Dr. Richard Grant
Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Canberra ACT 2600

3 October 2012

Dear Dr Grant

FSC SUBMISSION – SUPERANNUATION LEGISLATION AMENDMENT (FURTHER MYSUPER AND TRANSPARENCY MEASURES) BILL 2012

Thank you for the opportunity to provide a submission on this Bill.

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, private and public trustees. The FSC has over 130 members who are responsible for investing $1.8 trillion on behalf of more than 11 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

Please find our submission enclosed. We look forward to canvassing the contents with the Committee. At the time of submission we remain in discussions with the Government on this Bill.

Yours sincerely

ANDREW BRAGG

SENIOR POLICY MANAGER

FSC SUBMISSION – SUPERANNUATION LEGISLATION AMENDMENT (FURTHER MYSUPER AND TRANSPARENCY MEASURES) BILL 2012

INDEX

1. INTRODUCTION

Context

The Financial Services Council (**FSC**) welcomes the opportunity to provide comments on the Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012, which is the third in a number of tranches of MySuper related legislation.

This Bill contains a number of the elements of the MySuper policy proposed by the Government during the 2010 election and subsequently reaffirmed in December 2010 and September 2011.

MySuper, as announced by the Minister for Financial Services and Superannuation on 21 September 2011, has been substantially improved for consumers, employers and the superannuation industry through the course of extensive consultation. The FSC supports the objectives of the MySuper reforms. In particular the Government has materially improved this Bill on matters such as insurance and portfolio holdings disclosure following consultation on the Exposure Draft released in April 2012.

The FSC remains in consultation with the Government at the time this submission was provided to the Committee.

Regulatory burden

The FSC supports and endorses the introduction of the Stronger Super regime and acknowledges that this will define a new level of regulatory oversight, protection, transparency and competition for superannuation members. However, the FSC remains concerned that the reforms will introduce further regulatory costs on an upfront and ongoing basis.

Balancing the need for increased member protection and regulatory oversight is difficult and highly subjective. It must be noted that the lack of a complete Regulatory Impact Statement for the Stronger Super reforms makes it difficult for the superannuation industry, as well as the Parliament, to assess whether the legislation achieves this balance.

Given the truncated timeframe provided for making submissions to this inquiry, the FSC has sought to outline in a concise manner the substantive matters in the Bill that we feel require amendment.

In short the FSC's primary concern with the Bill is in relation to the transitional measures for MySuper.

Transition to MySuper – summary

Critically, the breadth of the drafting of the current definition of section 20B "accrued default amount" captures choice member balances. We believe that members who have chosen a fund should not be moved to a MySuper product. To do so would be a significant divergence from the central tenet of the MySuper reforms, being to principally protect members in workplace (default) superannuation funds.

The impacts of the current drafting of "accrued default amount" include:

1. Over one million non-default superannuation members within the choice framework being transferred into MySuper;
2. Members having their pre-determined risk/return profiles of investments jeopardised at critical stages of their lives (i.e. exposing a large number of pre-retirees to significant levels of sequence investment risk);
3. Significant transactional costs and market impact arising from the forced transfer of approximately $43 billion in choice member assets;
4. Loss of insurance and other member benefits; and
5. High level of post-transfer confusion and costs to unwind if 'opt out' communications are not actioned by each choice member captured by the transfer.

According to a preliminary assessment of FSC member data, at least one million Australians with chosen (**non-default**) superannuation accounts valued at approximately $43 billion would have their superannuation balances transferred due to this legislation. These are balances which should not be captured as part of the transfer as these members have either opted for a choice product or have explicitly invested in a particular option.

2. TRANSITION TO MYSUPER

Broad application of Section 20B

The definition under section 20B includes an "accrued default amount" that exists as an amount in all regulated superannuation funds that is attributed by the trustee to the member and either:

(a) the member has not exercised member investment choice in the fund; or
(b) the member's account is invested in the default option.

