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

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

2 August 2012

Subject: DEFAULT SUPERANNUATION FUNDS IN MODERN AWARDS

Dear Sir/Madam

Mercer (Australia) Pty Ltd welcomes the opportunity to provide our view on the Productivity Commission Draft Report on Default Superannuation Funds in Modern Awards.

Who is Mercer?

Mercer is a leading global provider of consulting, outsourcing and investment services, with more than 25,000 institutional clients worldwide. Mercer consultants help employers design and manage health, retirement and other benefits, and optimise human capital.

Mercer also provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds. Mercer has $55 billion in funds under administration locally, and provides services to more than 1.3 million super members and 15,000 private clients. Our own master trust, the Mercer Super Trust, has approximately 260 participating employers, 240,000 members and more than $15 billion in assets under management.

Mercer's reach into the Australian superannuation industry is broad and our clients represent all types of superannuation funds (including corporate, industry, public sector and retail funds). Therefore the views expressed in this submission are Mercer's alone and do not necessarily represent the views of our clients. Furthermore, where our clients have made a submission to the Productivity Commission, their submissions should be relied upon as expressing their view.

Executive summary

We believe the draft report is a good base from which to promote a move to a more transparent, competitive and innovative system where members can receive the best retirement benefit possible.

In reviewing the Draft Report, we highlight the following significant areas of concern:

- Removal of grandfathering provisions in draft recommendation 8.3
- The adverse impact of removing funds from a list specified in an award
- Liability of employers
- Defined benefit funds.

In addition, we propose a fifth Option as a better outcome for enhancing members' interests and increasing competition.

Proposal of a fifth Option (draft Principal Finding 8.1)

The draft report considers 4 main Options, of which Options 1 and 2 are dismissed by the Commission leaving Options 3 and 4 for more serious consideration. Whilst Mercer considers Options 3 and 4 to be a significant forward step towards enhancing members' interests and increasing competition, ***we consider a fifth Option would provide a better outcome.*** Our fifth Option would be based on a non-mandated list of funds, maintained outside the modern award. The list would include five to ten funds chosen by an appropriate panel or body determined in a manner equivalent to the Commissioner's proposed selection mechanisms under Options 3 and 4. Our fifth Option is a combination of the best features of Option 1 and Options 3 and 4 and removes some potentially adverse outcomes that may arise under Options 3 and 4.

Removal of grandfathering provisions (draft recommendation 8.3)

We strongly support draft recommendation 8.2 which would enable employers to choose a fund not listed in the relevant award (subject to a member interest test). ***However we consider that the member interest test needs to be clarified and improved.***

On the other hand, we have serious concerns with draft recommendations 8.3 and 8.5 although we acknowledge the good intent behind these recommendations.

The adoption of draft recommendation 8.3 would result in the removal of grandfathering provisions. This will be a major problem irrespective of which option is selected. Such removal would result in similar problems to those arising when a fund is removed from a modern award list (see our comments on recommendation 8.5 below). In addition, it would create new barriers to fund mergers and industry rationalisation.

Unless appropriate transitional measures are put in place, implementing this recommendation is likely to result in considerable disruption for employers currently utilising the grandfathering provisions as well as their employees who are members of those grandfathered funds. We recommend employers be provided with a three year period to justify their default fund is appropriate under the provisions of draft recommendation 8.2.

Further consideration would also need to be given to reduce the barriers to future merger/rationalisation activity which would be created by removing grandfathering provisions.

Process for removing funds from a list specified in an award (draft recommendation 8.5)

Whilst we support draft recommendation 8.5 to the extent that any demonstrably unsuitable, unauthorised or non-existent funds should be removed from a list of funds specified in an award, we consider that the removal of other well-performing funds is a serious flaw in the Commission's recommendations. Removing a fund from a list nominated in an Award could potentially result in:

- significant disruption and cost for many thousands of employers who would need to either select another fund (or justify the retention of the existing fund)
- significant disruption and cost for their employees who are members of the delisted fund and who may end up with two accounts (and two sets of fees and insurance premiums) and/or incur a withdrawal fee when their existing account is transferred to their new fund
- a potentially disastrous impact on the delisted fund (with a potential large call on its assets as members transfer account balances to the new default funds of the thousands of employers who can no longer contribute to the fund) and a significant drop in contribution inflows. The fund's liquidity and future investment returns may also be adversely impacted
- a potentially serious adverse impact on the remaining members of the delisted fund with its reduced scale, potential fee increases and potential lower liquidity

