IMPACT OF CHANGES TO THE FAIR WORK ACT ON THE AUSTRALIAN SUPERANNUATION SECTOR, EMPLOYERS AND THEIR EMPLOYEES

16 June 2014

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Foreword

This independent research report has been commissioned by the Financial Services Council (FSC) on behalf of its members affected by the Fair Work Commission's review of default superannuation terms in modern awards.

The brief was to investigate the potential impacts on the Australian superannuation system, employers and employees, of the rules for selecting default superannuation funds in modern workplace awards.

To enable a comprehensive assessment of the impacts on the various stakeholders, I have been provided with commercial-in-confidence data from affected organisations.

The analysis and opinions in this report are my own.

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16 June 2014

Executive summary and conclusions

The default superannuation market has long been regulated as an industrial issue. For employees covered by a modern award, default superannuation contributions can only be paid into a superannuation fund named in that award. Overwhelmingly, industry funds dominate listings in modern awards as, to date, only registered organisations that own industry funds have had the right to appear before the industrial tribunals that determine the content of awards.

Recent changes to the Fair Work Act 2009 (Cth) (FW Act) require the Fair Work Commission (FWC) to select at least two, but no more than fifteen, default MySuper products for each modern award to apply from 1 January 2015[1] (FWC process).

The consequences of this pending change are far-reaching – straining the fabric of Australia's established superannuation system and impacting more than 100,000 employers and over 2.25 million working Australians.

This report aims to provide a quantitative, as well as qualitative, insight into how these impacts are likely to play out during 2014 as employers and the superannuation sector move to meet the 1 January 2015 deadline.

The research draws on data provided by FSC members who have participated in this project. These organisations alone manage more than $88 billion in employer-sponsored superannuation fund assets on behalf of around 117,000 employers and their 2.5 million employees.

In summary, for affected superannuation fund members and employers of participating organisations, this report estimates that, if it is allowed to proceed as legislated, the FWC process will result in:

- at least **1.25 million employees** having to be redirected to alternate superannuation arrangements;
- a **potential cost to these impacted employees of $185 million**;
- **potential losses to these members of $50 million** from asset buy/sell spreads and crystallisation of tax losses;

1 There is potential for transition arrangements to apply, but these are not yet specified.

- **around 100,000 employers** will be required to redirect superannuation contributions on behalf of some or all of their employees; and
- a **potential cost to impacted employers in the region of $30 million**.

In addition, this report estimates a potential cost to all superannuation funds in the region of $25.5 million and to the Government of more than $40 million arising from the FWC process.

Allowing for other stand-alone superannuation funds and employers who use other master trusts or other funds not listed on a modern award, the **potential total cost of the changes could exceed $400 million**[2] – in return for what this report perceives to be no predictable gain. The reason that there is no predictable gain is because the Stronger Super regime – including the recent introduction of MySuper licensing and the strengthening of trustee board governance – has reset the competitive environment for superannuation funds.[3]

This report also challenges the notion that the legislation will drive further competition, efficiency and innovation – arguing that the opposite will result because of the lack of incentive to compete, the sharing of infrastructure of many of the larger listed funds and the very high entry barriers for new funds. Lower competition will ultimately impact employees in the form of higher than necessary costs and products that do not keep pace with employees' changing needs.

There have been strenuous efforts by various Governments to improve the efficiency of the superannuation system; however, if the legislated FWC process is allowed to proceed, we will potentially see millions of employees paying for additional inactive superannuation accounts and doubling up on insurance premiums.

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[2] This includes the sum of all the employees in the participating organisations increased by 20% for those active employees and employers not covered by the participating organisations. Conservatively, none of the non-asset transfer costs of employers or employees of industry funds that may need to transfer have been included.

[3] Since the recent introduction of the new MySuper product regime, it is not possible to predict future performance from the past performance of a different set of products. A particular concern in the public debate is the misunderstanding in performance statistics. As an example, the submission of Industry Super Australia (ISA) (dated 12 February 2014) to the Federal Treasury's November 2013 discussion paper entitled "Better regulation and governance, enhanced transparency and improved competition in superannuation" claims that retail members would be $7 billion better off if they were invested in industry funds rather than retail funds. ISA looked at the performance data for the year to 30 June 2013 of retail and master trusts. Around 44% of the assets in retail funds are for members over the age of 60. This is more than double that for industry funds. The error is that any performance difference between the sectors is actually masked by a difference in the underlying investment strategies; namely, retail master trusts would have a significantly more conservative investment strategy.

Impact on systemic stability

The systemic risk to Australia's broader superannuation sector is even more far-reaching. Whilst the FW Act requires the FWC to consider a range of factors when selecting default funds, the FWC does not have the brief – or potentially the expertise – to assess the systemic implications of its decisions.

This report outlines five particular areas of systemic concern, namely:

1. **Liquidity risk if assets need to be liquidated quickly, with the potential to ultimately impact the stability of Australia's broader financial system.**
   There is a risk that around $100 billion of assets will need to move from one group of funds to another. The speed at which assets will need to transfer will depend on the extent to which members transfer their existing assets. An asset transfer of such scale could impact the stability of the financial system and adversely impact employees through the crystallisation of tax liabilities and lower prices that may be realised for illiquid assets needing to be sold down en masse. Further, asset sales will be signalled to the market which will impact the strategy for asset sell downs and potentially negatively impact the price. There are plausible scenarios where members may suffer a greater than 0.1% loss or greater than $100 million from the sale of the assets.