As stated, the current drafting has significantly wider application than "default members". The present drafting captures three classes of members who should not have their balances compulsorily transferred as at 1 July 2017:

1. Members who have exercised choice of investment and invested all or in part in the product's default option (whether or not it is an employer-sponsor or a choice fund);
2. Members have exercised choice of fund, signed a PDS and elected to invest in a choice product but have not given an explicit investment direction; and
3. Members who are explicitly invested in a choice superannuation fund that has been subject to a prior a successor fund transfer.

We do not believe it is appropriate to transfer member balances which are invested due to a choice of fund decision or have explicitly determined to invest in a particular default investment option.

We have proposed an alternative drafting proposal (below) where member balances should only be transferred where members have genuinely defaulted into a default fund. We believe this would reflect the intention of Ministerial statements and the Government's MySuper policy objectives.

Stated policy

The FSC believes the adoption of the choice architecture model as recommended by the Super System Review will clearly segment the superannuation industry into "MySuper" and "Choice" regulatory spheres and that the transition to MySuper has only ever been contemplated in the context of MySuper.

Accordingly, MySuper and choice segments will have varying legal obligations for trustees, appropriately reflecting the level of engagement and active decision-making of members who choose their own fund and/or investment strategy.

The Cooper Review, both Stronger Super policy statements in 2010 and 2011 and the Regulatory Impact Statement clearly state that transition of "default members" would occur in 2017 and would not impact choice members.

Through the Cooper Review and the Stronger Super (Paul Costello) consultation in 2011, it was not contemplated at any time that choice superannuation funds would be subject to default / MySuper transitional arrangements.

According to the Cooper Review:

> The major difference in the choice architecture model is the clear distinction to be made between MySuper and choice products, as either may be offered by large APRA funds. The Panel's broad starting point in relation to the choice architecture model is that, as far as is reasonably possible, if the trustee of a large APRA fund does not wish for a product to comply with MySuper or ERF criteria, the product should continue to operate much as it currently does.
>
> A choice product trustee would be able to determine the extent to which it differs from a MySuper product in relation to the offer of investment choices, intra-fund advice or retirement products, among other features. This is appropriate and will allow the creation of a competitive choice sector.[1]

According to the 2011 Stronger Super policy statement: "Trustees of superannuation funds offering MySuper products will need to transfer the existing balances of their default members to a MySuper product by 1 July 2017."[2]

[1] Super System Review Part 2 Chapter 1 - http://www.supersystemreview.gov.au/content/downloads/final_report/part_two/Part_2_Chapter_1.pdf

[2] Stronger Super Information Pack (2.2.) "Transition to MySuper" http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/information_pack/mysuper.htm

According to the 2010 statement: "(t)he standards that a MySuper product must meet will be set out in legislation and enforced by the Australian Prudential Regulation Authority (APRA). Funds that do not operate as default funds, such as self managed superannuation funds (SMSFs) or choice products, will not have to comply with these additional standards."[3]

Further, the Regulatory Impact Statement did not countenance the transferral of choice member balances. It repeatedly refers to default members:

> Without a specific requirement, it is likely to take many years before the accrued default balances of some default members are moved into MySuper products. This is at least in part because many default members do not make active decisions in relation to their superannuation, and will not actively consolidate their accrued balance with their new MySuper account.[4]

It is clear that the stated policy and RIS has not considered applying a transfer to anyone other than a "default member", that is, it would not apply to choice members.

According to paragraph 6.12 in the Explanatory Memorandum, *accrued default amounts* capture amounts where the member has either *explicitly* or implicitly directed that the amount be invested in the default investment option. An explicit direction may occur by the member directing the trustee to switch monies into the default option or it may occur by a member enacting a 'future contributions strategy' – that is, the member actively determining to leave their existing account balance in the default option but to direct future contributions into another investment option.

We disagree with the presumption that an explicit direction to invest in a default option or to invest in a choice product is a delegation by the member to the trustee for investment decisions. It is in fact the member exercising either their right to choice of investment option (as envisaged under ss52(4) and 58(2)(d) of the Superannuation Industry (Supervision) Act 1993 (**SIS Act**)) or right to select their own superannuation product.

