Vision Super Pty Ltd

Vision Super - Response to the Productivity Commission Issues Paper on Alternative Default Models

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Vision Super's response

Introduction

Australia's superannuation system has the basics right. The Melbourne Mercer Global Pension Index ranks the Australian system among the top three in the world.[1]

Australians saving for retirement have compulsory contributions from their wages, made on their behalf by their employers into their super fund. They are protected by a range of measures, set out in legislation and regulations, that have been refined as the superannuation system has matured. Under the MySuper reforms, there are minimum standards funds have to meet in order for employers to be able to pay default contributions on behalf of their employees. Members of APRA-regulated funds are protected from having their money lost through fraudulent conduct or theft. Most Australians have a choice as to where their money is invested, having been able to choose the fund they prefer since 1 July 2005. It is easier than it has ever been for individuals to keep track of their super and combine multiple accounts. The taxation of superannuation has been designed to incentivise savings – something we sorely need given our ageing population, and the need for spending on the aged pension to remain in check. Opt-out insurance arrangements through superannuation provide much-needed protection for Australians, who are typically underinsured[2], and their families.

It will still be some time until we get to the point where retirees will have had compulsory super their whole working lives, but when the superannuation guarantee eventually goes up to 12% it will put Australia's retirement funding on a more sustainable basis. Importantly, most low-paid workers, who are typically employed under awards or Enterprise Bargaining Agreements, have the added protection of having their retirement savings in a not-for-profit fund that is run to benefit them as members, and which have historically outperformed retail funds, returning more to members – which means they have more in their pockets when they want to retire.

It is arguable that the system is not perfect. However, it is very effective, there are appropriate consumer safeguards in place, and there are also important threshold questions that governments should be asking before seeking further changes to a system that has already been through enormous upheavals. The constant tinkering and speculation about superannuation changes at a federal level is eroding Australians' confidence in the super system, and will start to have a major negative impact on contribution flows.

Governments need to be asking whether seeking changes based on ideological grounds, such as increasing competition or changing default arrangements, will benefit consumers more than the changes further undermine the system.

The superannuation system is functioning well and leading to better retirement outcomes for Australian workers. There is little to be gained and much to be lost by continuing to tinker with a system that is not broken.

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[1] http://www.globalpensionindex.com/wp-content/uploads/Melbourne-Mercer-Global-Pension-Index-2015-Report-Web.pdf

[2] According to KPMG research, the level of underinsurance of the lives of employed people in Australian families is an estimated $800 billion against premature death, and $304 billion per annum against disability (http://fsi.gov.au/files/2014/09/KPMG.pdf)

It is already evident from the changes announced in the previous federal budget that Australians are losing confidence in the system. Comments such as those below are indicative of lost faith:

> "I'd rather have the money now than wait for another 40 years. I can't see myself making a voluntary contribution ... who knows what the rules will be, and what investment performance will be like that far away. [I] would prefer to invest outside of super ... if I had excess funds"[3]

> "Tell me, with your hand on your heart, that we can trust that any government will continue to allow untaxed lump sum withdrawals from either a pension or even an accumulation account. No - I guess you just can't trust them on anything they now say. That is the major lesson of the great Turnbull/Morrison Betrayal. Even if you are nowhere near their stupid limits - you just can't trust them to not want to go further.... An old conman's saying goes "there's one born every minute"."[4]

What the superannuation system needs is a long period of stability with any changes made only to address urgent issues that are putting Australians' retirement at risk, not further changes that may or may not prove to actually increase competition or engagement with superannuation. The government should declare a moratorium on any further changes to the superannuation system for at least the next five years.

The rationale for defaults

The Productivity Commission's issues paper claims the rationale for defaults is no longer as relevant as it was when superannuation was introduced. Vision Super disagrees with this assessment. The Productivity Commission references defaults having been part of the system because of "… the inherent complexity that individuals face in making decisions about retirement incomes. Many employees appear disengaged from the superannuation system or do not feel qualified to choose a fund…"

These factors have not changed since the introduction of superannuation.

