28 April 2017

Attention: Karen Chester, Deputy Chair

Superannuation
Productivity Commission
Locked Bag 2, Collins Street East
Melbourne VIC 3000

Dear Ms Chester,

AustralianSuper's submission to the Productivity Commission Draft Report - Superannuation: Alternative Default Models

AustralianSuper is Australia's largest superannuation fund and is run only to benefit its members. The best interests of the fund's 2.1 million members drive all our decisions. Our sole purpose is to ensure members achieve their best possible retirement outcomes.

Australia's current default superannuation system invests over $400 billion of savings on behalf of at least 7 million people. Default funds have materially outperformed the superannuation system average for as long as data has been recorded. [1] These outcomes are consistent with the Productivity Commission's own conclusions about investment performance.

AustralianSuper's key comments on the draft report are:

1. There are strong grounds for a robust default system based on the information asymmetry and imperfect knowledge of a large number of consumers. The best design for a default system is one which protects and enhances consumer outcomes. The best measure of consumer outcomes is growth in their retirement balance via net investment performance over their lifetime.
   The key criteria for selection of default funds should be long term net investment performance.
2. All proposed changes to the current default system must be subject to a full cost benefit analysis using the current system as the baseline.
3. AustralianSuper recommends regulation prohibiting an employer from choosing, as its default fund, a superannuation fund that is part of a financial institution from which it receives other financial services.
4. The single biggest risk of change is that more people are defaulted into poor performing funds.
5. The legislated, but not implemented, Fair Work Commission Expert Panel, should be given the opportunity to operate.
6. Bold strategies should be implemented to reduce multiple accounts.

The risks of defaulting into poor performing funds
The outcome of any change to the default system must be to reduce the number of people defaulting into consistently poor performing funds.

[1] ISA 'Living in an Empirical World' 28 October 2016

AustralianSuper believes the Productivity Commission should investigate strategies to reduce the number of people defaulting into poor performing funds. Strategies for consideration may include:

- Triggering the Significant Event Notice requirements when an investment option/fund delivers sustained poor performance.
- APRA publishing a net benefit league table which easily allows members to identify poor performing investment options/funds.
- Any other material action that the Productivity Commission may identify.

AustralianSuper supports the current system enhanced by the yet to be implemented Fair Work Commission process.

Should the government favour the Productivity Commission's recommendations AustralianSuper supports a 'heavy filter' being applied to default fund selection to ensure only the best performing superannuation funds are eligible default funds.

A heavy filter would work best for employees, businesses and system performance.

The Australian Securities and Investments Commission (ASIC) recent submission to the Productivity Commission highlighted that 'although employers currently have the legal responsibility to make a decision in relation to the default superannuation product, employers are required to neither select a fund that is in the best interests of their employees nor to put their employees' interests ahead of their own in selecting the fund.'[2] A rigorous selection process for funds to become an eligible default fund would assist employers to choose a default fund with confidence that it is in their employees' best interests.

AustralianSuper acknowledges ASIC's work publishing guidance and advising employers on their responsibilities under the *Superannuation Industry (Supervision) Act 1993* (SIS Act), specifically their obligations relating to inducements. ASIC has noted that 'the real prospect remains of employers selecting a fund as a result of inducement, including lawful inducements and on the basis of competition directed to the employer rather than to the quality of the product.'[2]

Importantly, AustralianSuper supports regulation prohibiting an employer from choosing, as its default fund, a superannuation fund that is part of a financial institution from which it receives other financial services.

Strategies must be implemented to reduce current and future account proliferation
AustralianSuper acknowledges that account proliferation is an issue and commends the work of the ATO and other stakeholders which has resulted in a reduction of accounts from 33 million in 2010 to 27 million in 2016[3]. However the single most critical issue for defaulting members is the risk of defaulting into a poor performing fund, not multiple accounts.

AustralianSuper believes more action is required to reduce account proliferation including:

1. Increasing transfers of lost accounts to the ATO by:
   - Lifting the threshold.
   - Shortening the duration of inactivity before sending inactive accounts to the ATO.
   - Revising the definition of Lost Member so that it provides greater clarity and uniform implementation across funds.
2. Requiring a contribution from an employer or employee before a superannuation account is opened for a member.

[2] Submission 41- Australian Securities and Investments Commission (ASIC) Alternative Default Fund Models – Public Enquiry, November 2016
[3] APRA Super Fund Level Publications (Jun-16)

Cost/Benefit Analysis
In considering changes to default fund arrangements we recommend that the Commission conduct a full cost benefit analysis of any proposed change to current arrangement to understand and assess the costs benefits and risks associated with any alternative arrangement. Given the important role that default super funds have in the system, we believe that it is critical that proposals for change should be:

- tested against the arrangements that currently apply; and
- be evidence-based.