Further, in circumstances where trustees have received, prior to 1 July 2017, a direction from a member in relation to the fund's default investment option (or any other investment option) or

[3] Stronger Super 2010 policy statement
[4] http://ris.finance.gov.au/2011/10/17/stronger-super-reforms-%E2%80%93-regulation-impact-statement-and-prime-minister%E2%80%99s-exemption-%E2%80%93-treasury/

to invest in a particular superannuation product, the trustee should not have to revalidate the initial direction or become compelled to disregard the member's direction.

Loss of member rights / "opt out"

Without changing the definition, there will be significant unintended consequences that will impact over one million choice fund members. Where transfers relate to balances in choice products they are likely to directly abrogate member's exercised right to choice of investment or fund. Many of these members may be worse off or lose rights to which they are contractually entitled under their arrangement with their existing fund. These rights and benefits include:

- Insurance benefits due to reduced insurance cover or underwriting restrictions in the new fund;
- Asset allocations consistent with member direction;
- Investment returns derived on the basis of these allocations; and
- Access to a range of product features and services that may not be replicated in MySuper.

The members who lose these rights and benefits will predominantly be members who are satisfied with their current superannuation fund arrangements. Whilst there may be a suggestion that the solution to this problem is to give members the option of "opting-out", we caution that superannuation members do not always respond to such requests in a manner that is in their best interests. Reliance on an opt-out provision is extremely risky as members may be transferred when it is not in their best interests or against their prior direction.

The requirement for trustees to give prior notice of the transfer and obtain the member's express consent to opt out of the transfer to MySuper is not a practical solution. There are many reasons why a member may not respond to the notice such as where letters are lost in the mail, superannuation funds are not always provided with a member's current address, members may be on holidays during the notice period or a member may simply forget to respond.

In our experience, members of superannuation funds irregularly respond to requests providing in writing from their chosen fund – often because members feel that they have established

their financial arrangements and should not need to alter them subsequently. Superannuation funds have reported that binding death nomination forms are incredibly difficult to update / revise once a member has advised a trustee of their nominee.

For example, on a quarterly basis, an FSC member performs a mail out to members who have previously provided a Binding Death Nomination ("BDN") on their application form, informing them that their BDN is about to expire or has expired.

On average this superannuation fund receives a response rate of only 30% to this mail out. The call centre experience a significant spike in call volumes subsequent to each mail out from confused members who don't understand what they need to do. This is in spite of the fact that the mail out is clear in its instructions and communicates the implications of not providing a response which is that the members BDN will lapse.

It is apparent from these response rates and member interactions that members either do not read or do not understand the implications of not responding and therefore do not action the letter. These members are generally not default members. They have made an explicit choice of fund and investment option, have completed a BDN and would be considered "engaged". However this does not guarantee a response to all communications received from their superannuation fund, even where it may be in the member's best interests to do so.

Examples

The present drafting of accrued default amount inappropriately captures the following classes:

Class of member	**Concerns with compulsorily transferring this class to MySuper**
1. Personal members who have exercised choice of fund, submitted an application for a product to the trustee and invested in the product's default option	In this situation, the personal member has made an express and active decision to invest in the default option in the personal product. The compulsory transfer of their benefits to MySuper could have one or more the following consequences: ▪ if the MySuper product has a different investment strategy to the investment strategy for the personal product's default option, the compulsory transfer would contradict the express wishes of the member ▪ as personal products are not required to offer MySuper products, the compulsory transfer would involve the trustee either offering MySuper in a product that MySuper was not designed for or transferring members to a different product (or

