their assessment, such as:

- (a) a duty to make its assessments in the best interests of relevant employees, such as is found in s 961B(1) of the Corporations Act; or
- (b) a duty to conduct reasonable investigation into the relevant MySuper product, such as is found in s 961B(2)(e) of the Corporations Act; or
- (c) any of the other duties that apply to a person who provides financial product advice (as the creation of a default shortlist and filter may amount to) under the Corporations Act.

3.6 Possibility of litigation and liability

The Draft Report does not expand further upon the role and culpability of the Expert Panel, other than saying the Government will be involved and the Panel will be held accountable.

The Committee expects that, consistently with the principles of transparency and accountability, the Expert Panel's assessment, together with their reasoning would be published. Funds should also have a right of appeal from a decision of the Expert Panel. Presumably this will take the form of an administrative or judicial review.

In designing the permitted scope and process of such a review, consideration must be given to whether the Panel will allow submissions or representations from funds regarding other funds, and if the fund in question will have the opportunity to object to such information. Consideration will also need to be given to what redress (if any) will be given to an aggrieved fund (including what would happen if a fund objected to the information given or representations made to the Expert Panel in relation to it by another fund?).

Further, consideration needs to be given to:

- (a) what action would be taken against a Fund that provided misleading information to the Expert Panel or otherwise misrepresented its credentials; and
- (b) assuming the fund would be removed from the recommended or selected list, consideration needs to be given to what will happen to the contributions made to that fund for any new default members during the time the fund had been on that list.

Accountability implies liability of the Expert Panel regarding their assessments of funds eligible for the default fund lists and filters. Consideration therefore needs to be given to any liability that the Expert Panel may have in relation to its assessment of funds. In particular:

- (a) whether the Expert Panel requires a license to issue financial advice and if not, a licencing exemption;
- (b) whether the Expert Panel will be protected by legislation from litigation (in the form of individual or class actions) from an aggrieved fund trustee, employer or employee; and
- (c) if the Expert Panel will not be protected from litigation, the possibility that it may be liable to compensate:
 - (i) a fund that has suffered a loss as a result of an error made in assessing that a MySuper product not being recommended or selected by the Expert Panel;
 - (ii) a fund that has suffered a loss as a result of something published by the Expert Panel that is incorrect or misleading; or
 - (iii) employers or employees (whether individually or as a class) for loss suffered as a result of contributing to a product recommended and selected by the Expert Panel.

3.7 Conflicts of interest

The Draft Report recognises the difficulty in constituting an Expert Panel made up of members that are unbiased and unaffiliated.

The Draft Report aims to increase the pool of Expert Panel candidates by accommodating those who have expertise beyond superannuation and finance. A reliance on academics

instead of industry participants may result in theoretical rather than practical solutions to day to day member needs.

To operate at its best, the Expert Panel needs to consist of members with up to date knowledge and expertise on the workings of the superannuation industry and the relevant issues to incoming members. It is unrealistic to expect Panel members to refrain from working within the superannuation industry when the Panel is not in session.

The Draft Report alludes to an intention to have a revolving and updated membership on the Expert Panel. However, the small pool of viable candidates makes this difficult to achieve.

3.8 Government Affiliation

We note that the Draft Report has already identified that the Expert Panel will not sit within APRA or ASIC due to the competitive assessment nature of the selection. The Draft Report instead suggests that the Expert Panel will be overseen by and accountable to the Australian Government.

This raises the question of whether a new or existing subsidiary of the Government will administer oversight of the Expert Panel. The Committee suggests similar considerations to apply to any other Government subsidiary that the Expert Panel may report to.

Government control would necessitate considerable resources and likely result in confusion, politicisation or conflicts regarding the role Government will play in setting policy while mediating and overseeing the Expert Panel. An independent statutory body would be a more suitable alternative to oversee the Expert Panel, should this route be pursued.

3.9 'Moral expectation' on the Government

While the Draft Report is silent on specifics, any perceived failure on the part of the Expert Panel will be undoubtedly linked to the Government. A 'moral expectation' may arise for the Government to make good any losses suffered by funds, employers or employees as a result of the Expert Panel's decisions.

Even if the Expert Panel was exempted from liability, consideration needs to be given to the 'moral expectation' that this creates for the Government to make good any losses suffered by employers or employees who contributed to a MySuper product recommended and selected by the Expert Panel.

3.10 Application to defined benefit funds

The Commission should consider how defined benefit funds would be accommodated within each of the models. Defined benefit funds fulfil an important function (and ensure consumers do not bear investment risk), but it would be difficult for the Expert Panel to compare a defined benefit fund with an accumulation fund.