2. **Operational risk created from strain on Australia's superannuation fund administrators.**
   The changes will potentially prompt the transfer of over 2.25 million[4] employees in the coming year. This operational risk is exacerbated as the administrator of some of Australia's largest default funds is currently caught up in a prolonged technology transformation. The operational risks will manifest themselves as errors and omissions and potential breaches of employee privacy.

3. **The risk associated with a potentially large number of superannuation funds having to be quickly wound up.**
   This report predicts that at least 25 to 30 industry funds, with little or no capital backing them, will potentially need to close or merge with other larger funds as a result of not achieving a listing on a material number of awards. In effect, the contributions of around one million employees will need to be diverted to alternate superannuation arrangements over the short term, leaving behind assets of around $35 billion sitting in inactive accounts at the cost of the employees. Those industry funds losing future

[4] That is, the 1.25 million master trust employees plus one million industry fund members. This figure excludes other master trusts, corporate and public sector funds.

contributions will quickly become subscale and hence will need to wind up or merge.

4. **Concentration risk.**
   There are plausible scenarios where over half of the members of default funds will be in funds which share the same infrastructure support, namely administrator, asset consultants, investment vehicles and insurer. A failure in a key service provider would adversely impact employees and potentially require the Government to intervene.

5. **The risk to the stability of the insurance industry** at a time when the sector is under considerable pressure and group insurers have imposed unprecedented premium increases to cover increasing claims. Instability in the insurance industry will result in higher costs to employees.

Conclusions and recommendations

Requiring employers to now change the superannuation arrangements for their employees creates significant cost and disruption for no predictable gain – and in many cases significant potential losses for employees. The objective of MySuper was that employers should be protected from having to choose a fund.

If there is a systemic issue, then the Government will need to move quickly to ensure that confidence is not lost in the superannuation system. It is noted that over $400 billion of assets are held by members over age 60. These members could withdraw assets rapidly if they lost confidence. Costs of maintaining confidence in the superannuation system could be many billions of dollars as the Government will need to provide a financial backstop to the system.

One option that would minimise costs and disruption is to allow the new Stronger Super regime to settle in by allowing employers to choose any MySuper product as the default superannuation fund for their workplace, including allowing them to pay into their current MySuper fund indefinitely so as to avoid any disruption arising from changing funds.

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Section 1: Superannuation and the industrial system

This section considers the FWC process for listing MySuper products in modern awards and concludes that:

1. the FWC process will embed the existing named default funds;
2. there will be little incentive for superannuation funds to innovate or compete aggressively with each other through the design of their MySuper products;
3. it does not follow that limiting the number of listed MySuper products actually reduces costs from economies of scale; and
4. a limited list of funds will make it harder, not easier, for employers.

Modern awards and pre-modern award instruments, such as state awards and enterprise awards, have traditionally specified a default superannuation fund or funds.[5] If an employee is covered by an award then, with some exceptions, his or her compulsory contribution must be made to a fund specified in the award. The main exceptions are where: the employee has a defined benefit or chooses another superannuation fund; his or her employer has an enterprise agreement that specifies a fund for the compulsory contributions; or his or her employer was covered under the grandfathering arrangements.[6] The funds listed in awards are termed 'default funds'.

Default funds have never been chosen on merit. Default funds were predominately chosen by a registered organisation, being a union or employer organisation, making an application to list a fund in the award. For this reason, industry funds, which are co-owned by unions and employer organisations, controlled listing in modern awards and pre-modern award instruments and did not have to compete with other funds for default contributions.

The Fair Work Amendment Bill 2012 (Cth), introduced by the then Labor Government, has made substantial changes to the default superannuation system. Additional amendments were passed on 24 June 2013.

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[5] The specified funds were generally carried across from the old award system.

[6] Where an employer had been making contributions to a superannuation fund prior to 12 September 2008, they could retain this or any successor funds as their default fund.

The substance of the new rules is:

- the FWC will specify between 2 and 15 default funds to be listed on each modern award. In some situations, there may be more than 15 funds selected depending on the number of occupations covered by the award;

- the FWC are to establish an Expert Panel to consider applications by funds to have their MySuper product considered for listing in a modern award and make a list of funds eligible to be included in modern awards. The FWC will make the final decision as to which of those MySuper products should be listed in each modern award;

- there is, therefore, a three stage process in approving a MySuper[7] product:

  - Stage 1 requires an already licensed superannuation fund to seek an additional APRA authorisation to issue the MySuper product on the grounds that it meets strict consumer protection criteria;

  - Stage 2 is the publication of the Default Superannuation List, based on an assessment by the FWC's Expert Panel. The assessment includes evaluation against criteria such as historic returns, costs, insurance, governance and administration issues. The FWC will also consider submissions for and against a fund's inclusion, with an overlay of "best interests of a default fund employee, or particular class of default fund employee"; and

  - Stage 3 is the FWC's Full Bench selecting between 2 and 15 funds from the Default Superannuation List for each modern award, on an award-by-award basis;

- superannuation funds are able to make submissions, but superannuation funds or their promoters are not guaranteed standing in the same way an employer or union is guaranteed standing with the FWC;

- the existing grandfathering arrangements will be terminated;

- the new default arrangements will not commence until after 1 January 2015;

- default funds will be reviewed every four years;

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[7] MySuper is a new low cost option that requires APRA licensing. It has been introduced recognising that many employees do not actively select their investment or insurance profile. Amongst other things, the trustees are required to adopt a long-term investment strategy for MySuper products and to prove that the fund has a critical mass to ensure fees are competitive.