Per the Commission's own estimate, around two thirds of employees use their employer's default fund, despite choice of fund having been available to most Australians for the last decade. The ATO reports at 30 June 2016, approximately 43% of Australians with superannuation have more than one super account.[5]

ANZ's Survey of Adult Financial Literacy in Australia (2014) found one in five super fund members said they receive statements but do not read them, either because they 'couldn't be bothered' or found them 'too difficult to understand'. Across all superannuation fund members, one third said they find reading a superannuation fund statement difficult. 22% of fund members said they 'can't say' what the best indicator of fund performance is – a number that has more than doubled since 2005 - and one in five people with superannuation could not name any factors they would consider in choosing a superannuation fund. These last two points suggest around one in five people are poorly equipped to make a decision about changing or choosing a superannuation fund, and that people are now less equipped to make that decision that they were a decade ago. Of those who said they had chosen a superannuation fund (46% of fund members), 44% did not compare their chosen fund with any others before selecting it.[6]

Based on these statistics, it is far from the case that default funds are no longer relevant.

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[3] http://www.fsc.org.au/downloads/uploaded/2015_1011_FSC%20ING%20DIRECT%20YOUR%20SUPER%20REPORT%20FINAL%20LOW%20RES_df95.pdf

[4] http://www.theaustralian.com.au/business/opinion/tony-negline/how-much-superannuation-do-you-really-need/news-story/d8b938c0f1c8848d71b41dc2bf39b4fa

[5] https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/Super-accounts-data/Super-accounts-data-overview/

[6] http://www.anz.com/resources/3/1/31cbc1fd-9491-4a22-91dc-4c803e4c34ab/adult-financial-literacy-survey-full-results.pdf

One of the two main concerns for efficiency and competition articulated about the default system is that "where default products are largely homogenous, they might not meet the needs of members who have diverse characteristics and needs". It therefore seems astonishing that one of the solutions mooted in the paper is to move to a single national default fund to be determined by tender – which would exacerbate the situation further.

The other main concern is that the use of defaults "may diminish active participation by members, making them less responsive to price signals and other aspects of fund performance", leading to the persistence of high fees, lower quality products and erosion of member balances.

However, default funds named in awards and enterprise agreements are generally industry funds.[7] The returns of not-for-profit funds have outstripped returns of 'for profit' bank owned and retail funds by 2% over nearly two decades.[8] The average fees of an industry fund on a $50,000 balance are $506 a year, compared with $876 for the average retail fund.[9]

Despite a perceived lack of competition, default fund arrangements leave workers manifestly better off than they would be with retail funds.

Further, those covered by awards and enterprise agreements tend to be lower-skilled, lower paid workers,[10] who are the most likely to be low in financial literacy skills according to ANZ's financial literacy research[11] - those who are most likely to be with their employer's default fund, and the least likely to have the skills to pick a super fund for themselves.

Industry super funds were first established in the 1980s to protect Australian workers' super from high fee and commission retail products. They are still performing that role. There is no evidence that opening up default fund status to further competition would lead to increased active participation by members. There is no evidence that the current state of play has led to higher fees, lower quality products or the erosion of member balances – quite the opposite in fact. And there is plenty of evidence that continued changes to the superannuation system are detrimental to the system - even if removing default funds did offer marginal benefits in terms of competitiveness or enhanced member engagement, the benefit may well be cancelled out by the resulting disengagement caused by the further changes.

The best interests of members and the stability and integrity of the superannuation system are best served by leaving default arrangements as they are.

Criteria for assessing alternative models

Of the criteria proposed by the Productivity Commission, Vision Super considers members' best interests to be the paramount concern.

Most Australians have had choice of fund for over a decade. Most Australians have chosen not to exercise that choice, with the majority remaining with their employer's default fund.

No evidence has been presented that the disengagement with the compulsory super system is because of the default nature of funds. This is merely an ideological standpoint, unsupported by any data.

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[7] PC inquiry Default Superannuation Funds in Modern Awards
[8] Industry Super Australia: A Comparison of Long-term Superannuation Investment Performance
[9] http://www.superguide.com.au/smsfs/feeding-frenzy-super-fund-fees
[10] Ibid
[11] http://www.anz.com/resources/3/1/31cbc1fd-9491-4a22-91dc-4c803e4c34ab/adult-financial-literacy-survey-full-results.pdf

There is already a standard that funds have to meet - from 1 January 2014, employers have only been permitted to pay default superannuation contributions to an authorised MySuper product, which must comply with a regulated set of features, including:

- A single investment option
- A minimum level of insurance cover
- An easily comparable fee structure, with a short prescribed list of allowable fee types
- Restrictions on how advice is provided and paid for
- Rules governing fund governance and transparency.