Well rated funds should not be removed from the list in the manner proposed just because they are no longer one of the top five or ten funds as judged by the review panel. ***This adverse outcome could be minimised by:***

- ***Adopting our preferred Option 5; or***
- ***Having a different test for being taken off the list than the test for being put on the list; or***
- ***Allowing well performing funds to remain on the list (even if this increases the number of listed funds beyond ten); or***
- ***Allowing employers already contributing to such a fund to continue using it as a default fund.***

Other recommendations

Most of the other recommendations are connected with the operation of a list of funds being provided in modern awards. If a list is to be included, then we generally support these recommendations. We note that these recommendations could also be applied to our preferred Option 5. **We have however recommended any panel should also take diversity into account so that lists of funds in modern awards do not consist of funds which all provide similar investment strategies and services etc.**

Liability of employer

We are concerned, that whichever of Options 1 to 4 (or our Option 5) is adopted, employers will run the risk of action against them. This will apply whether the employer chooses a fund listed in an Award or an alternative fund. ***We consider employers need to be protected from liability for choosing a fund, which in hindsight turns out to be inappropriate, where the appropriate process was followed in choosing the fund.***

Defined benefit funds

The draft report does not refer to defined benefit funds. These are valid funds, generally providing members with benefits that are higher or equivalent to benefits provided from potential MySuper arrangements. ***The final recommendations need to take into account ongoing defined benefit arrangements and allow these to operate as default funds.***

Our more detailed comments are set out in an Appendix to this letter.

I welcome the opportunity to discuss our view in more detail. I can be contacted on 02 8864 6383 or david.anderson@mercer.com

Yours sincerely

David Anderson
Managing Director & Market Leader
Australia/New Zealand

APPENDIX

PART 1: Consideration of various options

Our comments in relation to each option put forward by the Commission are summarised below:

Option 1

Under this option all employers would be permitted to choose any MySuper product or other approved default product.

The Commission, in its draft report, has rejected this Option. This rejection appears to have been based mainly on its concerns for employees (the Commission considers this Option does not have the best interests of members as its explicit focus) and for employers (who may find difficulty copying with making a choice from a large number of MySuper funds).

We analyse these concerns below.

Best interests of employees

- The Commission argues that Option 1 does not, by itself, sufficiently protect the best interest of employees. However, under the MySuper regime all products will be required to satisfy numerous legislative requirements, be subject to ongoing monitoring under the *Superannuation Industry (Supervision) Act 1993* and be subject to APRA scrutiny. This will be the first time in APRA's history that APRA will be required to approve a particular superannuation product. In other words, APRA could be considered as the guardian of members' interests.
- Further, for employees of large organisations, the provision of a mandated short list of funds will actually operate to the employees' detriment. This is because large employers have greater purchasing power and can negotiate cheaper fees to reflect the economies of scale in dealing with a large employer. It is clearly not possible for any panel to take into account such negotiated fees in coming up with a short list of funds. A fund which is not on the list, perhaps due to its rack rates, could, for a large employer, have provided a much better outcome for employees.

Difficulties for employers in choosing from all MySuper funds

- The Commission also expects Option 1 to result in high search costs for employers. In our submission dated 5 April 2012 we recognised that the removal of nominated default funds from awards could provide difficulties for some employers. However we recommended a non-exclusive list of standard default funds for each award be maintained (outside of the Award). This list would contain a range of MySuper funds that may be suitable for each group of award employees. Under this scenario, our Option 5, employers could merely choose between the funds listed or, for those willing to go further, could choose a more appropriate default fund (including a fund not on the list) and thereby obtain a better outcome for their employees. This would minimise the search costs for employers deciding on a default fund. The non-exclusive list could be determined by adopting a primary selection mechanism consistent with the mechanisms under Options 3 and 4.

Other comments on Option 1
The Commission considers Option 1 has the greatest potential to cause instability in the system, especially in the short term as it could result in a high degree of switching (referencing the experience in Chile in the 1980s and 1990s). We consider that such fears are unfounded due to:

- the restrictions on commissions and other requirements of the FoFA legislation
- the provisions of Section 68A of the SIS Act which prevent trustees and their associates from providing benefits to employers on the condition that the employer's employees join the fund.

As noted in our comments on Options 3 and 4, we consider these options have far greater potential to create instability in the system than Option 1.

Option 1 would also remove the need for a selection process as any MySuper product would be eligible for selection under a Modern Award and avoid the difficulties highlighted under Options 3 & 4.