- the FWC will determine the transition period to apply where an existing default fund does not make it on to the new list; and

- employers can also use, as a default fund, any fund listed on the schedule of Approved Employer MySuper Products issued by the FWC's Expert Panel. This schedule is designed to include stand-alone corporate funds with authorised MySuper products, and tailored MySuper products for larger employers within corporate master trusts.

There may be up to 90 MySuper products that will be eligible to apply for a listing on a modern award.[8] Each of these MySuper funds would already have had to prove to APRA, the prudential regulator, that they had the critical mass and the capabilities to be eligible to receive default superannuation contributions.

It is important to recognise that, at the critical final stage of the process where the FWC determines which MySuper products are to be named in each modern award, only registered organisations are entitled to make submissions. This ability to make direct representations to the FWC will provide unions and employer organisations with a significant advantage over other superannuation funds in advocating support of the superannuation funds they own. It will also entitle those unions and employer organisations to continue to benefit from the direct payments made to them from superannuation funds through directors' fees.

With the prospect of having to select no more than 15 funds per award, it is also reasonable to expect that the following criteria will offer a practical way for the FWC to decide on the final list:

1. the "best interests of existing default members" would dictate that there will be a bias towards the existing named default funds (assuming these funds pass the selection criteria to be on the Default Superannuation List), given the impact on existing award employees if they are forced to move funds;

2. there will be a bias against those funds that have developed a new MySuper product that lacks a track record, making it likely they will struggle to compete for a listing against those funds having products with a track record;[9] and

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8 Whilst APRA has authorised over 120 MySuper products, only around 90 of these products would be eligible for listing, the balance being MySuper funds for standalone corporate or public sector funds and tailored MySuper funds.

9 Whilst it is difficult to determine the exact nature of all MySuper products, as an indication there are at least 25 new MySuper products and at least 50 re-badged MySuper products.

3. to minimise disruption to employers and employees, an effort will be made to offer the same funds across multiple awards.

Based on the process defined within the FW Act and the pressures on the FWC to minimise the disruption to employers and employees, it is therefore reasonable to expect that:

- the existing listed large default funds (that is, mainly large industry funds) will retain their position on the list;
- for those awards with less than 15 funds currently listed, it seems logical that the FWC will favour nominating default funds listed on other awards rather than new funds not currently listed as default funds; and
- new MySuper products will struggle for a listing because they have no track record of investment performance. This largely applies to commercial or 'retail' funds which were unable to 're-badge' their existing performance history.

Most of the superannuation funds that achieve a listing will have achieved this status – not because they are the most innovative, provide superior service, are best governed, have the best anticipated investment performance or have the most capital backing them – but because they are already well-established in the system.

This report notes that the FWC is required to review the existing listings every four years. This review process may appear to provide the opportunity to the FWC to encourage competition with the threat of weeding out the underperforming funds. However, the author believes it will have the opposite effect. There are significant barriers to entry of new funds. First, it is difficult to see how an incumbent default fund would be removed from the list. It would need a major period of underperformance to justify the reallocation and the disruption caused to the employers and employees associated with the fund. To avoid the risk of removal, listed default funds could have an incentive to replicate the strategies of the others.

Secondly, forcing the default market onto the limited number of listed funds could result in many smaller industry funds and master trust operators leaving the market. It is hard to imagine a scenario where, in four years time, a fund not listed on a modern award could offer a MySuper offering that would get through the testing regime imposed by the FWC that denied them a listing in the first round. Embedding the default funds through the first round will place significant hurdles on new superannuation funds to displace existing funds in subsequent review periods.

It has been claimed that an advantage of selecting a short list of funds is that they can make the most of the critical mass available. However, there is no basis for thinking that if there were only 15 superannuation funds in Australia these would operate more efficiently than if there were 90 funds. Economies of scale available in the industry are transferable depending on how the trustees of the funds manage their outsource arrangements and what incentives there are for large funds to aggressively compete with each other. In fact, as part of the assessment undertaken by APRA in approving MySuper licences, there is a specific test of scale – it is a requirement that trustees of funds constantly prove that they have access to scale economies. Whilst it can be argued that larger funds in general can achieve scale economies unavailable to smaller funds, it cannot be generalised that smaller funds are less efficient or more expensive than larger funds. In practice, the trustees of funds constantly need to ensure that the fund is operating in the best interests of its members. The onus will be on the trustees to take action if the fund does fall below a critical mass. The capacity under the FWC process for an industrial tribunal to determine whether a fund has sufficient scale to continue to receive default contributions places such funds at significant risk of losing considerable market share, effectively overnight.