Vision Super believes that members' best interests are represented by leaving the default system as is. There are strong minimum standards in place, and the best interests of working Australians are already represented by the industry funds that are part of awards and enterprise bargaining agreements.

The framework proposed by the Productivity Commission for designing alternate models is flawed. Australia's existing system is stronger than the comparative overseas models discussed in the paper, including the compulsory nature of superannuation and the quantum of contributions.

The conflict at the heart of the retail funds

Retail funds, such as those owned by the banks, have an inescapable conflict built into their structure.

The *Corporations Act 2001* states that directors have a duty to act in the best interests of the company, and case law in Australia has supported what has been called the "shareholder primacy" view - that the overriding goal of a corporation is to maximise shareholder value. This view is deeply entrenched.

However trustees of superannuation funds have an obligation to act in the best interests of members including under Section 52A of the *Superannuation Industry (Supervision) Act 1993,* which sets out that they must:

"perform the director's duties and exercise the director's powers as director of the corporate trustee in the best interests of the beneficiaries" [ie the fund members]

Herein lies the conflict. The best interests of shareholders are served by maximising returns. The best interests of superannuation fund members are served by minimising those returns, so that more ends up in their accounts. In fact the Act is quite specific in relation to additional obligations of trustees in relation to a MySuper product, in Section 29VN, that the members' best interests include their financial returns:

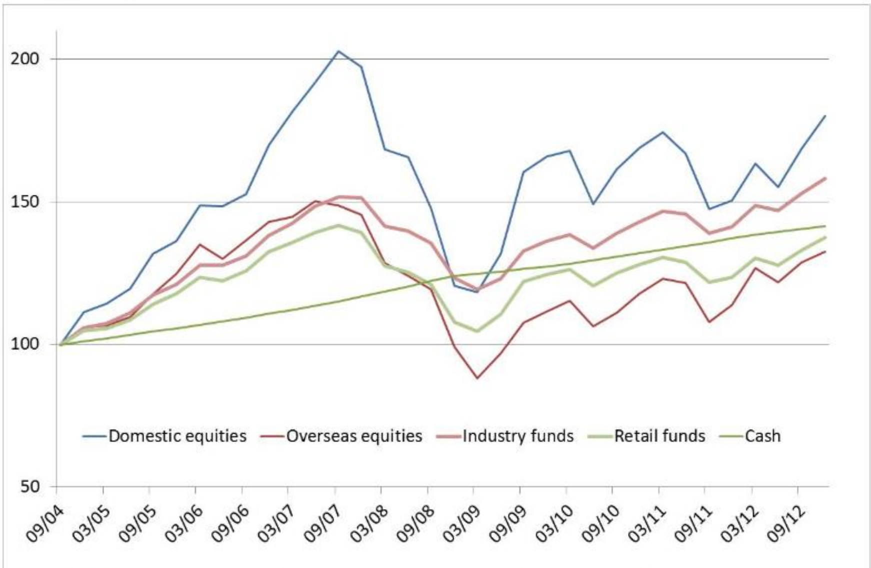
"Each trustee of a regulated superannuation fund that includes a MySuper product must:

(a) promote the financial interests of the beneficiaries of the fund who hold the MySuper product, in particular returns to those beneficiaries (after the deduction of fees, costs and taxes)"

This conflict is inescapable. You cannot serve two masters – the more you return to shareholders, the less goes into the retirement savings of Australians who have their superannuation with the retail funds.

It cannot even be argued that the retail funds have better expertise and therefore their members end up better off despite the profits to shareholders coming out of their retirement nest eggs. For the last decade, industry funds have out-performed retail funds

Figure 1 Superannuation fund performance during and since the GFC, September 2004 – December 2012



Sources: APRA (2013) *Quarterly Superannuation Performance*, Frontier Investment Consultants (2013) *Proprietary dataset.* [12]

If the default system were changed to allow retail funds to participate, this would see a further problem develop.

