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Productivity Commission
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Superannuation: Alternative Default Models

I attach a submission from Cbus in response to the Draft Report into Superannuation: Alternative Default Models.

If any matter needs clarification, please contact Rod Masson on (03) 9910 0054.

Yours sincerely,

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Productivity Commission Draft Report
Superannuation: Alternative Default Models

1. Introduction

Cbus welcomes the opportunity to comment on the PC's Draft Report in its inquiry into Superannuation: Alternative Default Models.

Established in 1984, Cbus is the industry superannuation fund for the construction, building and allied industries. Cbus recently received recognition for its 11 years as a platinum rated fund by independent ratings agency SuperRatings. Cbus is run only to benefit members, and doesn't pay commissions to sales agents or financial advisers.

Cbus also invests back into the construction and building industry, which not only provides strong long-term investment returns, but helps boost our economy and create jobs within the industry.

Cbus has over:

- 740,000 members
- 120,000 employers
- $37 billion in funds under management

Cbus, as a member of Industry Super Australia (ISA) and the Australian Institute of Superannuation Trustees (AIST) endorses the views expressed in their submissions in response to the Draft Report.

Overview

The Australian superannuation system is recognised as one of the best in the world.

The default fund process is, correctly, anchored in the industrial relations system. This recognises the heritage of superannuation in Australia as almost predominantly the result of the industrial process and that superannuation is the deferred wages of employees.

Beyond that, organised interest groups such as employer associations and trade unions play a significant role in ensuring that members' best interests are paramount in the administration of their superannuation. It is for that reason that the industry fund model is run on an all-profit to member basis and has consistently outperformed superannuation offerings from the for-profit sector.

It is also a consequence of their role in the superannuation system that significant investment decisions and strategies have been implemented that not only benefit the individual member, but look to long term capital direction that provide real-economy benefits and societal good.

They also bring unique insights into the nature of work and the industry they are drawn from. This provides a powerful foundation for tailoring investments, products and services that meet the unique needs of employees in specific industries.

Further, they are also the only groups capable of providing sufficient counter balance to the tremendously powerful, for-profit, financial services sector, dominated by the big four banks in Australia.

This is important in the context of the selection of default funds in a compulsory superannuation system. The default fund process should act as a form of consumer protection for those incapable or ill-equipped to make an informed choice of their superannuation fund.

The correct body to determine default funds is the Fair Work Commission. It is independent, transparent and subject to appeal. It has vast experience in weighing the interests of industry and employees and in determining appropriate safety nets. And it is not conflicted or beholden to the interests of the finance sector.

It should also be noted that the best performing superannuation or pension systems in the world are industrially based, and they are not Chile or New Zealand which the Commission focussed on. They are Denmark and the Netherlands.[1]

We note the Commission has accepted and adopted for the purposes of this exercise the Government's preferred "objective" for superannuation being to provide income in retirement to substitute or supplement the Age Pension, even though this objective has not been adopted by the Parliament.

Cbus argues that this objective is too narrow and lacking ambition. Nevertheless, the Commission's Draft Report and proposed four alternative default selection options arguably fail to meet even this test, promoting as they do either:

- A race to the bottom on fees and its implications of passive investment strategies likely to weaken returns;
- An opening up of the default safety net to inducements and politicisation;
- A failure to protect default members from being 'flipped' into more costly, lower performing options;
- A liquidity squeeze threatening long-term investment in illiquid assets such as the built environment and nation building infrastructure and the return benefits such asset classes provide;
- A drive to short-term investment horizons to align with short-term performance assessments, exacerbating problems clearly identified with short-term thinking and management, threatening longer-term sustainability.

1 http://www.globalpensionindex.com/news/2016-melbourne-mercer-global-pension-index-media-release/

This last point deserves far more consideration by policy makers and those charged with responsibility to advise them, particularly when considered in the context of international commitments such as delivering the United Nations Sustainable Development Goals or meeting our nation's obligations under the Paris Agreement on Global Warming and Emissions. Such matters require patient, long-term capital investment.

Cbus is of the view that our superannuation system should be seen as more than just another financial services commodity that will somehow benefit from increased market competition – although the Commission's Draft Report is somewhat confused on this matter.

Cbus does not fear competition. We have a strong brand, high levels of satisfaction from members and employers and scale that provides scope for innovation in investment. However; we do not believe the construct of defining default selection as a competition or auction in which the "winners" get to extract value from members sends the right signals or delivers on the default rationale. Rather, we advocate for a default system that protects and provides value <u>for</u> members.