To further illustrate the flaw in the critical mass argument, over 30% of Australia's total superannuation assets are now invested in self-managed superannuation funds (SMSF) – over 500,000 small funds run by individuals or families. For funds with greater than $500,000 in assets, it is possible to establish an SMSF tailored to the specific needs of the individual(s) involved and that is cheaper to operate than placing the assets into a large superannuation fund. More generally, a number of MySuper funds have been tailored to suit particular industries or employer arrangements. Many large employers, after significant due diligence, have tended to opt for specialist master trusts over industry funds because of lower fees and greater flexibility around insurance cover.[10]

Section 2: Master trusts in context

All the organisations that participated in this report provide their superannuation offerings primarily through a superannuation vehicle termed a 'master trust'. APRA uses functional classifications in grouping superannuation funds. Master trusts are classified as retail funds. The description is somewhat misleading, because many master trusts are provided on a wholesale basis to employers, presenting substantial cost benefits for members.

Master trusts are generally operated on a commercial for-profit basis. Master trusts emerged as a product/service out of the significant consolidation in the superannuation industry that started around 30 years ago. Rather than all employers having their own standalone superannuation arrangements, some financial services businesses offered a master trust

[10] Large employers appoint specialist tender consultants to assess their superannuation options. The tender consultants assess the various superannuation funds against a broad range of criteria including investment performance, fees, insurance, service levels to members, investment options, member advice and communication capabilities.

whereby the costs of running a trust were shared between many employers. The master trust is, in effect, an administrative and legal structure that pools accounts from multiple employers.

Master trusts can differ significantly in their product design, pricing structure and target market. Some financial services organisations offer master trust products to very large employers. Master trust product offerings can be very sophisticated with significant choices of investment vehicles and insurance arrangements. Other master trusts offer more standardised products and services to small employers or individual employees.

The following table[11] sets out the distribution of superannuation assets across all sectors of the superannuation industry regulated by APRA (that is, excluding SMSFs):

Table 1: Distribution of superannuation assets

	Number of entities	Number of member accounts ('000)	Assets ($ billion)	Average account balance ($'000)
By fund type				
Corporate	108	512	61.3	119.7
Industry	52	11,524	324.7	28.2
Public sector	38	3,337	256.9	77.0
Retail	127	14,395	422.8	29.4

The bulk of the retail classification is master trusts. The combined assets of the master trusts that have participated in this report equal around $320 billion (or 75%) of the total retail assets of $422.8 billion. Of the $320 billion, at least $88 billion is attributable to corporate superannuation funds with active members. The annual contributions to these funds are around $11 billion. Around 80% of the total numbers of employees have been defaulted into these funds, and over 90% of employers who use the master trusts of the relevant organisations appear to do so under the earlier grandfathering arrangements.

Around 20% of the assets and employees are attributed to employers who have an

[11] APRA Annual Superannuation Bulletin June 2013 (revised 5 February 2014).

enterprise agreement or the fund is mentioned in an award.[12] Around an additional 10% of employees and assets are attributed to employees who have selected their fund. Some of the employers contributing to the master trust also have arrangements with other default funds, mainly industry funds. It is not possible to accurately calculate the extent of this contribution, but it is not material in the figures quoted above.

In summary therefore, around 90% of the existing employer clients of the participating FSC members, and 70% of the employees of the clients, are likely to be impacted by the new default listing rules unless the master trust they contribute to is listed on the relevant awards or the employees opt to remain with the existing master trust. Section 4 below analyses the likely costs for employers and their employees.

Section 3: Stronger Super implications

In considering the implications of the new default listing rules, it is necessary to understand some of the recent developments in the regulation of superannuation funds. This section discusses the recent Stronger Super amendments and concludes that the substantial changes recently introduced have yet to settle in. In light of the new Stronger Super reforms, it is not possible to generalise about past performance as an indicator of future performance as the superannuation landscape has so fundamentally changed.

In September 2011, the previous Government announced a package of Stronger Super reforms of the superannuation system.[13] An objective of these reforms was to provide enhanced protection for people who did not take an active role in managing their superannuation. The reforms resulted in three specific actions, namely:

1. the creation of MySuper, "a new simple low cost default superannuation product" with significant consumer protections, including APRA authorisation;
2. the introduction of 'SuperStream' which is the infrastructure required to automate many of the manual processes involved in transactions across the superannuation industry; and

12 This 20% includes those employees defaulted into funds covered by an enterprise agreement. This analysis is based on the primary data provided by the participating organisations.

13 http://strongersuper.treasury.gov.au/content/Content.aspx?doc=home.htm

3. strengthening "the governance, integrity and regulatory settings of the superannuation system".[14]

MySuper is a significant initiative by the government. Superannuation funds are now required to gain approval from APRA for their MySuper products. The onus is on the trustees of the fund to design a MySuper product that demonstrably, that is to APRA, promotes employees' best interests. There are rules regarding the application of fees, limits on cross subsidies, rules on insurance and a requirement that the investment strategy reflect the long-term nature of the employees' interests. Trustees also need to show that the MySuper product will have the critical mass required to compete. There is also a 'large employer' discount provision in the legislation.

