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2 August 2012

Mr Brian Daley
United Voice National Office
303 Cleveland Street
REDFERN NSW 2016

Dear Brian,

PRODUCTIVITY COMMISSION REVIEW INTO DEFAULT SUPERANNUTAION FUNDS IN MODERN AWARDS

In January 2012, the Federal Government requested the Productivity Commission conduct an inquiry into the selection and ongoing assessment of default superannuation funds in modern Awards. On 29 June 2012, the Commission issued a draft report, and called for public responses by 3 August 2012.

On the back of this HOST**PLUS** commissioned Rice Warner to prepare a report to assess the potential impact of the proposed measures on the operating expenses incurred by superannuation funds, which ultimately affect the retirement incomes that can be paid to superannuation fund members.

HOST**PLUS** is happy to authorise the release of this report to United Voice in support of any submissions it seeks to make to the Productivity Commission.

Yours sincerely

David Elia
Chief Executive Officer

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31 July 2012

Mr David Elia
Chief Executive Officer
HOSTPLUS
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By email: delia@mail.hostplus.com.au

Dear David,

Default Superannuation Funds in Modern Awards

Background

The Productivity Commission inquiry

In January 2012, the Federal Government requested the Productivity Commission conduct an inquiry into the selection and ongoing assessment of default superannuation funds in modern Awards. On 29 June 2012, the Commission issued a draft report, and called for public responses by 3 August 2012.

The purpose of this report is to estimate the potential impact of the proposed measures on the operating expenses incurred by superannuation funds, which ultimately affect the retirement incomes that can be paid to superannuation fund members.

Implications of the proposed measures

Most Australian workers are entitled to receive Superannuation Guarantee (SG) contributions paid by their employer into a qualifying superannuation fund. Employers are required to direct the relevant contributions to a 'default' fund specified in an approved industrial Award or EBA (Enterprise Bargaining Agreement). Default funds for Modern Awards are determined by the Fair Work Australia.

Under the current Modern Award system, employees can choose a fund into which their SG contributions will be paid. However, in most cases, employees do not exercise their right to choose, and large funds, nominated in awards, have strong cash flows from contributions.

Under the changes proposed in the draft report, default funds would no longer be covered by the Fair Work Australia. Employees would be encouraged to exercise their right to choose their superannuation fund (which must be an approved 'MySuper' option under the new Stronger Super measures). Employers will still need default funds to accommodate cases where employees are not actively engaged with their superannuation. Criteria will be determined to ensure an objective process for determining default funds where they are required. The Commission has recommended a model where employers would be provided with a list of between 5 and 10 funds.

The measures proposed in the Commission's report will effectively increase competition between superannuation funds. All things being equal, we would expect that competition will have a direct impact on distribution costs within the industry.

In the first instance, the measures are likely to add cost pressure to many smaller Industry funds, as they currently have limited distribution channels other than the Modern Award system.

As a result, the Industry fund segment is likely to consolidate quickly, possibly to as few as five to ten large funds and a number of smaller funds specialising in delivering service to much smaller groups.. On its own, the impact of scale would be expected to reduce average member costs in administration and investments.

However, the largest Industry funds are already efficient and their members are unlikely to see significant benefits from the increased size and membership. Research gathered by Rice Warner shows that scale benefits for administration are marginal once funds achieve a certain critical mass.

Moreover, the large industry funds remaining after the consolidation process would need to invest heavily in business development teams to maintain their market share. By contrast, most of the Commercial corporate master trusts that compete directly with Industry funds are owned by one of the major banks, and have direct ownership of the banking relationships with both the superannuation fund members and their employers, which would give them a competitive advantage.