Terms of reference

Cbus believes that the term of reference provided by the Treasurer to the Productivity Commission for the review were incomplete; consequently, the subsequent draft report and proposed models are also incomplete and compromised by omission.

The Treasurer chose not to direct the Commission to do an assessment of the current system and the Commission chose to assume a theoretical baseline of 'no defaults'. Consequently, the draft report proposes four models that would lead to a radical overhaul of the default fund selection process without even assessing the merits of the current system. We submit that this process is flawed.

A starting point of 'no defaults' is a low and abstract benchmark to evaluate and compare the models. The Commission asserts that the "*use of a no defaults baseline exhibits a refreshing absence of ideological preference and is about as objective a benchmark as possible*."[2] It may well be an 'objective' benchmark but it is an academic tool that disregards the current system. The declaration that this approach exhibits an 'absence of ideological preference' is questionable given that it implicitly prefers overhauling the current system without evaluating it first. This process has consequently produced models that appear more like solutions looking for problems.

We believe the rationale for such change has not been made. In any event, the Commission has already recommended an alternative model for default selection

2 Superannuation: Alternative Default Models - Draft Report (page 60).

that has not been allowed to operate – namely the FWC Expert Panel and quality filter.

We also note that the Commission was directed to "*consider the merits of different approaches…. This should include consideration of … the strengths and weaknesses of competitive processes used internationally, such as Chile, New Zealand and Sweden*." We do not believe that it automatically follows that consideration should be limited to these jurisdictions; nor should it suggest any different or favourable treatment should be given to these countries; however, it appears that the Commission has done exactly that.

We submit that there is no major fault in the current default system. There may be room for improvement; however, we need evolution, not revolution.

Our Super is super – it's not banking

> "*Our superannuation system is the envy of the world and those people who seek to fiddle with it are putting that at risk*" – The Hon. Christopher Pyne, Minister for Defence Industry & Leader of the House[3]

These comments were made in the context of a different debate regarding superannuation; however, the observation is still entirely relevant and applicable to the discussion regarding arrangements for default superannuation.

The Australian superannuation system is a long-term success story. It has worked well, as demonstrated by our ranking as 3rd best in the world,[4] and improves the lives of almost every Australian. The $2.2 trillion in superannuation embodies the accrued savings of Australian workers and retirees. At an individual level, it allows people to achieve a higher standard of living in retirement than otherwise would be the case, and at a macro level it increasingly provides potential for large scale investment

Superannuation also helps the sustainability of the Commonwealth budget. Over the next few decades the expected growth in superannuation assets and earnings will assist the Commonwealth's Age Pension expenditure and help to preserve Australia's expenditure on public-provided pensions as among the lowest in the OECD.

More broadly, the superannuation system is a significant and growing source of funding for the Australian economy.[5] The impact of Australia's superannuation system extends much beyond just providing more than $70 billion[6] in retirement benefits each year. With savings in excess of our national GDP and on track to reach

3 http://www.smh.com.au/business/federal-budget/its-a-pity-christopher-pyne-lashes-colleagues-for-public-disunity-ahead-of-budget-20170412-gvk23f.html
4 http://www.globalpensionindex.com/news/2016-melbourne-mercer-global-pension-index-media-release/
5 http://www.industrysuperaustralia.com/publications/reports/funding-australia-superannuation-and-the-financial-system/ and http:/ /www.industrysuperaustralia.com/publications/reports/industry-super-and-the-australian-economy/
6 http://www.industrysuperaustralia.com/publications/reports/funding-australia-superannuation-and-the-financial-system/

$7 trillion by 2030, the system delivers enormous benefits to the economic and social lives of all Australians.[7]

The outperformance of Australia's industry super funds is well documented and Industry Super Australia (ISA) estimates that this has added around $51 billion in total to national superannuation savings over the last 19 years.

Industry super is uniquely positioned to deliver economy and society wide benefits for Australia by mobilising super capital into longer term nation building. The broader benefits of long-term investment in illiquid assets including infrastructure and property have been shown to flow directly into the Australian economy and federal budget.

Industry super has delivered economy and society wide benefits for Australia by:

- Stimulating economic activity through capital expenditure:
- Deepening the stock of productive capital:
- Deepening the pool savings, helping to lower the cost of borrowing: and
- Acting as a liquidity buffer to financial markets and the broader economy through long-term investment.