APRA has approved around 120 MySuper licences, inclusive of tailored and corporate MySuper products. Out of these, it would be expected that there would be less than 90 that would be eligible to be listed as a default fund.

Superannuation law provides the flexibility to offer employers with more than 500 employees a MySuper product tailored to the needs of their particular workplace. These products can differ from a fund's main MySuper product in terms of investment strategy, employee services and fees. A number of large employers have also negotiated MySuper arrangements on more favourable terms than those available under the funds' generic MySuper offerings.

In addition to the MySuper initiatives, APRA has moved to strengthen trustee governance standards.

In the author's view, the MySuper regime, along with the more rigorous governance standards, has reset the competitive environment for superannuation. The removal of commissions for default employees has meant that future costs are broadly similar for most MySuper options, and the impact of commissions and fees which are now banned on "legacy" products skewing the 10 year performance numbers, is not relevant for the future for default employee contributions.

Section 4: Impact of the FWC process

This section investigates the potential financial and other impacts on employers, employees, the superannuation funds and the Government. Note that the calculations of cost impacts to

14 http://strongersuper.treasury.gov.au/content/Content.aspx?doc=home.htm

employees and employers in this section relate only to those members of the participating organisations.

Impact on employers

The analysis indicates that around 117,000 employers use the master trusts of the participating organisations. The vast majority of employers who use master trusts as their default funds will be doing so as part of the grandfathering arrangements. From January 2015, employers will be required to contribute to a superannuation fund listed on the relevant modern award. A small number of employers with enterprise agreements will be able to retain their existing superannuation arrangements.

If the master trusts of the participating organisations do not achieve a listing on a material number of awards,[15] the author's research estimates that less than 20% of the employers mentioned above will escape the impact of the changes (that is, no more than 20,000 out of 117,000 employers). The 20% allows for the fact that some of the master trust MySuper products may be listed on a limited number of awards.

Given that almost all of the employers who contribute to master trusts are covered by the grandfathering arrangements, it will be necessary for many of them to make future compulsory contribution payments to a new superannuation fund listed on the relevant award, or convince their employees to proactively exercise choice of fund so as to remain in the master trust currently supported by the employer. Employees with contributions made to an alternate fund would be left with an inactive account in the existing fund, unless arrangements were made to transfer the assets.

An added difficulty is that some employers do not have a detailed understanding of the exact award coverage of their workforce. To reduce the risk of fines, employers may tend to select a default superannuation fund listed on most or all of the modern awards. Based on analysis of the data provided by the participating organisations, the expectation is that more than 80% of employers surveyed will opt for a superannuation fund listed on a modern award and that this will not be their existing fund.

The deadline of 1 January 2015 is also a major impediment to employers who wish to properly assess their options. Given the rush in decision making, it would be expected that smaller employers would not undertake a detailed assessment of the available options.

[15] It is not possible to predict the extent to which the participating organisations will achieve a listing. The analysis of the likely process indicates that new MySuper products will struggle to achieve a listing on a material number of modern awards.

Whilst the FWC is able to decide on appropriate transition arrangements, there is no indication yet of what this transition period will be. Employers will not want to risk being fined and hence will be under pressure to make and implement a decision before the 1 January 2015 deadline. This leaves very little time for detailed and considered decision making.

The stated objective of the new default fund arrangements is that the FWC will make a quality determination and hence, theoretically at least, employers could select any fund from the lists on modern awards. There would be little opportunity for employers to negotiate special arrangements and there is unlikely to be time for proper assessment of what is in the best interests of the employees.

As a conservative assumption, it would be expected that the small employer would spend at least 4 hours or $200 of time/money in making a decision, including making arrangements for the termination of the existing arrangements and the necessary paperwork for the communication to employees and transfer of contributions to a new superannuation fund.[16] Larger employers could well spend significantly more to assess their options.[17] This research has conservatively estimated that employers would, on average, spend $300 on selecting new superannuation arrangements.[18] The costs to the approximately 100,000 employers impacted by the changes is therefore in the vicinity of $30 million.

No allowance is made here for the cost of potential fines many employers would be expected to pay simply because they were not aware of their new obligations.

The issue here is that the limiting of funds on modern awards and the removal of the grandfathering is triggering the need for employers to undertake an assessment. If all MySuper products were available to be chosen by employers as the default fund for their workplace, then there would be no need for the assessment process.

As discussed, there are employers in master trusts who may retain their existing superannuation arrangements because they are covered in an enterprise agreement or are

16 The same small business cost assumption used by ISA in its submission referred to in footnote 3 above has been used. In its submission, ISA noted that additional red tape costs of $160 million would apply if the government were to open up default listings to all MySuper products. The ISA submission has missed the point. If the rules were changed so that every MySuper fund were allowed on the list, then the employer costs would be zero because they would just stay put with their current MySuper fund. There would be no search cost. See the submission at: http://www.industrysuperaustralia.com/wp-content/uploads/2014/02/120214-ISA-Submission-Governance.pdf

17 To illustrate, very large employers could spend in excess of $150,000 in consulting services to properly assess their options. In addition there would be internal costs, such as time spent by senior management in assessing their options.