Any change to the current default arrangements should only be undertaken when there is confidence that the changed system would work better for defaulting members.

If you have any questions or would like further information, please do not hesitate to contact Louise du Pre-Alba on 03 8648 3847 or email lduprealba@australiansuper.com.

Yours sincerely,

IAN SILK
Chief Executive

AustralianSuper's response to the Productivity Commission Draft Report – Superannuation: Alternate Default Models

We are pleased to provide a submission in relation to the above draft report.

AustralianSuper generally supports the comments made in the submissions of Industry Super Australia (ISA) and the Australian Institute of Superannuation Trustees (AIST) in response to the report.

In this submission, AustralianSuper will respond to the three draft recommendations and the four options proposed in draft findings 5.1, 6.1, 7.1 and 8.1. In assessing the recommendations presented by the Productivity Commission AustralianSuper has applied the following criteria:

(i) *Is this recommendation/model in the best interests of defaulting members?*
(ii) *The ability of the recommendation/model to deal with poor performing funds.*
(iii) *The ability of the recommendation/model to reduce the number of superannuation accounts.*

The alternative models developed by the Productivity Commission must be assessed against the current default system. Furthermore, any change to the default system should only occur when data-driven evidence demonstrates the change will deliver improved long term (lifetime) net benefit to members.

PRODUCTIVITY COMMISSION DRAFT RECOMMENDATION 3.1
To avoid perpetuating the legacy problems of the current system, any future alternative system for allocating members to default products should be premised on employees being assigned a default product only once, when they join the workforce.

The primary objective behind a reduction in accounts must be to ensure that members are provided with prudentially sound and sustainable superannuation products that are suitable for the long term and cost-effective for the member.

Under the current system
A proliferation of accounts means people are paying more in administration fees than they otherwise would, may be paying more in insurance premiums than they otherwise would (sometimes with little extra benefit), are less likely to be aware of their full superannuation position, and less likely to be engaged with their superannuation.

We believe account consolidation is in the best interests of members and beneficial to the long term sustainability of the sector. We believe more needs to be done.

Under any future alternative system
AustralianSuper commends the Productivity Commission's view that account proliferation should be curbed.

The inherent danger of moving to a system of a 'one default fund' decision for employees is that the employees may be defaulted into a poor performing fund and this problem will compound over time.

'One default fund' will also detract from consumer outcomes as it assumes that circumstances do not change at either the personal or default organisation level, concentrating the risk at commencement of employment. These factors have the potential to be more damaging to an individual than account proliferation. Consequently it is essential that there is a rigorous selection process for eligible default funds based on long term net investment performance.

(i) *Is this recommendation in the best interests of defaulting members?*

This recommendation is in the best interests of defaulting members if there are safeguards in place to ensure members can only be defaulted into high performing funds.

(ii) *Ability of the recommendation to deal with poor performing funds*
This recommendation does not, in itself, to deal with poor performing funds.

(iii) *Ability of the recommendation to reduce the number of superannuation accounts*
This recommendation has the ability to reduce the future proliferation of superannuation accounts.

PRODUCTIVITY COMMISSION DRAFT RECOMMENDATION 3.2
The Australian Government should establish a centralised online service for members, employers and the Government that builds on existing functionality of myGov and Single Touch Payroll. The service should:
• allow members to register online their choice to open, close or consolidate accounts when they are submitting their Tax File Number on starting a new job
• facilitate the carryover of existing member accounts when members change jobs
• collect information about member choices (including on whether they are electing to open a default account) for their employer and the Government.
There should be universal participation in this process by employees and employers.

The implementation of SuperStream has resulted in major improvements in the back office of superannuation and significant improvements in service delivery and outcomes for members, employers and funds.

The industry has provided millions of dollars in funding to the ATO for SuperStream, and we are supportive of a single clearing house that facilitates efficiency for employers and reduces Super Guarantee non-compliance provided members' interests are protected and they are not compelled to make rushed choices particularly in relation to choice of fund and account consolidation that is not fully informed particularly as it relates to fees, performance and insurance coverage.

The lack of consumer knowledge and understanding on the importance of selecting or continuing to select a high performing fund at commencement of employment or job change could concentrate the risk and compound the impact of selecting a 'poor performing' fund. Consumers should be encouraged to review their superannuation as their circumstances change to maximise their retirement objectives. A centralised online service could assist consumers in the decision making process if the appropriate information, processes, checks and balances are in place.