Further, the Commission should be mindful of the impact on defined benefit funds and their ongoing viability if they were to be excluded from being default funds for new default members. For example, a defined benefit fund that ceases to be a default fund for new default members would experience a progressively ageing cohort of members with flow on effects to the cost of insurance and funding and operational costs. At its worst, these effects may adversely affect the ongoing viability of that fund to the detriment of the remaining members over the medium term.

Defined benefit funds might also struggle to accept contributions from members from all industries, especially if their employers have not entered into funding agreements with the trustee.

3.11 Application to non-public offer and public sector superannuation funds

Not all funds that wish to receive default contributions would necessarily have the appropriate Registrable Superannuation Entity (**RSE**) licence authorisation to accept contributions from non-standard employers - in particular, funds that do not have a public offer authorisation.

Indeed, even if a fund did have the necessary authorisation, it may not wish to accept contributions from members other than its existing industry or target market. This may be the case for where for example, the specific features of the fund have been tailored to a particular industry (e.g. insurance, investments etc.). The fund may not be able to accept contributions for other reasons – take for example public sector funds that are restricted by legislation.

The Committee questions whether these funds will have the opportunity to continue to accept new default members only in their existing industry or target market or would the fund be excluded from consideration by the Expert Panel if it wished to do so?

3.12 Transitional issues

Consideration should also be given to the implications of fund changes in the interim between Expert Panel reviews. The Committee questions how the Expert Panel will respond to the loss of key people, fund wind-ups, substantial changes in investment strategy, substantial underperformance, insolvency, loss of AFS or RSE licence, fund mergers and other serious regulatory concerns. For example, will the listed/winning fund be taken off the recommended or selected list, re-evaluated or will a fund not on the list be upgraded?

4. Assisted choice models - Model 1 (employee choice) and Model 2 (employer choice)

The simplification and selection of default funds into a narrow list or filter aim to encourage members to make more active, educated choices regarding their superannuation. However the Commission should consider the unintended consequences of providing employees and employers with a list of recommended default funds.

The shortlist and filters provided to employers and employees will be assessed on whether they are a 'good' fund. The Expert Panel will need to frequently assess what will be categorised as a 'good' fund to uphold member interests. A continuous review process is therefore necessary to align 'good' with market context and members goals. For instance, a fund that had invested in (for example) CDO's immediately before the Global Financial Crisis may have been considered a 'good' fund based on its returns at that time.

A low threshold list will negate the filtering aims that the Commission aims to achieve. However too high a threshold will force standardisation among fund options, limiting the specificity that is integral to member interests (demographics, saving goals, expectations etc.) taking away the strength that diversification adds to the superannuation industry.

The list may also reduce the likelihood that employees and employers will take a proactive and informed approach to superannuation on the basis that the Expert Panel has assumed the responsibility for conducting the necessary due diligence for them to make a selection.

The preference for standardised funds will likely exclude niche funds that target specific industries or member groups. This is detrimental to member interests who require different options to suit their needs.

The emphasis on new default members also shifts product focus towards appealing to young people first entering the workforce rather than meeting the needs of all members regardless of their life stage.

5. Submission on the tender/auction model – Model 3 (tender) and Model 4 (fee-based auction)

A tender or fee auction model will reshape Australian superannuation by introducing a competitive process to the default scheme. The Committee believes the Commission should consider the effects of low fees, a finite pool of products and the Chilean case study.

The emphasis on fees and costs when assessing and selecting the most appropriate default products for members, actively encourage funds to prioritise fee reduction at the expense of other areas.

Although these models may increase competition, they will more likely impede innovation and optimal investment by encouraging short-termism. Such a focus contradicts the long term nature of the superannuation industry.

Selecting funds based on member fees also encourages the homogenisation of available products that will favour a 'no frills' approach over tailored default products that serve the Members' best interests. The pursuit of lower fees to the detriment of qualitative factors jeopardises the quality of systems, services, investments and returns for funds and members.

One of the major weakness of these Models (and, in particular, Model 4) is that they will only be able to achieve their stated aim if the Expert Panel is provided with accurate and reliable data on the true costs of the tendering funds.

The Commission may be aware that ASIC has recently issued Regulatory Guide 97 (**RG97**) in an attempt to standardise fee and cost disclosure. However, even this exercise has shown that it is extremely difficult (if at all achievable) to accurately compare costs of superannuation funds. For example, one of the unintended consequences of RG97 is that funds investing directly in property appear more expensive than funds investing in property indirectly (through collective investment vehicles).