We therefore consider the Commission has placed too much weight on the above concerns. In our view, Option 1 will provide appropriate protection for employees, greater stability in the system and concerns of employers can be overcome by providing a non-mandated list of funds provided by an appropriate review panel.

Option 2

Under this Option, a subset of five to ten funds would be determined by the industrial parties to be listing in Modern Awards. We agree with the Commission's decision in its draft report to reject Option 2 as it does not sufficiently open up the process by which funds are listed in awards to greater contestability and competition or ensure the best interests of employees are taken into account.

Options 3 & 4

Under these Options, the selection process would be opened up to allow all funds to present their case to be listed in Modern Awards to either a FWA panel (Option 3) or an expert body independent of FWA (Option 4). These Options will provide a system under which search costs for employers would be minimised. Nevertheless, they raise their own serious problems.

The major issues resulting from these Options are as follows:

Choice of appropriate panel

We consider it would be more appropriate for an independent panel of experts (Option 4) be adopted over an expert panel established by FWA.

We do not believe any existing body is appropriate to perform the proposed tasks. It would therefore be necessary to establish a new panel with personnel chosen for their ability to properly assess superannuation funds.

Criteria for selecting a fund – need for diversity

Although the criteria proposed by the Commission are appropriate, we believe that any panel should also ensure there is a reasonable level of diversity included in the funds chosen.

For example it would be disturbing if all funds chosen were very similar in their make-up and adopted similar investment strategies and styles or all provided the same levels of member services or level of insurance. Potentially this could lead to employers effectively being given no choice other than the particular organisation running the fund.

We note that the concept of lists in modern awards is also likely to discriminate against funds which concentrate their activities in a particular State (for example a fund which has members primarily in Victoria may only provide seminars etc in Victoria). Bearing in mind the national nature of modern awards, such funds might find difficulty in becoming listed even though they are extremely competitive in their local area.

We consider any list should include a diverse range of MySuper products. Diversification in relation to the following could be considered:

- ***investment risk (for example it could be appropriate to have a lifecycle, a 70% growth and a 50% growth strategy***
- ***investment style (eg passive with potentially lower fees/active with the potential for higher returns)***
- ***range of member services***
- ***default insurance levels***
- ***geographical spread of services such as education seminars***

In this way, it would be more likely employers could choose a fund which caters for the needs of its employees.

Major disruptions if fund removed from Modern Award list

Where only a small number of funds are listed in an Award, it is likely that many thousands of employers could be contributing to a fund which is about to be removed from a list.

Each one of those employers will face considerable disruption if a fund is removed. In order to remain compliant with the Award, they will need to:

- Be informed in some manner that a new default fund will need to be chosen. We note it is not clear how employers will be advised of such changes in the list and who will provide such advice
- Select a new default fund (or otherwise justify the continuing use of the existing fund)
- Issue a new Choice of Fund form to each employee in the current default fund
- Ensure they appropriately implement the individual choices of their employees
- Consider whether a bulk successor fund transfer is appropriate (or possible) noting that this can take a considerable period of time to implement. (A successor fund transfer may result in a higher consolidation of account balances and less likelihood of significant adverse changes to insurance cover and multiple insurance premiums as a result of the change in default fund. However, it is a process which is only likely to be attempted by large employers)

Each employee of those thousands of employers in the current default fund will need to:

- Consider whether they wish to remain in the current fund (and complete the Choice of Fund form appropriately)
- Consider whether the insurance levels in their new fund will be adequate (and how they compare with their existing cover)
- Ascertain whether they may be unable to obtain insurance cover in the new default fund (perhaps due to a recently acquired pre-existing condition)
- Consider whether they want to consolidate their existing account balance by rolling over to the new default fund (under current legislation this is often a tedious process)

At the same time, the current default fund is likely to be put under considerable strain and potentially could run into liquidity problems. This may result in an application to APRA to defer any requested transfers to a new default fund. This will also lead to members having multiple accounts and paying multiple fees for a period.

Remaining members of the fund may also be adversely impacted, particularly if the loss of membership is such that the ongoing viability or scale of the fund is threatened. These remaining members could include former employees, retirees receiving pensions and other non-employees.

Removal from a list is potentially a very serious matter and we believe the Commission has seriously underestimated the impact on a fund and its remaining members. We would be very concerned if a fund was removed from a list in a modern award if it was now considered to be the “eleventh best” fund (out of hundreds of funds which could have been chosen) based on the views of the relevant panel. Removal from a list should therefore only be considered in extreme circumstances.