AustralianSuper believes that the implementation of a centralised online service, Single Touch Payroll and myGov, together with a superannuation account registered with the ATO for each individual will have a bigger impact on reducing inactive accounts than the four alternative default models proposed.

(i) *Is this recommendation in the best interests of defaulting members?*
This recommendation is aimed at simplifying the front end of superannuation for members, employers and the government. It is in the best interests of fund members if appropriate protections are in place as it will improve the quality of data and ease of system use for participants.

AustralianSuper believes the system needs to strike a balance between efficiency and informed decision making for employees. Specifically at the point of decision making for choice of superannuation fund, employees need to be aware of comparative fees and long term performance, in addition to implications for insurance (including different terms that may apply) should they change provider or consolidate accounts.

(ii) *Ability of the recommendation to deal with poor performing funds*
If the centralised online services have an easy and comprehensive way in which members can compare performance, then poor performing funds should find themselves in an unsustainable position where existing members are consolidating away from them. Additionally on the assumption that poor performing funds have a high proportion of inactive member accounts it may accelerate consolidation.

(iii) *Ability of the recommendation to reduce the number of superannuation accounts*
This will result in an immediate consolidation effect and should reduce the number of accounts in the system

PRODUCTIVITY COMMISSION DRAFT RECOMMENDATION 3.3
The Australian Government should introduce a formal framework that specifies the process and obligations of trustees when making or considering merger proposals. As part of the framework, trustees would be required to disclose all merger attempts involving their fund, as well as the reasons for any decisions.

AustralianSuper supports the introduction of a formal framework that specifies the process and obligations of trustees when making or considering merger proposals as part of a complete review of the merger process***.***

Above all else the primary measure for trustees considering merger proposals must be the best interests of members and the ability to improve the retirement outcomes of members.

Other factors for consideration include the impact of the comparative assets, current and future insurance arrangements and services standards for members and employers.

We understand that requiring trustees to disclose 'all merger attempts' may hinder preliminary merger discussions. AustralianSuper respects the complexity and challenges involved in any merger. We support disclosure of merger attempts and recommend that 'merger attempts' be defined as 'when a formal proposal has been made by one board and considered by another board.'

We believe the following measures are also worthy of consideration as mechanisms to assist superannuation fund mergers:

- Extend capital gains tax relief for superannuation fund mergers indefinitely - this relief expires on 30 June 2017.
- Tier APRA's operational risk reserve requirements of funds based on their operational capacity, risk management framework, net cash flow, scale and member assets.
- Enable APRA to provide special MySuper authorisation for merging funds to establish special purpose MySuper investment vehicles to facilitate small fund mergers prior to their ultimate merger with a large MySuper investment option - this would ensure that members of large MySuper investment options do not subsidise the cost of multiple mergers of small superannuation funds.
- Review the successor fund transfer requirements to provide exceptions to equivalent rights where funds are merging as a result of APRA approved prudential supervision reasons.
- Encourage APRA to report annually to the Council of Financial Regulators on their progress and results in the application of the scale test in MySuper products.

(i) Is this recommendation in the best interests of defaulting fund members?

Should consolidation accelerate, fund members will be better off in terms of reduced fixed costs per member.

(ii) *Ability of the recommendation to deal with poor performing funds.*
The recommendation does not directly target or address the issue of poor performing funds but it is much more likely that smaller funds will underperform over time and so consolidation will reduce that risk.

(iii) *Ability of the recommendation to reduce the number of superannuation accounts*
This recommendation would contribute to a reduction in the number of superannuation accounts as mergers inevitably reduce duplication on transition and a less fragmented industry has greater capacity to drive account consolidation.

Consideration of the four alternative options put by the Productivity Commission

Central principle of once only default

The proposals put by the Productivity Commission involve a departure from the current practice of making a new default fund available to employees when they change employment. In each of the four options put by the Commission, current practice is replaced with a once only default fund being made available to employees – when they commence first employment.

The principle of once only default where 'employees who fail to exercise choice will be allocated to a default product only if they do not have an existing superannuation account' will likely reduce future account proliferation.

This approach, as suggested by the Financial Services Inquiry in 2014, would primarily impact on new entrants to the workplace (the first-timer pool) and they would remain in that default fund unless they actively switch.

Once only default, at first time employment, could distract from consumer outcomes as it assumes that circumstances do not change at either a personal or default organisation level. There is risk associated with assuming that the default fund an individual joins when starting employment would be ideal in the later stages of their working life.

AustralianSuper believes the advantage of once only default must be balanced by:

- ensuring only the best performing superannuation funds, measured by long term net investment performance, are eligible default funds;
- mandated communication to fund members if the fund they have been defaulted into consistently underperforms; and
- other safeguards identified to ensure members have the best possible retirement outcomes.