The impact of consolidation

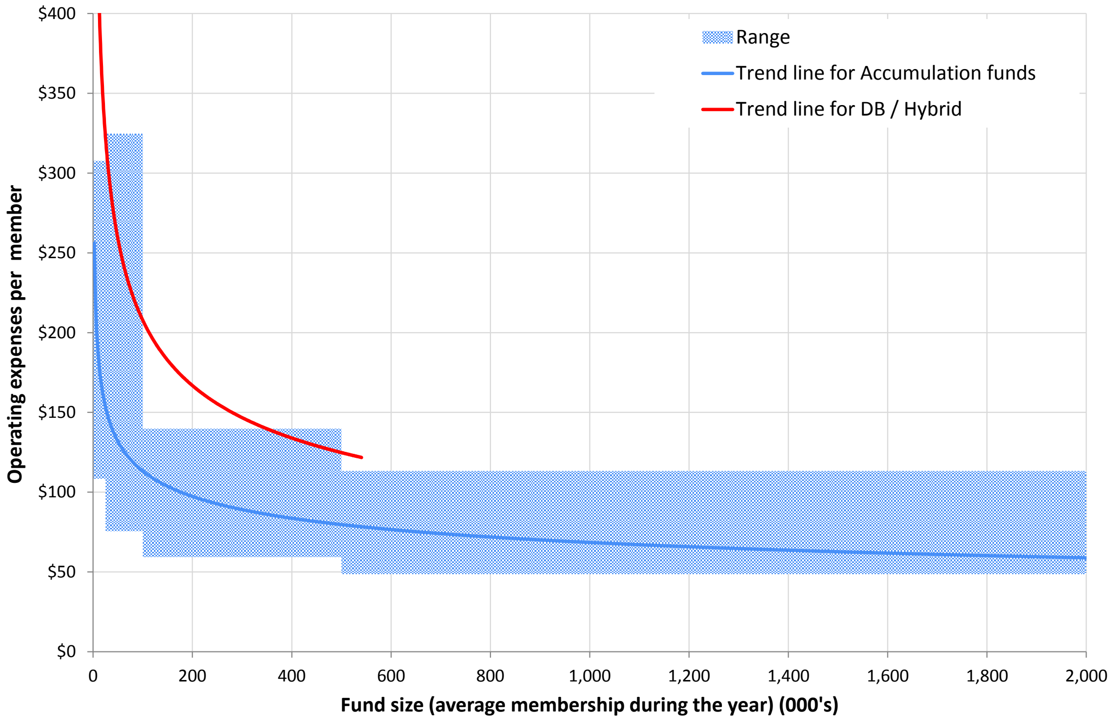
Consolidation of Industry Funds

As described in Section 1, the proposed measures are likely to lead to an immediate consolidation of Industry funds.

The average Industry fund cost (operating expenses and investment expenses) is estimated to be $218 per member per annum after consolidation, compared to $248 before consolidation, a reduction of $30 or 12%. These estimates are based on the results of Rice Warner's from Rice Warner's *Superannuation Fund Expense Survey 2011*.

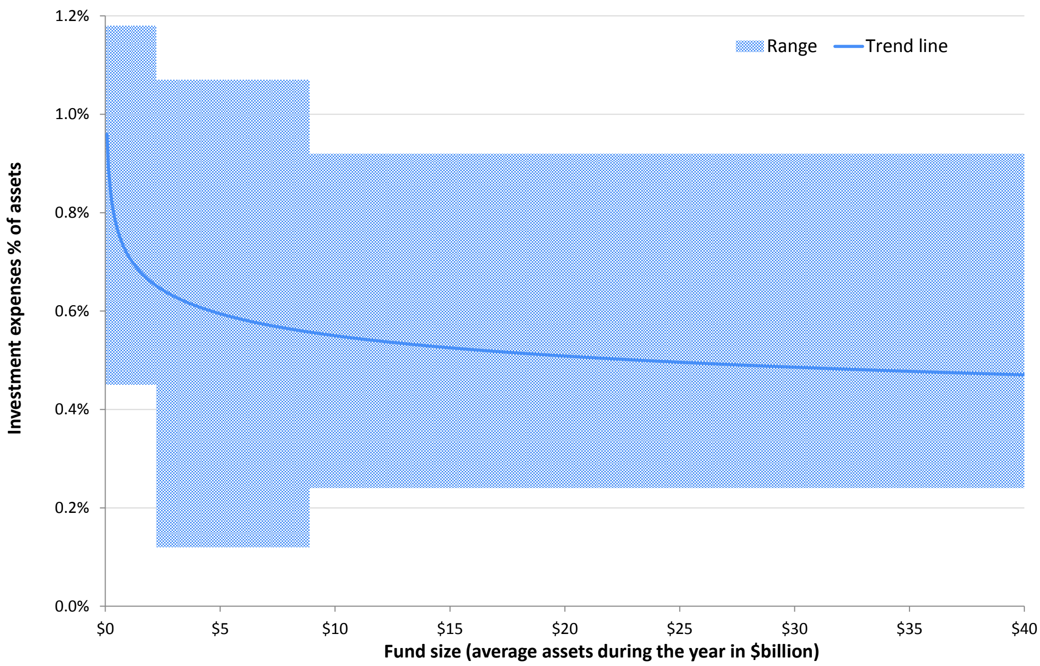
The average cost of the five largest Industry funds is currently $226 per member per annum, and the average benefit from consolidation is therefore lower ($8, or a 3.5% reduction). The diminishing effect of scale can be seen in the following two graphs.