However such an approach creates a further problem if there is a strict limit on the number of funds on the list – the most appropriate funds may continue to be excluded from the list in the award – even though their adoption may be in the best interests of employees. Existing default funds will therefore become entrenched and competition and contestability diminished.

Our Option 5 would cope better in such circumstances as the list would only be a guideline. Employers could continue to use the fund (unless APRA considered its MySuper authorisation should be withdrawn).

These are potentially serious concerns and need to be appropriately reflected in the Commission's recommendations if they proceed with Options 3 or 4. ***These problems could be minimised if the following set of recommendations is adopted:***

1. ***Where the fund being delisted is still reasonably competitive, but is no longer considered to be in the top 5 or 10 funds to be included in the list, it should be possible for employers who have already selected that fund to continue to use it as their default fund. However it could no longer be selected as a default fund by an employer choosing a default fund for the first time or by an employer looking to change their default fund (unless chosen under the criteria adopted for draft recommendation 8.2). (Alternatively, its continued use could be restricted to existing members –this would at least reduce the problems of multiple accounts, multiple fees and insurance premiums and withdrawal fees)***

2. ***On the other hand, where a fund is badly underperforming in relation to the selection criteria, it could be removed from the list and employers already using the fund would need to choose another default fund.***

3. ***Where very serious issues exist, we note these should have been picked up by APRA and their MySuper authorisation would be threatened. The relevant panel should work with APRA to ensure any adverse impact on members and employers are minimised. This could include a grace period enabling the fund to consider appropriate merger opportunities which may minimise any adverse impact on members and enabling employers to continue contributing to the fund whilst they select a new default fund and appropriately communicate with members.***

Grandfathering Provisions (draft recommendation 8.3)

Currently, employers can continue using a fund as its default fund if it was using the fund (or its predecessor) on 12 September 2008.

Once MySuper is introduced, we understand it will only be possible to use such a fund if it offers a MySuper. We note that this will create specific difficulties for employers (and relevant employees) providing defined benefits – refer to our comments on defined benefits below. The Commission's draft report recommends the total removal of these grandfathering provisions and, if adopted, this will lead to disruption for the many employers currently using these provisions.

In some ways, this will result in similar adverse implications as the removal of a fund from a list in a modern award. Various protections need to be built into this recommendation in order to minimise such implications.

The employer may be able to justify the continued use of the existing default fund (under draft recommendation 8.2). This will generally take some time and could require a tender process to be undertaken involving an independent tender manager, the fund and others providing written and face-to-face presentations. ***We consider a period of at least three years notice should be provided (from the implementation of MySuper) before the grandfathering provisions are removed. This should allow employers and funds a reasonable period to make a relevant assessment of the relevant funds which could be used as a default.***

Any shorter period may hinder the ability of employers to make an appropriate choice of default fund as tender managers may not be able to cope and those funds with many employers using them under the grandfathering provisions will be under extreme pressure to justify their continued ability to operate as a default fund for each particular employer.

We note that a significant majority of the 260 employers using the Mercer Super Trust as their default fund are currently only able to do this because of the grandfathering provisions in Modern Awards. These employers have generally gone through a rigorous selection process before selecting the Mercer Super Trust.

The removal of grandfathering would also create a further barrier to fund mergers and rationalisation of the industry. For example, if a fund on a modern award list were to merge with a fund not on the list, the current grandfathering provisions would generally enable employers to continue contributing to the merged fund. However, if grandfathering were removed, this would not be possible unless the relevant modern awards were all amended (presumably following a sitting of the panel charged with choosing the modern award list of funds) to include the merged fund. At the very least, this would result in a considerable delay in the merger process.

Further consideration would need to be given to reduce the barriers to future merger/rationalisation activity.

Choice of an alternative fund

We strongly support the Commission's draft recommendation 8.2. This will create greater competition and enable those employers who are prepared to spend time and money to determine the most appropriate fund for their employees.

However, while we agree some test should be applied, we do have concerns with the wording used in the draft report.

The proposed test involves two components. In particular the employer needs to justify their choice, if called upon, by demonstrating that:

1. The factors for consideration identified by the Commission were taken into account when making the decision
2. Their employees are at least no worse off than if the employer had chosen a fund listed in the relevant award.

We accept the first point i.e. considerations identified by the Commission should be taken into account. However, in addition, the employer should also be able to take into account the potential disruption caused by a change of default fund and any adverse impact a change in default fund would have on its employees.