Model 1: Assisted employee choice

AustralianSuper believes that Model 1 – Assisted employee choice as a default model, by definition, is a contradiction. Assisted employee choice is not a default arrangement and does not address any of the issues related to default.

The imperfect knowledge and information asymmetry of a large number of consumers underpin the need for a robust default system. The assisted employee choice model fails to provide a robust system, fails to protect and enhance consumer outcomes and there is no evidence that it would result in an improved net investment performance over the long term.

This model seeks to engage members to make a choice from one of up to ten funds, which are selected via a heavy administration filter, on the assumption that first time employees are more likely to select these funds. This is in stark contrast to current practice that demonstrates, overwhelmingly, first time employees prefer to take advantage of the default system.

Under the Commission's model, when such members do not choose one of these funds, they end up in what is termed a 'last resort fund'. This is of deep concern because it will not have gone through any administration filter, will not be required to have diversified investments or be subject to MySuper rules in relation to fee charging and cross subsidisation.

AustralianSuper is opposed to eligible rollover funds (ERFs) being offered as a last resort fund where it would result in suboptimal outcomes for default members. Forcing choice on members and then providing them with defaults funds which were not designed to be long term default funds, but rather 'holding funds', is not in the best interests of those members.

The Productivity Commission proposes the shortlist be updated every four years to balance cost and competition factors. If a shortlisted product no longer performs well, fails to meet a future shortlist or does not reapply for inclusion on the shortlist, the defaulting members may remain marooned in that fund. The Commission supports simply making the information publicly available and leaving the decision to the (defaulting) affected member, even though this would most likely result in poor consumer outcomes.

AustralianSuper believes this is inadequate. If an independent government body has the capacity to nudge people towards a shortlist of preferred products that independent government body has an obligation to advise all members who act on the recommendation if the product fails to remain on the shortlist.

The Productivity Commission acknowledges one of the outcomes of this model will be a significant system-wide increase in marketing expenditure to attract and retain new members. A heightened level of competition and marketing by superannuation funds and other parties, such as broader financial institutions, will require additional government resources to monitor, strengthen and enforce existing regulation. This must be considered in the cost benefit analysis of this model.

AustralianSuper is opposed to offering prospective members short-term benefits unrelated to the superannuation product as we do not believe this meets the Sole Purpose Test. We concur with ASIC that such incentives may distract a member from making an informed financial decision.[4]

Instead of trying balance the pros and cons of regulation of short term incentives the Productivity Commission should recommend the government legislate to prohibit funds, other financial institutions and financial advisers from offering short-term benefits that are unrelated to the superannuation product (such as consumer goods or discounts on banking products).

Model 2: Assisted employer choice (with employee protections)

This model enables employers to choose any default product offered by an approved provider, as long as the product meets minimum criteria imposed by administrative filtering. This administrative filtering involves the use of a mandatory 'light' filter to determine eligibility to be chosen as a default product and a voluntary 'heavy' filter for the purpose of determining a 'preferred default list'.

[4] Submission 41 – Australian Securities and Investments Commission (ASIC) – Alternative Default Fund Models, Nov 16

In outlining a dual-list approach the Commission has stated the purpose of the 'light' filter is to eliminate poor quality or underperforming products while the 'heavy' filter is designed to ensure that employers can choose products assessed to be of relatively high quality.

Essentially the option for employers is to choose a high quality fund from the preferred default list or an inferior product resulting from the light filter. If the Commission is committed to improving retirement outcomes it is counter-intuitive to introduce a two tiered default system where employers choose between a high quality product and an inferior low quality product as the default arrangement for employees. The Commission should eliminate the inferior 'light filter' option.

AustralianSuper supports a comprehensive heavy filter with long term net investment performance as the key criteria to become an eligible default fund.

The Commission's own finding that 'the current Fair Work Act criteria provide sufficient coverage of relevant considerations, and represent an adequate basis for developing the heavy filter to determine the preferred default list'[5] acknowledges the value of the current default arrangement and indicates that the FWC Expert Panel can meet the Commission's objectives if it were given the opportunity to operate.

AustralianSuper supports the Productivity Commissions view that 'providers should be prevented from offering employers inducements (including preferable deals on non-superannuation products) to choose their products as defaults, and regulators should actively enforce this. The Commission considers the existing provisions in the SIS Act, and their enforcement, would require strengthening if the model presented in this chapter were to be adopted.'[6]

AustralianSuper believes that the strengthening and enforcement of the SIS Act must be actioned immediately.