In recent weeks, the banks have been in the news as there has been a sharp increase in the number of customers switching to bank-owned super products, which it is claimed is because tellers get bonuses for signing up new customers, sidestepping the Future of Financial Advice (FOFA) protections against conflicted remuneration and their duty to act in customers' best interests by offering additional levels of general advice over the counter, which does not have the same restrictions as tailored advice.[13] Westpac chief Brian Hartzer and National Australia Bank chief Andrew Thorburn conceded that staff are subject to the quotas to refer clients.[14]

This may be the results of plans the banks had some time ago. In 2013, NAB's then-executive general manager retail, Vicki Carter, told The Age's Business Day that NAB was planning to train all of their tellers to provide 'lite' financial advice, saying "'The reality is that a lot of Australians won't pay $4000, $5000 for a financial plan,but many Australians still need help with simple rollover products, their superannuation products and their simple protection needs. That is unfilled at present, so … this is actually a gap in the market."[15]

This is far from a new issue. As far back as 2012, ASIC conducted a 'shadow shopping' exercise on retirement advice, which found wide spread conflicts of interest in recommending superannuation products, especially from the big banks.

> "66% of the advice examples involved the recommendation of 'in-house products' or products associated with the advice group. Of these, 11 of the 13 advice interactions with advisers from one of the big four banks (or their financial planning divisions) resulted in an in-house product

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[12] http://www.industrysuperaustralia.com/assets/Reports/Long-Term-Superannuation-Investment-Performance-Update.pdf
[13] http://www.afr.com/business/banking-and-finance/superannuation-war-heats-up-as-industry-funds-attack-banks-over-teller-sales-20161003-grto65#ixzz4NIQl8TIj
[14] http://www.theaustralian.com.au/national-affairs/big-four-banks-lashed-for-putting-heat-on-pushy-tellers/news-story/a26c0510bf2650b1c5d075b8b92bcea0
[15] http://www.theage.com.au/business/nab-to-offer-lite-choice-on-its-financial-advice-20131208-2yzdo.html

> recommendation… there were also cases where the in house products recommended were relatively more expensive, or other reasons meant that the product switch was not adequately justified."

They also noted that:

> "This aligns with wider industry research that finds the recommendation of in-house products is endemic in financial and superannuation advice. Roy Morgan Research surveys found that, in the four years from July 2007 to June 2011, the six largest institutionally owned advice groups had directed 73% of superannuation recommendations to their own products, which included superannuation fund platforms.
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> In one example, the client saw a financial adviser employed by a major bank. The client had insurance and estate planning needs, as well as substantial upcoming expenses. However, these requirements were not considered by the adviser, who focused on the lump sum required to provide the client's desired income, and on switching their superannuation to one of the bank's funds.
>
> The basis for the switch was lower fees, but no comparison of costs (the old fund versus the new fund) was provided. The risks of switching superannuation funds, including the possible loss of benefits, were not addressed."

Further, they concluded that advisers had, through remuneration structures that rewards sales, a motive to "prioritise product recommendations or sales over product neutral strategic advice".[16]

It is easy to see how this issue will be replicated at a business level if banks-owned funds are allowed to become part of the default system.

Business bankers, who have existing relationships with their corporate customers, will be in an exceptional position to recommend those businesses switch their default super fund away from a traditional provider, to a bank owner fund. They may offer incentives for the customer to do so – not in any way officially tied to the switch in super funds, but perhaps a lower interest rate on an overdraft, or reduced transaction charges as a reward for "customer loyalty". Employers, who in many cases may not understand and in some cases may not care that their employees may be worse off with a retail fund, may well be motivated by such incentives, which will increase their own bottom line and not affect their own plans for retirement.

It is simply unconscionable that such a situation should be allowed to occur. It is manifestly not in the best interests of members.

[16] http://download.asic.gov.au/media/1343876/rep279-published-27-March-2012.pdf

The alternative models

A single default provider

While a single default scheme might be theoretically appealing from the perspective of reducing costs, this theoretical appeal is not borne out by real world experience.

If fees were simply related to size, AustralianSuper (the largest super fund) would have the cheapest fees in the country. They don't. There are at least five funds with cheaper fees than AustralianSuper.[17]

Size does not necessarily mean better performance either, which is also essential to maximise the long-term savings of Australians and minimise future reliance on the aged pension. According to SuperRatings, of the top 20 largest super funds as at 30 June 2015, only 10 were in the top 20 performing super funds.[18]

Further, a tender process that was a race to the bottom on fees – particularly if repeated at regular intervals – would be disastrous for customer service, as well as member education and engagement. We know, for example, that retiring members with low balances tend to take their super as a lump sum on retirement, and make choices such as putting it into a term deposit account. Research shows that this is because the choices can be overwhelming, and members with low balances are unlikely to obtain financial advice. The sort of cost-cutting that would be necessary to win such a tender would mean initiatives such as those aimed at educating and helping lower-balance retiring members would no longer be affordable.