Another major weakness of Model 4 is that it focusses only on fees and does not consider the relative value enjoyed by member for those fees. For example, funds with an active investment strategy will almost certainly be more expensive than funds with a passive investment strategy, even though they may deliver returns that offset the additional fees.

Models 3 and 4 may, therefore, have the unintended consequence of discouraging funds from adopting investment strategies, or investing in assets or sectors, that will make them appear more expensive even though doing so may yield better returns and be in the best interests of members.

The obvious benefits of exposure and credibility to funds that win a place on the recommended or selected list places pressure on the need for an objective and quantifiable selection criteria that evaluates more than just member fees.

The tender and auction model both limit member choice to the winners of the tender or auction process respectively. This inevitably excludes funds from the opportunity to gain new default members until they can next participate in the selection process. The Draft Report proposes that the Expert Panel convene every few years and less over time.

The Committee considers that the Commission would need to consider the effect on funds that fail to be selected, including:

- (a) Funds that fail to be selected will lose considerable market share due to the lack of exposure and consideration from prospective default members which will impact on the cash flows, and the on-going viability, of those funds. The Commission should consider the impact over the medium to long-term (say 5 to 15 years) on the remaining members of those funds.
- (b) The anticipated difficulty in removing funds once they are on the winning lists creates significant barriers to entry for competition.
- (c) The effect on decision-making by funds in relation to longer term investments (such as infrastructure) where there must be some level of certainty as regards to expected contribution in-flows and out-flows.

The Chilean retirement income system has inspired the proposed tender model. The Committee believes that it is difficult to draw a comparison between both countries because of their very different market, fee and investment structures. The Chilean tender system was adopted in 2010 because of its small amount of high fee funds (five pension funds).⁵ Australia currently has low cost MySuper options available from a broad range of providers that offer tailored products to employees and employers. The Committee submits that, based on ASFA's research, the use of a singular default model in Chile has resulted in lesser competition with little benefit to members and the industry.

6. Draft recommendation 3.3 – Formal Framework for Trustee assessment of fund merger proposals.

The Committee refers to the desirability of there being an 'efficient exit for funds' and notes that the current successor fund transfer rules are a potential barrier to this process.

The Committee notes that the successor fund transfer process in the SIS Act is intended to protect the interests of members, and that the way the legislation is interpreted is a matter for the courts, not APRA. Rather than pressing trustees to take aggressive views on the meaning of equivalent rights to benefits in the successor fund definition in the SIS Act, the Committee thinks that there should be a different mechanism available to trustees who decide that they should close their fund and transfer members to another fund.

Part 18 of the SIS Act (Amalgamation of Funds) already gives APRA the power to transfer all the benefits of members and beneficiaries to another fund if reasonable attempts to bring about the transfer under another provision of the SIS Act or regulations have failed. If there is a real need for funds to be closed, the SIS Act could be amended by removing the current condition to the exercise of APRA's power in Part 18 (that reasonable attempts to transfer

⁵ The Association of Superannuation Funds of Australia (ASFA), 2017. *The Chilean pension tender model*, 4.

benefits have failed). Alternatively, trustees could be given a broader power by the legislature than they currently have, noting that any exercise of power should include protection for members.

The Commission recommends a formal framework be introduced to specify the process and obligations for trustees in making or considering fund merger proposals. As part of the mandatory framework, trustees would be required to disclose all merger attempts and the reasons for their decisions.

The Committee notes that APRA-regulated super fund trustees already have imposed express statutory covenants that apply to initiation or consideration of any merger proposal and, in the Committee's view, are sufficient to regulate the trustee's conduct in respect of dealing with merger proposals under the prudential supervision of APRA.

In particular under s 52 of the SIS Act, trustees (and trustee directors individually) must, when assessing any aspect of a merger proposal (including whether it is initiating or responding to such a proposal):

- (a) act honestly in all matters and dealings;
- (b) exercise a prudent and professional superannuation trustee standard of care, skill and diligence;
- (c) perform its duties and exercise its powers in the best interests of the fund beneficiaries; and
- (d) if a conflict in duties or interests arise give priority to the duties and interests of the fund beneficiaries.

Any prescription of a process framework (including any new disclosure requirements around merger proposals and reasons for decision) should only be considered where APRA has identified risk of systemic failure in trustees dealing with these issues.

We are not aware of any evidence that would suggest such additional measures are warranted, noting that APRA retains power and is the appropriate regulator to assess this matter and provide additional prescription (i.e. via prudential standards and/or guidance) or intervention should that become necessary.

Contact

The Committee would be pleased to provide further information or to answer queries in relation to this submission. At first instance, please contact the Chair of the Committee, Luke Barrett