As an additional safeguard, AustralianSuper strongly recommends regulation prohibiting an employer from choosing, as its default fund, a superannuation fund that is part of a financial institution from which it receives other financial services. This should apply whatever model the Productivity Commission recommends.

Model 3: Multi-criteria tender

In this model, participants compete for rights to a share of the default pool by making proposals against a number of different weighted assessment criteria, which are then run through a selection process.

The tender would be administered by an independent panel, constituted by the Australian Government, who would make a recommendation to the relevant Minister. The Minister would be free to accept or reject the advice and would be required to disclose any departure from the panel's recommendation.

The Productivity Commission's prototype multi-criteria tender appears to be largely based on the New Zealand KiwiSaver default tender process that commenced in 2006. Analysis of the formal default provider appointment process highlights the risks associated with this model. 'Before the selection process began, the market understood that the Treasury initially recommended either four providers be appointed or all providers that satisfied minimum criteria. The expert panel did not have to explain its decisions but

[5] Superannuation: Alternative Default Models Productivity Commission Draft Report, pg 204

[6] Superannuation: Alternative Default Models Productivity Commission Draft Report, pg 198.

anecdotally, initially chose four. However, following direct representations to the government by interested parties, two additional providers were apparently added to the group recommended by the panel.'[7]

AustralianSuper concurs with the Productivity Commission that this highlights the possibility (and risk) of Ministerial (or other) intervention in the tender processes, and particularly multi-criteria tenders where the weighting given to the various considerations (and therefore the final decision) might be unclear[8].

This model is highly susceptible to industry lobbying and political intervention. It is essential the Commission investigate mechanisms to eliminate this.

The Commission's prototype model would identity up to 10 winners of the tender with employees allocated to products sequentially. It is most likely large employers will pay contributions to up to 10 default funds plus choice options of employees.

As a result of sequential allocation there is a danger that people assume the government has done due diligence in allocating their default fund, the myriad of default funds in their workplace creates complexity and competition amongst superannuation funds to access workplaces may lead to members become less engaged with their superannuation and increase information asymmetry.

AustralianSuper believes further research is required on the long-term impact of sequential allocation of default funds.

The multi-criteria tender model is a high cost option for the government and superannuation funds when there is no evidence that it will result in materially better retirement outcomes for members.

AustralianSuper believes there are significant challenges, including the integrity of the decision making process, that must be addressed before this model could be considered a viable option.

Model 4: Fee-based Auction

Under this model products competing for default fund status would bid on the basis of cheaper member fees.

AustralianSuper does not support a system that ultimately selects funds based on fees because low fees do not of themselves deliver better retirement outcomes for members.

This model would encourage the creation of new suboptimal superannuation products designed to offer lowest fees at the expense of diversification and higher potential returns. Low returns are inappropriate for long term accumulation of retirement benefits. This would not reduce the number of poor performing funds but accentuate the opportunity to create new poor performing funds.

Such a system would need to rely on a complete, transparent and comparable fee disclosure regime in superannuation, which does not exist presently.

Sustainability issues will also arise if it is determined that pre-existing default fund members of the successful bidder would be subject to the same fee regime as that of the successful bid. Most likely a new cost regime would require a significant change in portfolio and investment strategy. This may lead to significant foregone performance, possible liquidity impacts and will introduce transition costs.

---

[7] Littlewood, M. 2012, *KiwiSaver: Changing the Default Provider Regime*, University of Auckland Business School, Auckland.

[8] Superannuation: Alternative Default Models Productivity Commission Draft Report, pg 232

AustralianSuper strongly cautions against pursuing lower costs at the expense of long term net benefit to members.

We reject this approach as costly to individuals and the system.

Conclusion

AustralianSuper believes the outcome of any change to the default system must be to reduce the number of people defaulting into consistently poor performing funds or it will have failed.

Default funds have materially outperformed the system average for as long as data has been recorded and we believe this will be further enhanced if the legislated, but not implemented, Fair Work Commission Expert Panel is implemented.

Changing the default fund arrangements will introduce costs and risks and therefore any recommended change should be subject to a full cost benefit analysis which has at its heart the long term net benefit for members as compared with the outcomes of the current system.

AustralianSuper strongly recommends regulation prohibiting an employer from choosing, as its default fund, a superannuation fund that is part of a financial institution from which it receives other financial services.

AustralianSuper supports the reduction in the number of accounts in the system. However we reiterate the single most critical issue for defaulting members is the risk of defaulting into a poor performing fund, not multiple accounts.

Retirees and the community cannot afford to move to any system that risks more members being exposed to poorer net investment performance. Any change to the default arrangements must only be undertaken when there is data-driven confidence that any new system would result in better retirement outcomes for members.