AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

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Superannuation
Productivity Commission
Locked Bag 2, Collins St East
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Dear Sir/Madam

APRA submission to the Productivity Commission Issues Paper, *Superannuation: Alternative Default Models*

APRA welcomes the release of the Productivity Commission Issues Paper, *Superannuation: Alternative Default Models* (the Issues Paper) and the opportunity to make a submission on aspects of the Productivity Commission's inquiry into alternative models for a competitive process for allocating default fund members to products in the superannuation system.

The key objective for any such model should be achieving adequate retirement outcomes for 'default' members within the context of the Government's broader retirement income policy settings.

In that context, APRA supports the five assessment criteria areas set out in the Issues Paper, namely members' best interests, competition, integrity, stability, and system-wide costs. We would note, however, that these areas are quite broad and require assessment of a wide range of both qualitative and quantitative measures. Further, it will be important to strike an appropriate balance between these criteria when assessing alternative default allocation models.

1. MySuper product quality – broader focus on member outcomes

A primary consideration under any alternative default allocation model is the underlying quality of MySuper products. If, for example, all MySuper products can be expected to meet a sufficiently high standard of quality across a range of quantitative and qualitative criteria on an ongoing basis, additional quality filters would not need to be applied when allocating members to particular default funds; each MySuper product could be expected to be reasonably likely to achieve the objective of adequate retirement outcomes for default members over the long term.

When the Stronger Super reforms were implemented in 2012/13, authorisation criteria were established for an RSE licensee to be able to offer a MySuper product. These included heightened RSE licensee duties in relation to MySuper products, specific MySuper product features, and the requirement for an annual assessment of the MySuper product to be undertaken by the RSE licensee (referred to as the scale test). The current scale test focuses on the number of beneficiaries who hold a MySuper product and the pool of assets in that product, relative to other MySuper products.[1]

APRA's view, based on our experience during, and since, the MySuper authorisation process, is that both the current legislative MySuper authorisation criteria and the scale test could be strengthened with a view to MySuper products being of overall better quality.

APRA data indicates that, since 1 July 2013, there has been considerable variation in net returns and fees for different MySuper products, leading to a wide range of outcomes for members across these different products. While there has been some evidence of reductions in fees and costs since MySuper products were introduced, particularly for products with previously very high fee levels, there is clearly room for further improvement. Further, while many MySuper products have achieved their net return targets over the past few years, some have fallen well short.

Ongoing transparency of outcomes and robust application of the scale test requirement by RSE licensees, taking into account the comparative data that is now readily available for MySuper products, should lead to some improvement in member outcomes over time. However, the current narrow focus of the scale test does not ensure that all of the factors that may affect member outcomes, including insurance, advice and administration services, are considered by RSE licensees when assessing the relative quality of their MySuper product.

APRA has emphasised to RSE licensees the importance of having a broader 'member outcomes' focus when undertaking their annual scale test assessment (and also in assessing the ongoing sustainability of their business operations). This requires looking beyond net investment returns to broader qualitative and quantitative outcomes for all members. While achieving target net returns is important, the concept of member outcomes extends to all of the key services and features offered to members. There would therefore be merit in legislating both stronger authorisation requirements and a broader member outcomes assessment in lieu of the current scale test, with a view to lifting the bar that MySuper products need to meet on an ongoing basis.

2. Ensuring superannuation system stability and sustainability

As a prudential regulator, one of APRA's key areas of focus is financial system stability, and the superannuation industry is clearly an important segment of the financial system. System stability depends significantly on the soundness and stability of the individual entities within it. Accordingly, APRA seeks to establish and enforce prudential practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system.