The second point is more problematic in that:

- Any such assessment will generally be subjective, particularly when comparing a range of fees, insurance premiums, services, likely investment performance
- In any situation some employees may be worse off however the majority of employees may be better off
- As with the removal of funds from a list in a modern award, it would be disappointing if an existing default fund could no longer be used as a default fund if it was marginally less optimal than the funds listed in the modern award (but still an attractive fund)
- It implies that the fund chosen from outside the list needs to be better than all of the funds on the list, potentially involving detailed comparisons with up to ten funds.

As indicated in the draft report, it would be necessary to determine an appropriate body to assess, when called upon, whether the employer's choice is appropriate. In our view, a new panel would need to be established to consider such issues.

There is also a question relating to who could lodge a "complaint" about the choice of default fund. In our view, it would be inappropriate to allow a single member or employee to lodge such a complaint as that member would have the right to choose another fund under Choice of Fund legislation. Rather it should be necessary for a group of members (we suggest the lower of 100 or 10% of the employer's employees in the default fund) to lodge a "complaint".

It should not be possible for other funds or unions to **lodge** complaints as these could potentially be lodged on the grounds of self-interest. On the other hand, it should be possible for those organisations to have their concerns heard once a complaint has been lodged with the panel.

There should also be no penalty imposed on an employer, or requirement to compensate employees, if it is found that employees were worse off than if they had joined another default fund, provided the employer has adopted a reasonable selection process. Any potential penalties would be a significant deterrent to employers choosing a fund from outside the list. This would make it unlikely any employers would choose such a fund and its employees would, in many cases, be worse off as a result and the competitive aspect of draft recommendation 8.2 would be lost. The panel should however be able to require the employer to choose another default fund.

The Commission's final recommendations should be based on the following:

- ***As for our recommendations in relation to the removal of grandfathering provisions, employers using an existing default fund not on the relevant modern award list should have at least three years in which to justify the continued use of their default fund***
- ***The criteria to be taken into account should include the disruption and costs to be incurred by members as a result of a change in default fund***
- ***The employer should not be required to test the proposed fund against all funds listed in the modern award. This could be a very expensive task and would deter employers from trying to achieve a better outcome for their employees. Particularly where the employer is trying to justify the continuation of a current default arrangement, it should only be necessary to ensure that the continuing fund is more suitable than one of the funds on the list.***
- ***Any tests should not be on the basis of individual employees but should consider all employees for whom the employer is proposing to use the default fund***
- ***An employer should not be able to select a new default fund unless the fund is more suitable for the employees, as a group, than any one of the funds listed in the modern award***
- ***A new panel should be responsible for determining claims as to the appropriateness of any default fund***
- ***Complaints on the appropriateness of any default fund should not be heard unless at least the lesser of 100 or 10% of the employer's employees in the default fund lodge the complaint***
- ***Other funds and unions should not be able to lodge complaints but should be able to be heard as part of any hearing***
- ***If a complaint is successful, the only power of the panel should be to require the employer to choose another default fund.***

Defined benefit (DB) funds as default funds

In our previous submission we highlighted that only funds which have a MySuper product will be able to be nominated in modern awards in the future.

The Government and the Commission must still ensure that there is some provision for the continued use of DB funds as default funds under modern awards. Currently many defined benefit arrangements can be default funds under the grandfathering provisions.

It is therefore important that provisions in modern awards continue to have a mechanism under which defined benefit arrangements can continue to operate without members having to complete a Choice of Fund form to remain by lodging a Choice of Fund form. If this is not achieved, disengaged defined benefit members may lose their entitlement to defined benefits and the protection from market fluctuations which such members currently enjoy.

The Government should appropriately modify legislation already tabled in Parliament to:

- ***Enable employers to satisfy their SG obligations by contributing to a defined benefit fund for defined benefit members (even though it might not have a MySuper)***
- ***Enable trustees to avoid allocating contributions for defined benefit members to a MySuper product***
- ***Enable employers to satisfy their obligations under modern awards by the use of a defined benefit fund as a default arrangement (for defined benefit members).***

The Commission should take defined benefit arrangements into account in relation to its draft recommendation 8.2. We note that some of the criteria which employers must take into account are not necessarily relevant to defined benefit funds.

Liability of employers

It is unreasonable to expect employers to always make the correct choice of a default fund. Such choices have to be made in advance whilst the appropriateness of the decision can generally only be made with the benefit of hindsight.

Yet it is clear, whichever Option is chosen, employers need to make a choice. This will be the case if employers choose from an abbreviated list or whether an employer justifies a fund outside the list.

We consider employers need to be protected from liability for choosing a fund, which in hindsight turns out to be inappropriate, provided an appropriate selection process was followed.