13 April 2012

Default Superannuation Funds in Modern Awards
Productivity Commission
LB2 Collins Street East
MELBOURNE VIC 8003

By email to: default.super@pc.gov.au

Dear Sir/Madam

Response to Default Superannuation Funds in Modern Awards Issues Paper

The Actuaries Institute ("the Institute") is the sole professional body for actuaries in Australia, providing independent, expert and ethical comment on public policy issues where there is uncertainty of future financial outcomes. It represents the interests of over 3,800 members, including more than 2,000 actuaries.

Some of the principles that guide the Institute's inputs into public policy are:

- Acceptance of public sector involvement where the market does not meet societal needs,
- The need to take a long term policy view, with appropriate transitional arrangements,
- Ensuring that consequences of risk taking behaviour are borne by the risk taker,
- Issues of intergenerational equity, and
- Clear and reliable information available for decision-making.

We refer to your Issues Paper dated February 2012 and thank you for the opportunity to provide our comments on some of the particular issues you have raised.

Selection Criteria

Paragraph 3 of the Issues Paper addresses the crucial issue of whether or not it is sufficient for a superannuation fund to simply meet the requirements of the proposed MySuper standards in order to be eligible to be included as a default fund in an Award, or whether additional criteria are necessary.

Since the introduction of the Superannuation Guarantee (SG) in 1992, actuaries have regularly assisted employers in selecting a suitable default fund for receipt of SG contributions when their employees do not exercise their right to direct contributions to a different fund of their choice.

Often the selection process will go to a formal market tender with submissions requested from several possible funds. There are generally two main criteria involved in the selection process:

a. What is an adequate set of standards for a fund to qualify as a possible default fund?

b. What criteria should be used to evaluate the qualifying funds?

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Applying this process to the question raised in the Issues Paper, we believe that the MySuper standards should be adequate to determine whether a fund should be able to qualify as a default fund in an Award. If they are not considered adequate, then it would be preferable to strengthen the MySuper standards in an appropriate way rather than adding an extra set of criteria for qualification as a default fund.

In relation to what criteria could be used to evaluate the qualifying funds in the process of selecting a default fund under an Award or an individual enterprise agreement, we have provided an outline of the issues that would normally be considered in the Appendix to this letter.

Importantly, many of these issues require qualitative judgements and, as a result, we do not believe that the selection process can therefore be reduced to a mechanical sequence of decisions that could be codified. Consequently, it would therefore be preferable to simply codify the factors that should be considered.

Of course, a key objective of the selection process should be to ensure that the default fund selected for an Award or agreement is appropriate for the needs of the employees under that Award or agreement. It should also be incumbent on those who determine the default fund to demonstrate that a suitable process has been followed.

There is a reasonable argument that with the advent of MySuper it should be unnecessary for awards and agreements to contain a limited list of eligible funds (i.e. any MySuper product should be a suitable default and can therefore be chosen by an employer). However, if it is determined that awards and agreements should continue to contain a limited list of eligible funds, then we would support a regulatory framework that codified the matters that should be taken into account as part of the process for selecting a default fund in an Award or agreement.

This framework should also be applied when a new fund is added to the list of eligible default funds in an Award or agreement, as well as any periodic review of the list of eligible default funds.

The limited list of funds contained in an Award or agreement could be either exclusive or non-exclusive. If it is non-exclusive, an employer could choose a fund outside the list but, in that situation, the employer should be required to follow the regulatory framework.

Specific Issues

The Issues Paper identifies two areas in which quantitative analysis is required. The Institute believes that care needs to be exercised when drawing conclusions from this analysis. Our comments on each of the questions raised in the Issues Paper are set out below.

1. Fund Expertise and Performance

Should a fund's investment management expertise be factored into the selection of default superannuation funds for inclusion in Awards, and if so, how?

The long term investment return achieved by a default fund is one of the most important factors in determining the final benefits available to a member on their retirement. Therefore it is vital that a fund that is to be included in an Award has appropriate investment capabilities. The major factors that would be considered in determining that these capabilities are adequate are the quality and quantity of the investment management staff

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(taking into account their expertise and experience), the quality of the investment process used by the team, and the success of the team measured, in part, by past performance.

How relevant is a fund's past net performance as an indicator of its potential future performance? What weight, if any, should be placed on the past performance of a fund in assessing its suitability for inclusion as a default fund in Awards?

Past investment performance (net of investment fees and costs and investment taxes) is one of the many factors that should be considered when assessing the investment capabilities of a fund. However, the absolute level of past investment performance provides little, if any, guide to the absolute level of future investment performance, particularly when this is considered over relatively short periods of time.

Consideration of past investment performance against past index performance and, to a lesser extent, the past performance of other comparable funds, may provide some indication of the relative performance that might be expected in the future.