The design and implementation of alternative default models is likely to affect cash inflows and outflows, potentially materially, for individual superannuation funds. In particular, a change in whether a particular superannuation fund, or more specifically its MySuper product, is designated as a default product as a result of the application of the default allocation process may significantly alter (either positively or negatively) the ongoing sustainability of that superannuation fund/MySuper product. Similarly, how any particular default allocation model treats new and existing members (and hence future contributions and existing account balances) will also potentially materially affect future cash inflows and

[1] Refer to s. 29VN of the *Superannuation Industry (Supervision) Act 1993*.

outflows of individual funds/MySuper products and hence the ongoing sustainability of that superannuation fund/MySuper product. These individual fund impacts may, in the extreme, adversely impact the stability of the superannuation system as a whole, unless the cash flow impacts under the default allocation model are able to be managed in an orderly manner both at a fund and system level.

Crucial to the successful design of any potential default model, therefore, will be the implementation and transition processes supporting that model and the degree to which they may mitigate any stability concerns. For example, under a market based model, suitable transition timeframes for implementation of a change in default fund status – particularly if transfer of accrued balances out of an “unsuccessful” default fund is required - would assist in managing such potential fund level, and hence system-wide, impacts.

To the extent that a default allocation model does significantly impact the ongoing viability of individual superannuation funds or products, increased consolidation or wind-up of funds (including potentially some funds that are otherwise of reasonable quality) is likely. Larger funds are likely to be better placed to weather the loss of default fund status, as they may be better able to manage changes in liquidity or develop alterative business strategies to support their ongoing sustainability. Whilst there is room for consolidation within the superannuation industry, too much consolidation may have unintended or undesirable consequences. For example, significant industry consolidation may result in much higher levels of industry concentration, potentially removing the incentive for the remaining, much smaller number of, large incumbent funds to vigorously compete under the default allocation model.

3. Risk of short-termism

The Commission has noted that a frequent default allocation process potentially places “an unhelpful emphasis on short-term performance”. APRA concurs that it is important to ensure that any default allocation process focuses on the assessment of appropriate member outcomes over the long-term, rather than (further) encouraging undue focus on metrics such as net returns and fees over shorter periods (of, say, less than three years).

Depending on the nature and frequency of the default allocation process, RSE licensees may be encouraged to adopt a more short-term, narrow focus with respect to investments and product features and their associated costs. Superannuation, by its nature, is a product where the long term financial interests of members should be central to decision making by RSE licensees. Aligning investment strategy to the demographic profile of the default members in a MySuper product may, for example, suggest that a reasonable allocation to higher cost, relatively illiquid, investments such as infrastructure is appropriate as over the long term such investments are likely to contribute to achieving adequate retirement outcomes for members. However, a regularly repeating competitive default allocation process under which there is a relatively short period of exclusive or shared default status may discourage such investments. It would clearly be undesirable if the default allocation model did not align with, or even undermined, RSE licensees’ meeting their obligations in relation to achieving adequate retirement outcomes for members over the long term.

4. Member equity considerations

The design and implementation of a default allocation model needs to consider the implications for both existing and new superannuation members. This will include issues related to the equity of treatment over time of new members entering the superannuation system relative to existing members, and of accrued entitlements relative to future contributions. Any default allocation model should seek to ensure, to the extent possible, that the benefits of the more competitive and efficient superannuation system that is intended to follow from a revised default allocation process do not solely accrue to new entrants to a fund or to the system. It is also important that possible negative, or unintended, consequences are minimised to the extent possible.

APRA recognises that addressing equity issues across member cohorts and funds/products is likely to add complexity to any default allocation model. There are, however, some measures that promote member equity that could be included in different allocation models where needed. For example, if the allocation process is a market based model, those products that are successful under the model could be expected to provide the same terms and conditions, such as reduced fees, to all current and new members and for both accrued entitlements and future contributions (as appropriate).

A market based (or other) allocation model where some RSE licensees that offer a MySuper product are not allocated default fund status would be expected to provide competitive pressure for RSE licensees to improve the performance and efficiency of MySuper products, to mitigate against the risk of not obtaining default fund status, or their active members seeking to transfer to another product if they did not have default fund status. This would clearly have benefits in terms of improving outcomes for members however, as noted above, stronger legislative requirements may be needed to support this outcome.