	superannuation fund) ▪ many members invest in personal products as a result of financial planning advice. Compulsorily transferring these members to MySuper could involve the member's benefits being invested in a manner that is not consistent with the advice received ▪ in personal products, the default option can be used in different ways. See below for further information on this.
2. Standard employer-sponsored members who have exercised investment choice to invest in the default option of a superannuation fund (including members who have made an active decision to roll over amounts into the default option)	The concerns raised in relation to (1) above also apply to this situation.
3. Members whose benefits have been successor fund transferred into their current superannuation fund (whether or not the benefits are invested in the default option) and who have not since exercised member investment choice	The inclusion of all benefits where the member has not exercised investment choice in the current fund means that all successor fund transfers into the current fund, no matter when the transfer occurred, would be caught unless the member has since exercised investment choice. The successor fund test in summary is that the receiving fund must provide equivalent rights to benefits. To ensure equivalence is satisfied for those members who have exercised investment choice, the receiving trustee maps account balances to equivalent investment options in the receiving fund. However, if the member has not since exercised investment choice, the definition of 'accrued default amounts' effectively requires the receiving trustee to transfer all amounts to the MySuper product. This could involve the trustee transferring benefits from a range of single sector options (eg Australian equities option or international fixed interest option) to the MySuper product which is likely to be a balanced investment option. Successor fund transfers occur for many reasons, including closure of a corporate fund and consolidation of a financial organisation's superannuation arrangements through the amalgamation of their superannuation arrangements (eg some financial organisations have a number of superannuation funds acquired to mergers and acquisitions).

Example – cash hub

In superannuation funds which offer members a broad choice of investment options it is not unusual to have a feature of the fund by which the liquidity of each member's investment portfolio is maintained by a requirement of the fund's governing rules that every member maintain a cash investment. This can be known as a "cash hub account".

The cash hub account is a repository of cash income earned on the assets in the member's portfolio and the proceeds of sale of portfolio assets, as well as any cash refunds to the member's account. The cash hub account is also used to pay pensions (if the account is in pension phase) and fees and taxes on behalf of the member.

The fund rules will commonly provide that a member must hold a certain percentage of their account in the cash hub account (sometimes up to a specified dollar cap). This is disclosed in PDSs and hence the member is expressly choosing to invest in a product that requires a certain proportion of their account balance to be invested in a cash hub account.

A hub is commonly used in superannuation wrap products. It is used to collate rollovers and contributions (i.e. as a default option), prior to investment -- moreover, it forms an integral and active part of an account, allowing members to:

- Maintain enough liquidity to pay fees, taxes, premiums and pension payments;
- Manage this liquidity by drawing down from investments to minimise capital gains; and
- Accrue sale proceeds and income amounts in the account, prior to them being re-allocated into other nominated investment options.

In such a fund at the time each member joined the fund the member chose their investment strategy by selecting investment options from the wide menu of choices made available in the fund. No one can become a member as a result of employer actions.

Amounts attributable to a member that are not directed by the member to be paid to a particular investment option, are paid by the trustee into the cash hub account on the member's behalf. The member then, subject to the rules of the fund, can give the trustee fresh instructions about the investing in other investment options the amounts held in the cash hub account on behalf of the member.

Trustee -directed transfers of amounts to or from the cash hub account are to give effect to the wider strategy of the member; but at an individual transaction level the members have not chosen the cash hub strategy.

The cash hub is not expressly described as a "default" investment strategy, but in the context of the legislation, where a distinction is drawn based on whether a member has exercised

choice in relation to their s fund investments, amounts in the cash hub account are categorised as non-choice default amounts.

As the drafting currently stands, amounts held in a cash hub account at any time fall within the definition of "accrued default amounts" and thereby would be subject to an obligation by the trustee to transfer those amounts to a MySuper product.

Size of problem

FSC data reveals that under this drafting:

a. In excess of 1 million choice members will have their superannuation dislodged
b. $43 billion will be transferred from choice products (non default) in MySuper products

Further, another million to two million people who have indicated a choice preference to a successor fund will also be subject to the transfer provisions.

Costs to members

Where superannuation funds are required to sell and repurchase assets due to the transitional rules capturing choice and explicit default members, the transactional costs will be extensive. Unfortunately, members will bear the costs of doing so.

Many (non-cash) default options in choice and employer-sponsored products contain an allocation to growth (such as shares) and defensive assets (such as fixed interest), all of which carry different transactional costs and risks depending on the time of execution / trade. There will be asset value and taxation consequences which can not be foreseen at the time of transition – 1 July 2017.

Further, there are default investment options in choice and employer- sponsored products which are captured by the current drafting that do not contain an asset allocation which is consistent with MySuper provisions mandating a diversified investment strategy.