If past performance is considered important in assessing a fund's suitability for inclusion as a default fund in Awards

- *Over what time period should past net performance be assessed?*
- *How should funds with no net performance record (for instance, newly merged funds or new entrants to the market) be assessed?*
- *Should net performance be assessed in absolute or relative terms? That is, should the top performing funds be selected (regardless of their absolute returns), or would funds be required to meet a particular target level of performance?*

Past investment performance should be calculated according to the following criteria:

1. For comparison purposes, investment returns should be calculated for all funds for periods ending on 30 June. This will ensure that comparative returns will not be distorted by market movements varying during different time periods.
2. Investment returns should be net of investment fees and costs and investment taxes. Only investment related fees/costs/taxes should be allowed for in the calculation to avoid distortions resulting from allowing other fees/costs/taxes.
3. If possible, investment returns should be determined for three contiguous periods of four years; a total of 12 years. The use of separate contiguous periods is aimed at reducing the scope for trends in relative performance to be distorted by the performance in recent years.

As indicated above, consideration of past investment performance against past index performance and, to a lesser extent, the past performance of other comparable funds, may provide some indication of the relative performance that might be expected in the future.

Further, the imposition of a target level of investment performance would likely constrain the level of risk that a fund would then be prepared to accept, which would potentially lead to lower investment returns over the long term.

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2. Fees

Should fees be factored into the selection of default superannuation funds for inclusion in Awards and if so, how? For instance, are there circumstances in which paying higher fees could serve the interests of members of default funds? Does this differ across industries? Should maximum fees be set for funds that are selected for inclusion as default funds in Awards?

Fees and costs need to be one of the factors considered when choosing a default fund in an Award or agreement. However, it is vital that both fees (those paid directly by members) and costs (fees that are effectively paid by members indirectly) are considered, and that fees and costs for administration services be considered separately from investment fees and costs for investment services.

With respect to investment fees and costs, the analysis of investment performance net of these fees and costs is an appropriate way to consider the impact of these fees and costs. With respect to administration fees and costs, there are a number of issues that need to be considered, including:

a) A comparison of administration fees and costs must consider the impact of these on the final benefit payable to members and to take into account different contribution levels and different durations of membership.

b) The fees and costs should be reported gross of "tax benefits", but the comparison of the impact of fees and costs should take into account the impact of tax.

c) The level, extent and quality of the services provided by a fund should also be taken into account when comparing administration fees and costs.

In the past two years the Institute has made a number of submissions to Treasury, APRA and ASIC that relate to fees, costs, investment performance and MySuper. We would be happy to provide further information about these. Importantly, we do not believe that it is necessary to impose a maximum level on fees as transparent disclosure and competition amongst MySuper funds should ensure that administration fee and cost levels will be reasonable.

Employers Choosing Between Default Funds in an Award

Whilst ideally employers would follow a similar process in deciding between default funds available in an Award or agreement, this could impose a large administrative burden that seems counter intuitive to the concept that MySuper funds are regarded as appropriate default funds for employees outside Awards. Therefore, an employer should be able to meet an Award requirement by choosing any fund on the default fund list in that Award or agreement without being required to demonstrate how they made that decision or the process for doing so.

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Please do not hesitate to contact either Melinda Howes, Chief Executive of the Actuaries Institute (Phone: (02) 9239 6106 or melinda.howes@actuaries.asn.au) or Andrew Boal, Convenor of the Actuaries Institute's Superannuation Practice Committee (Phone: (03) 9655 5103 or andrew.boal@towerswatson.com) in this regard, or for any further information.

Yours faithfully

Electronic signature affixed

David Goodsall
President

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Appendix

In the process of selecting a default fund under an Award or an individual enterprise agreement, qualifying funds could be evaluated with reference to:

1. Organisational expertise and strength.
2. Investment menu, investment management staff and expertise, experience, process and performance and investment risks.
3. Insurance benefits, terms, premiums, administration and claims history.
4. Fees and costs charged to members together with additional information on whether fees are gross or net of tax deductions to members and whether they include performance fees. Also, details of any other costs such as consulting fees and the cost of member protection. Also details of crediting rate/unit-pricing and reserve methodologies and information about transaction fees such as buy/sell spreads.
5. Details of administration and contact centre staff and experience, details of processes, systems, service standards, electronic processing capabilities, contact centre hours, internet facilities.
6. Details of employer-specific services that may be provided such as the provision of information and ability to tailor services or materials.
7. Details of member services, communication and education.
8. Details of financial planning services.

As indicated in the Issues Paper, assessing funds against a given set of selection criteria does not necessarily provide a clear 'winner'. The assessment of some criteria is qualitative and the judgement of the relative weights to be given to different criterion is subjective and, importantly, will differ for each circumstance. For example, the fee structure for fund A might favour members with low account balances while the fee structure for fund B might favour members with high account balances. However across all members the judgement might be that funds A and B are "equivalent".

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