Further, increased levels of switching by members to more competitive offerings may have benefits at an individual member level, but could result in increased transaction costs across the superannuation system. On the other hand, as noted by the Commission, large numbers of members are disengaged and hence it is highly like that they will not actively switch to another fund and hence may be ultimately disadvantaged relative to members in designated default products.

5. Default insurance and potential for increased costs

In outlining the steps in designing alternative models, the Commission has restricted its focus to accumulation products in defined contribution schemes and proposed that a separate competitive process would be used to allocate insurance that is currently bundled with default superannuation products.[2]

This proposed approach does not appear practical or desirable given the current structure of MySuper products in which insurance is a key component of the product offering. It is also likely to result in increased costs and inefficiencies for all participants without necessarily leading to enhanced member outcomes.

It is inevitable that additional costs will flow from separate allocation processes for the investment and insurance components of MySuper products. Additional ongoing administration costs for RSE licensees in managing what would probably become separate default offerings for these different product components are also likely. Further, effectively separating insurance from the core MySuper offering may have other unintended consequences and costs, for example, in relation to insurance underwriting processes and/or premium levels.

Finally, having separate default allocation processes for the investment and insurance components of MySuper products may also result in an increase in the number of members holding multiple accounts with different funds. In most cases, holding multiple superannuation accounts is inefficient due to payment of multiple sets of fees (and also the

[2] Issues Paper, p. 10.

potential for unintended duplicate insurance cover). Superannuation members appear to be becoming more aware of this issue, as reflected in increases in account consolidation - in part driven by reforms driven by the Australian Taxation Office. APRA would view it as undesirable, however, if a revised default allocation model – and in particular the treatment of insurance under such a model – incentivised, or resulted in more members holding, multiple accounts.

The offering of insurance inside superannuation is complex and, in light of the experience in recent years, requires reconsideration to ensure its ongoing sustainability and suitability. Insurance inside superannuation plays an important role for members, which should continue, but the nature and level of that insurance must strike an appropriate balance that meets members' needs at a cost that does not unduly erode accumulation for retirement. Further, as noted in APRA's recent letter to the superannuation industry, there is scope for improvements in claims management practices.

Currently RSE licensees, in almost all cases, undertake competitive tender processes for their group insurance arrangements and it is not apparent that an alternative allocation model or process would result in significant improvements in outcomes for members (or address the product design and claims management issues noted above).

6. Regulatory impediments

The Commission has requested input on regulatory impediments to competition that may be relevant. As indicated in our submission on the Commission's *Issues Paper on Superannuation Competitiveness and Efficiency*, APRA does not consider that the existing regulatory and prudential settings are a material barrier for new entrants to the superannuation system. Rather, they establish an appropriate minimum standard for all RSE licensees.

The unique characteristics of the superannuation system, including member disengagement, compulsion to participate and preservation rules, mean that it is appropriate that there is a robust set of regulatory requirements to be met in order to offer superannuation products. These factors also necessitate a continued focus by APRA on ensuring that RSE licensees meet the prudential requirements.

7. Role of APRA

The Commission has also sought input on the responsibilities of regulators under alternative default allocation models.

As the prudential regulator for the superannuation industry, and given our role in authorisation of MySuper products offered by RSE licensees, APRA is a key stakeholder in the development and implementation of any default allocation model. APRA's superannuation data collection, and the insights and information gathered through our supervision activities, provide a wide range of information to support the implementation and ongoing monitoring of default funds. In particular, APRA has a key role to play in monitoring the implications of the default allocation model that is ultimately implemented for all RSE licensees and their MySuper products, and also system stability.

However given APRA's broader role in relation to the superannuation system, it would be inappropriate for APRA to have any decision-making role in relation to the selection of a sub-set of MySuper products that may be eligible default funds under any default allocation model.

APRA looks forward to working closely with the Commission as the review progresses and would be happy to answer any questions you may have in relation to our submission, or the superannuation system more broadly.

Yours sincerely

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