Graph 1. Operating expenses per member by fund size (membership)



By way of example, HOSTPLUS had approximately 960,000 members, and average operating expenses of $76.21 during the 2011 financial year.

Graph 2. Investment management expenses per member by fund size (membership)



HOSTPLUS had approximately $8.6 billion in assets during the 2011 financial year.

The impact of competition

Estimating distribution costs

In the award system, there is limited competition between funds. Funds provide information for employers, backed by the support of the employer associations and trade unions which sponsor the fund. As the employer has to select a fund, there is limited competition between those funds nominated in awards but little movement of employers between funds.

Under Productivity Commission's proposed structure, employers would be encouraged to choose other funds. This will require nominated funds to develop distribution resources to defend their existing membership and to seek new employers. Funds will also seek to attract members under choice, more vigorously than they do at present.

The closest proxy for measuring distribution costs is the Commercial corporate master trust market. Several of these funds are owned by the wealth management subsidiaries of the major banks. Other key funds are owned by AMP and Mercer.

Marketing to the very large employers is normally done via salaried teams of professional business development staff. Both the Commercial and Industry segments already operate in a similar way, with the Industry segment providing direct support via professional relationship managers. Costs are similar, with Industry fund costs generally being somewhat lower.

The Commercial segment has hitherto marketed to smaller employers using their distribution networks of commissioned advisers. Distribution costs average around 0.50% of assets for the smallest employers (those with total employee superannuation balances less than $1 million). For larger employer plans, the distribution costs reduce as a percentage of assets under management. These estimates are based on recent research gathered by Rice Warner.

We would expect that Industry fund distribution costs would be lower, due to the non-Commercial business basis and the ability to employ lower cost staff (who would not be financial advisers). A reasonable estimate might be 0.35% of assets under management. Based on an average account balance of $21,675 (for Commercial master trusts), this would represent approximately $75 per member per annum.

The proposed changes may influence the numbers of member making an active choice; we have not differentiated costs between MySuper and "Choice" members.

Overall cost impact

Taking the cost reductions from scale together with the added cost of distribution, we get the following outcomes:

Table 1. Cost impact per member per annum

Cost estimates	Average industry fund member	Member of one of the five largest Industry funds
Benefit of consolidation	$30 reduction	$8 reduction
Distribution costs	$75 increase	$75 increase
Net cost impact	$45 increase	$67 increase

Impact on fund members

The following table demonstrates the impact of additional distribution costs on a typical superannuation fund member's account balance at age 65 (in 2012 dollars).

Table 2. Cost impact per member per annum

Case study			Estimated retirement benefit at age 65	
Age	Current balance	Annual salary	With current annual costs	After introduction of proposed measures
25	$15,000	$50,000	$330,000	$303,000
45	$80,000	$90,000	$344,000	$327,000

The impact of the proposed changes would reduce estimated retirement benefits by $27,000 (8.2%) in the first case and $17,000 (4.1%) in the second case.

This letter was prepared and reviewed by the following consultants.

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