These investment options will not simply be permitted to “rebadge” as a MySuper product. Therefore these assets will be sold and repurchased.

Drafting

The following is our preferred alternative drafting:

RECOMMENDATION

20B *Accrued default amounts*

(1) Subject to this section, an amount is an ***accrued default amount*** for a member of a regulated superannuation fund if:

(a) the amount is attributed by the trustee or the trustees of the fund to the member of the fund; and

(b) the member is a standard employer sponsored member of the fund and the investment option applying to the member's entire balance in the fund under which the asset (or assets) of the fund attributed to the member in relation to the amount (the ***underlying asset(s)***) is invested is one which, under the governing rules of the fund, would be the investment option for the underlying asset(s) if no direction were given except where the member has given a direction to the trustee to invest in that investment option or to the trustee of any previous fund prior to the transfer of benefits to the fund or to any predecessor of that fund as a successor fund to invest in an equivalent investment option.

Our proposed amendment leverages two key concepts.

1. The existing legislative definition of "standard employer sponsor" in the Superannuation (Industry) Supervision Act 1992; and
2. Member directions provided to the trustee to invest their superannuation in a particular manner (i.e. an investment option).

By using the existing definition of employer sponsor, it ensures that members who have exercised choice of fund and are no longer members of employer sponsored superannuation fund are not captured by the definition. Further, it assures members who have instructed a trustee to invest their superannuation in an investment option which is captured by the "accrued default amount" definition, will not have their investments dislodged.

This would allow a trustee to determine that the member has demonstrated a preference for the default option or the choice product which would wrongly be overridden by the transfer of the amounts to a MySuper product.

The trustee may also be satisfied that it has received a direction from a member if the member is making regular ongoing contributions (either employer or personal contributions) into the investment options in the non-MySuper interest or the trustee has received a switch request from a member.

OTHER MATTERS

Dashboard requirements for superannuation wraps

Within a superannuation wrap (platform) environment the exemption under Section 1017BA(4)(c) will remove from dashboard reporting requirements listed equities and term deposits. However it will not remove the requirement to produce a "dashboard" for underlying managed investment schemes as such assets may not satisfy the provision of a "single asset".

The purpose of the dashboard on a website is to create a simple way for members to see key investment option data. We believe that trying to regulate a dashboard for managed investment schemes will create a complex and expensive database that will not add to member engagement or understanding.

Within choice products, trustees must actively engage with their members so they understand their investments and the benefits of the fund. We support transparently disclosing information that members need to assess the performance of their superannuation fund.

However, we do not support the extension of the product dashboard concept across all choice products. The dashboard concept is suited for simple products with limited investment options, to allow a simple side-by-side comparison of investment features. But there are choice products this concept is not suited for, specifically superannuation wraps where the member does not invest in a single asset.

Therefore, requiring the trustee of a superannuation wrap product to publish investment options:

- Will not improve comparability with MySuper products;
- May diminish the overall effectiveness of the dashboards, given the volume of data and investment combination to be tabled;
- may, where an inappropriate comparison is allowed, mislead a member into making an incorrect product choice; and
- Would represent a significant cost to a trustee that would need to be passed on to members.

RECOMMENDATION

Widen the drafting exclusion to include managed investment schemes which a member can invest in through a superannuation wrap.

General fee rules and choice products

The Bill, under the General fee rules, extends the MySuper principles designed for disengaged members to choice products. This is contrary to the explicit intent of the Stronger Super changes, as announced by the Government on 21 September 2011: "Trustees will not be limited on the types of fees that can be charged in choice products[1]"

Limiting trustee discretion on fee structures impacts the design of benefits that can be chosen by engaged members. For example, offering engaged members the choice two fee structures – one suitable for low trading activity, the other suitable for higher trading activity – would not be possible under the General fee rule.

RECOMMENDATION

The application of the general fee rules in Part 11A of the Bill be strictly limited in its application to MySuper products.

[1] Stronger Super Information Pack, 21 September 2011, s 2.7, p. 6.