18 That is, $200 for small employers, increasing with increasing size of the employer.

on the schedule of Approved Employer MySuper Products. Over time however, these employers will need to reassess their existing arrangements. There are scenarios where some employers will need to change their arrangements because their superannuation service provider needs to withdraw its MySuper product because it has become non-viable.

An alternative option for employers to avoid transferring all employees to new arrangements is for the employer to approach each impacted employee separately and to convince them to stay put. Some employers will adopt this approach, but the cost to the employer will likely be greater than simply selecting a new fund. Further, for a medium to large employer, there would be employees who would refuse to opt for the employer-nominated fund. Over time, employers would likely need to select a default fund.

Impact on employees[19]

The analysis of the master trusts of the participating organisations has determined that they have a total active membership of around 2.5 million in their corporate-sponsored superannuation funds. The research indicates that around 50% of members will likely be impacted and be required to have their superannuation contributions made to an alternate fund.

To be clear, the 50% not affected allows for those employees who:

1. work for an employer with an enterprise agreement or a superannuation fund that is listed on the schedule of Approved Employer MySuper Products; or
2. have selected their own fund; or
3. the existing master trust is listed on a modern award and their employer opts to continue contributing to this fund.

The balance of this section assumes that the number of employees potentially impacted is around 1.25 million.

Moving to another superannuation fund has some important direct implications for the employee. First, the employer is only bound to make future contributions to the new fund – the existing accumulated asset can stay where it is. It is possible to make a mass transfer of

[19] Those members of large industry funds named in many existing modern awards are assumed unlikely to be affected by the review, and so the numbers quoted below are for other employees subject to the terms of modern awards.

all assets to the new fund without the employees' approval (so called 'successor fund transfers'), but the trustees of the respective funds need to agree that the employees are no worse off after the transfer. There is a growing view amongst superannuation lawyers that the successor fund transfer is problematic in regard to MySuper transfers and comes with significant costs and complications for the employer and the trustees of the various funds. There is no incentive for the employer to transfer employees' funds en masse.

It is likely that most employees will be left with two accounts, one inactive account in the old fund and one in the new fund. If an employee proactively decided to consolidate accounts, then he or she could transfer the assets. Some funds charge a transfer fee of around $60. If the employee decides to retain the existing arrangement, then the employee would be required to meet the account keeping and investments costs applicable in the old fund. Costs would be at least $75 per annum.[20]

In any event, in the first year of the transfer, the employee would incur one or both of an account-keeping fee for the old fund and the transfer fee for moving assets between funds.

Moving to a new fund could also trigger additional, and unnecessary, insurance for the employee. MySuper products are required to provide sufficient insurance cover on death and disability unless the employee opts out. Employees could already have an insurance arrangement in the old fund. If the employee does not make a definitive decision, then both insurance arrangements could remain active. Costs could be greater than $150 per annum on average per fund. Further, many employees would be entitled to lower benefits in the new fund compared to the old. If their insurance arrangements in the old fund were terminated because of their inactivity, then they would end up with less insurance cover than they previously enjoyed.[21]

It is worth noting that many of the funds likely to be listed as default funds have experienced significant increases in insurance costs. Some of the largest funds have seen insurance premium increases of over 80% within one year, with more to come.

It seems reasonable to assume that the average transferring employee could be worse off by at least $150 in the first two years of transfer. This cost is a combination of holding two accounts and paying asset transfer fees and additional insurance coverage. Some employees may take a number of years to consolidate their accounts. Others could have

[20] Most funds charge a weekly administration fee and an asset charge. The $75 represents the average administration fee per annum. To be conservative, the asset fee has been excluded.

[21] Some superannuation funds terminate insurance cover if the member stops contributing. Generally speaking though, cover is maintained whilst a member has an asset sufficient in the fund to meet the insurance costs.

their assets captured as part of the lost super arrangements. Total expected cost is therefore around $185 million for the 1.25 million members impacted. These costs to employees come with no guaranteed or even predictable gain.[22]

Another, more subtle, impact on the employee will be the impact the change in superannuation arrangements may have on the investment strategy of the underlying assets. Many new MySuper products offered by master trusts and some industry funds default to a so-called 'lifestage' investment strategy. Under the lifestage approach, the investment profile of the underlying assets changes as the employee ages. In effect, the investment profile becomes more conservative as the employee approaches retirement age. The trustees of these funds have determined that this lifestage investment profile facilitates the capturing of the higher long term returns available from more risky equity-type investments when the employee is young, whilst protecting the older employees from the short term volatility that may come from sudden drops in the equity markets. The MySuper products in the current default funds do not commonly offer this lifestage protection. It is not possible to speculate on what is the preferred option for the employee, but there are clear differences in what trustees consider to be an optimal investment strategy for employees. Employees who are defaulted into funds will be exposed to the impact of the different views of trustees. Further, employees who are defaulted into another fund but retain their assets in the existing funds will be exposed to two potentially conflicting investment strategies.

Costs to the superannuation system

In addition to the costs to employees and employers, there will also be costs of funds applying for listing. In its submission to Treasury's November 2013 discussion paper entitled "Better regulation and governance, enhanced transparency and improved competition in superannuation", the FSC noted that there would be a cost to the retail superannuation fund sector of $25.5 million. This cost allows for the need to prepare submissions to the FWC. This will be the cost borne by the industry if the FWA process proceeds.