It is easy to imagine the sort of customer service a member would get if they needed to call the super fund that was the sole default fund in the country – most Australians have experience dealing with outsourced call centres and telephone systems that ask you to "press one" or "use a few simple words to describe your issue", as well as with extensive hold times and consultants who refuse to deviate from a script.

It's also all too easy to imagine cost cutting resulting in suboptimal financial controls, fraud prevention, and online security. The 2016 Threat Report from the government's peak cyber agency, the Australian Cyber Security Centre, flagged that the serious and rising threat of cyber attacks to the security of government networks, which suffered 1095 serious cyber assaults from all sources, including foreign espionage, in the 18 months to June 30 this year.

Administrative model

The idea that members' best interests would be enhanced by a new government agency creating a filtered list of default products or even allocating members with different demographic characteristics to different funds is quite simply bizarre.

There will be no increase in competition, as this situation would simply create a situation where a small number of funds could compete effectively while blocking the entrance of new players into the centrally controlled market.

Vision Super does, however, agree that efficient competition would be enhanced by improving product comparability – something that could be done quite simply by creating an online resource for consumers that allowed them to easily compare funds, similar to the government's existing energy ratings website, where consumers can quickly and easily compare the energy use and cost of running different appliances. With the introduction in early 2017 of RG97 - Disclosing fees and costs in PDSs and periodic statements, it will be easier to produce accurate comparison tables.

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[17] http://www.superguide.com.au/boost-your-superannuation/comparing-super-funds-check-out-the-cheapest-funds

[18] Performance measured over 5 years to 31 December 2015. http://www.superguide.com.au/boost-your-superannuation/top-20-largest-super-funds

This would allow those Australians who wish to exercise super choice to compare different products, without creating a new layer of bureaucracy or an oligarchy of funds chosen by the government.

Active choice by employees

Under this model, employees would have to make an active choice of super fund when they started employment and there would be no default funds.

This is presented in the paper as an option that would increase engagement – however no evidence is offered to back up this assertion. Behavioural economics suggests it is very difficult to get people to engage with retirement saving until they near retirement age – forcing people to choose a fund is extremely unlikely to overcome the problems posed by hyperbolic discounting and a general lack of engagement with the future self.

It is postulated in the paper that this system would drive down costs through increased competition. This is based on the erroneous assumption that people make rational decisions about products such as superannuation based on information about fees. We know from behavioural economics that this is also not the case. Most financial decisions are made on the basis of emotions.

As discussed above, it is also the case that around a fifth of Australians lack the financial literacy skills to make a decision about choice of superannuation provider. There is a very real danger that many would turn to their bank for a super fund, simply for convenience and because it is a brand they recognise, despite the bank funds charging higher fees and underperforming the industry funds. This would not serve the best interests of members.

In this model, funds that wished to remain competitive would need to spend an enormous amount on marketing to increase brand awareness and gain new members – pushing up costs and reducing benefits to members.

Conclusion

The current superannuation default arrangements are serving members' best interests better than any of the proposed alternative models. Those Australians who want to choose their super fund are able to do so, and are able to do so easily. Those covered by awards or industrial agreements who do not wish to make a choice, or who lack the skills to do so, are served by having their retirement savings in the industry funds that are run to benefit them as members, which charge lower fees, and which have historically out-performed retail funds.

No cogent argument has been made for switching to a single default provider, a short list of default providers, or a full member choice system. Such a change, absent compelling evidence that the system would be substantially improved and the best interests of members far better served, will simply further undermine the faith of Australians in the superannuation system – a faith that has already been shaken by the changes announced in the previous federal budget.

It is time for governments of both persuasions to start keeping the promises they make to leave the superannuation system alone. Australians' interests are best served by having a system of retirement savings they can rely on to operate on the same rules when they retire as it did when they started making contributions. Australian workers should not have to be worried that if they put their money into their super, the rules will change again and they will not be able to access it when they need to, or it will be taken in taxes, or they will be unable to rely on the provider their super sits with.