Other potential costs to Government

On the introduction of the new listing of default funds, it would be expected that the Government would need to organise for a community education campaign to make employees and employers aware of the changes. The Government would also need to meet

22 As already discussed, it is not possible to predict future performance from the past performance of a different set of products.

the costs of the FWC in its deliberations and monitor award compliance. It is difficult to put a cost on this. When the GST was introduced, an allowance of $402 million was made, including $36 million for the 'Unchain my Heart' advertising campaign. In the case of default superannuation, it would be expected that all employers would need to be made aware of their responsibilities. It is difficult to see how, if the Government chose to run an information campaign, the cost to Government to lift awareness to employers and employees, and for the evaluation and monitoring process, would be less than $40 million.

Section 5: Risk to systemic stability

This section discusses the implications of the FWC process for Australia's superannuation system as a whole.

This report contends that the mass movement of employees and assets between superannuation funds could risk the stability of the superannuation system itself, ultimately to the detriment of employees.

Whilst the FWC will carefully consider the funds that need to be selected as default funds, it can only work within its brief and area of expertise. The rules require that the new default arrangements apply from 1 January 2015. There may be transition arrangements, but there could be a rush of employers who want to make a decision to avoid a fine. Based on the analysis, there could be around 1.25 million employees working for 100,000 employers who may need to have their future superannuation contributions transferred to a new superannuation fund over a period of months. These represent the impact on the participating organisations' master trusts only. There are also other master trusts, corporate and public sector plans and many industry funds that may be impacted. Employees will need to pay for assets and insurance arrangements in inactive accounts.

There are five areas of particular systemic concern, namely:

1. the liquidity risk if assets need to be sold down quickly;
2. the operational risk created from strain on the superannuation fund administrators;
3. the risk associated with a potentially large number of superannuation funds having to be quickly wound up;
4. concentration risk; and
5. the risk to the stability of the insurance industry.

These risks are discussed in more detail below.

Liquidity risk if assets need to be sold down quickly

A mass movement of employees from one fund to another may result in the need to transfer material assets between funds. It is difficult to predict the extent to which assets will be required to be transferred, but it is plausible to envisage a campaign by default funds to expedite the transfer of assets for employees who are transferred.

A mass transfer of assets could trigger severe liquidity, and even risk stability in the financial system, as assets such as buildings or infrastructure need to be sold in a rush. Up to $100 billion[23] of assets are at risk of being moved in short order. Employees could suffer through the crystallisation of a tax liability and the lower asset prices that may be realised from a quick sale.

There may also be asset buy/sell spreads that are triggered. It is also plausible to speculate that an asset transfer of $100 billion may result in losses of greater than $100 million or 0.1% of total assets to the members. A further issue is that it will become clear in the market which funds will need to sell down their assets. This signalling to the market could impact the selling process and potentially negatively impact on the price to the detriment of employees.

Operational risk created from strain on superannuation fund administrators

There is significant operational risk in having to transfer en masse potentially 2.25[24] million members of superannuation funds to alternative arrangements over a relatively short period of time.

Employers will need to enter into new arrangements with superannuation funds by 1 January 2015.[25] The new superannuation funds will need to process applications. The risk is exacerbated because the administrator of some of the largest default funds is currently caught up in a major technology transformation project which appears to be many years from completion.[26]

Administering superannuation funds is complex and requires the collection of many pieces

23 The $100 billion allows for the assets in master trusts and industry funds at risk of being transferred, including investment returns and contributions since 30 June 2013.

24 The 1.25 million members from the participating organisations and an additional 1 million members from other organisations, including industry funds.

25 There is provision for the FWC to decide on transition arrangements, but there are no guarantees. Even with transition arrangements, employers will still rush to change to avoid any risk of a fine.

26 http://www.afr.com/p/technology/botched_it_project_costs_super_funds_7sKqjMy4TlQ10wPCdFBSwN

of information on behalf of the employees, including their personal details and tax file numbers. There are risks of error and potential breaches of privacy.

Risk associated with superannuation funds having to be quickly wound up

The mass redirection of employees' existing contributions to alternate arrangements could result in many of the existing superannuation funds falling below a critical mass. The promoters of these funds will need to consider options for winding up the funds.

To illustrate, there are currently around 50 industry funds. The analysis predicts that over half of these would not be listed on a material number of modern awards. These funds have no capital backing them and they would need to quickly decide to wind up or merge with a fund that is listed on a modern award. The speed of wind up will depend on the extent to which the existing assets are also transferred.

Industry funds which are not in the top 30 have a total membership base of around 560,000 members and combined assets of $11.5 billion. Industry funds which are not in the top 20 have a total membership base of around 1,760,000 members and combined assets of around $35 billion.[27] The rush to decision making would create a risk for the employees remaining in the fund as fees increase as a result of membership falls, triggering the need to renegotiate administration, insurance and investment arrangements.

Depending on the extent to which existing member assets are transferred to alternate arrangements, the funds would need to lay off their staff and organise the transfer of any remaining assets. To facilitate transfers, it may be possible to organise successor fund transfers but, as already discussed, these transfers may be problematic and could take years to finalise. In the meantime, members would be paying for inactive accounts.

With these industry funds alone, it could be envisaged that over 1 million employees would need to be moved with combined assets of over $35 billion.[28]

Corporate and public sector funds are in a similar position to industry funds in that they have no capital backing. Many master trusts may be in a similar position. Master trusts do generally have capital backing them and hence they will potentially have more time to consider their options. There are still risks for master trust members however, since those employees who remain in MySuper products could suffer increases in fees and ultimately be

[27] As at 30 June 2013.

[28] Allowing for contributions, interest up to the actual date of transfer.

forced to transfer to another superannuation fund. These costs have not been estimated in this report.

Concentration risk

Many of the funds likely to achieve listing on the modern awards have common back office infrastructure. This infrastructure has been built to capture economies of scale.

There are plausible scenarios where over 50% of the members defaulted into a listed default fund will be in funds with the same back office infrastructure, for example administrator, asset consultant and shared investment vehicles and insurer. Whilst superannuation fund balance sheets are not geared in the way those of banks or insurers are, having such concentration of risk in infrastructure supporting these major default funds exposes the system to systemic risk if one of the providers fails. Employees may need to meet the costs of failure or the Government may need to intervene at the costs of taxpayers.

Risk to the stability of the insurance industry

Employees will be entitled to insurance in their new default funds. The insurance arrangements may be different to their existing arrangements. Many employees may not be aware of the difference, and hence may either pay too much for insurance they did not know they had or do not need, or their old fund may terminate their insurance because the employee becomes inactive in the old fund.

The issue for the insurance industry, however, is that people who are aware of their insurance coverage will be influenced in their decision by their state of health. There will be significant risk of selection against the insurers as people who are less healthy will tend to retain higher levels of cover than people who are healthy. The selection effect will flow through to higher claims than expected, hence higher premiums, and potential impact on the insurers' profitability, solvency and capital requirements.

There have already been significant losses reported by insurers and reinsurers in the group life market.[29] Premium increases of over 100% in one year are not unusual. The new rules

[29] A group life contract is the formal arrangement that exists between the life insurance company and the trustees of the particular superannuation fund. The contract sets out the prices and conditions of death and disability insurances that are to apply to the members of the fund.

for selecting default schemes will exacerbate the problems in the group life insurance market. Instability in the insurance industry will result in higher costs to employees.

Summary

These systemic risks are contingent on how employees, employers, fund promoters, trustees and others act as a result of the rapid change in superannuation arrangements.

It is not possible to predict exactly what the outcomes will be, but these risks are real and one or a combination of events could trigger an episode of financial distress. The Government will need to move quickly to resolve any distress effectively, with a minimum adverse impact on the financial system and economy and at a minimum cost to taxpayers.

In particular, the Government will need to ensure that confidence is not lost in the superannuation system. Over $400 billion of assets are held by members over age 60. These members could withdraw assets rapidly if they lost confidence. Such a withdrawal of assets would create significant liquidity issues in the economy and could lead to financial instability. Costs of maintaining confidence in the superannuation system could be many billions of dollars as the Government may need to provide a financial backstop to the system.

Notes

Methodology for collecting data

This report aims to determine the impact on employers, employees and the superannuation industry generally, based on data provided by the affected organisations. Each of these organisations has adopted its own methods for collecting the data and assessing its potential exposure. The methodologies used have been reviewed and some adapted to ensure consistency across the group. Data has been aggregated.

Obligations under confidentiality agreements prevent disclosure of the detailed analysis to each of the relevant organisations or to any other party. The assumptions have been tested with a number of the organisations and other independent consultants. The conclusions drawn in this report are robust to changes in assumptions.

About Rafe Consulting

Rafe Consulting is an independent consulting and research organisation with specialist insights into Australia's investment, superannuation and financial services sector.

Barry Rafe BSc FIAA FAICD

Barry is a financial services professional with more than 30 years' experience as a director, CEO and consultant to significant financial services firms and superannuation funds.

Barry provides strategic business advice to financial services businesses and large superannuation funds on issues such as product development, long range business planning and board governance.

Barry is a Fellow of the Institute of Actuaries of Australia, a Fellow of the Australian Institute of Company Directors and has recently achieved first class honours in Philosophy at the University of Sydney. Barry presents courses on board governance for the Australian Institute of Company Directors and has written their course on superannuation fund governance.

He was an executive director of a number of subsidiaries of large international financial services businesses. He has also been President of the Institute of Actuaries of Australia, a director and treasurer of the Responsible Investment Association of Australasia and a past director of ASFA, the superannuation industry representational body.

Barry has held senior consulting positions as a strategy partner at Accenture and head of the financial services practice at Trowbridge Consulting. He was a senior manager with AMP and the CEO of Mellon Bank's Australian operations. In his consulting roles, he has advised many of Australia's largest financial services businesses on distribution and product development. As a consulting actuary, he has also been involved in some of Australia's largest financial services transactions including as lead actuarial consultant to the National Australia Bank on its acquisition of MLC. He was also an advisor to CBA on its acquisition of Colonial.