Superannuation is a product of good social and economic policy. It is not 'just another financial product' nor should it become one. If superannuation becomes conceptualised and consequently treated the same as other commercial financial products, such as banking or insurance, then it will become subject to the same market forces that have arguably produced numerous consumer problems over the last decade.

It is critical that culture and values are given their rightful due in the context of assessing the superannuation system, in selecting default funds and applying quality filters.

Institutions that view members as an exploitable resource are inconsistent with the history and purpose of our superannuation system; consequently, their motives for seeking to gain access to greater numbers of default fund members should be viewed sceptically.

Current default system has performed well

It is important to remember that superannuation is deferred wages and an industrial matter.[8] The existing default system in superannuation is industrially based and contains over $400 billion of savings of about 7 million people, and has consistently outperformed the average.

7 http:/ /www.industrysuperaustralia.com/publications/reports/industry-super-and-the-australian-economy/

8 The claim that superannuation was not an industrial matter was dismissed by the High Court - 160CLR 341 (15 May 1986)

This is entirely consistent with international evidence that clearly shows industrially based systems are the best performers around the world.[9]

We note that the models proposed by the Commission would largely reduce or remove the industrially based structures for allocating default funds and consequently reduce the role of unions and employers. We believe this is a mistake. One of the main reasons that industry funds such as Cbus have been effective in delivering strong outcomes to members is due to the involvement and cooperation of these parties. Historically, unions and employer organisations have worked very well on the boards of industry super funds. Where problems have arisen, the parties involved have resolved them quickly through cooperation in the best interests of members and employers.

The foundations of superannuation were built from the leadership of trade unions and agreement with employers to provide superannuation for all workers. Their shared purpose to provide profit to members (rather than shareholders) has delivered consistently better returns. Unions and employers, and their peak bodies, have intimate specialist knowledge of the labour force, labour mobility, the capacity of employers to manage payroll and others systems, employee financial literacy, the insurance needs of the workforce and the investment preferences of the workforce.

They also bring a significant counter-balance to the profit-driven interests of the finance sector, instead seeking to extend culture and values that are completely focused on the best interests of fund members.

They have and they should continue to play a central role in the default system.

Selection of default funds

We are pleased that the Commission has acknowledged that a quality filter is needed, and that the filter should be stronger than simply MySuper.[10]

In the Draft Report, the Commission has explored the possibility of a periodically-appointed expert panel that would oversee the selection and monitoring of default funds.

Cbus supports the selection of default funds by a government body that has the characteristics identified by the Commission, and note that it would be required to exercise significant judgement in this regard. However; we do not support the creation of a new body given that the FWC architecture already exists for the selection of defaults. Constructing a brand-new entity would be wasteful, awkward, and potentially increase the risk of politicisation, but is highly unlikely to have the

9 *Living In An Empirical World, The Best Retirement Income Systems in the World Rely on Industrial Defaults* – Industry Super Australia Submission re: Alternative Default Models Issues Paper - http://www.industrysuperaustralia.com/assets/Submission/PC-submission-on-alternative-default-FINAL.PDF

10 Page 132, DEFAULT SUPERANNUATION IN MODERN AWARDS - "The Stronger Super and related reforms provide an effective foundation to promote disclosure and comparability of default superannuation products and funds but, given the uncertainty surrounding the likely number, mix and quality of MySuper products, there needs to be a 'quality filter' to distinguish among them."

judicial and legislative controls (such as appeals mechanism) that regulate the Fair Work Commission.

In addition, we suspect it will be difficult to find people who, one the one hand, have the essential skills and experience, but on the other hand, are free from conflicts of interest.

Also, the possibility that the panel determining eligibility for default status would cease to exist once it had made its decisions does not seem to be consistent with a proper level of accountability.

We submit that the proposed FWC expert panel process, and the 'quality filter' adopted in the *Fair Work Act*,[11] should be allowed to operate before any overhaul of the current system is contemplated. We believe that this is appropriate and consistent with the objectives of transparency or competition, and recognises the industrial relations heritage of superannuation.

The FWC expert panel would decide where employees have failed to exercise a choice, either individually or through bargaining. In this situation, the panel is essentially charged with trying to uncover the views of the workforce. Representative industrial parties, especially unions, are best placed to provide the views of the workforce as to the fund attributes and features that are valued by workers in a particular occupation or industry.

If selecting a default fund from a potentially long list of default-eligible funds were to rest with an employer, then their commercial interests may mean he or she is not well placed to stand in the shoes of an employee who does not exercise choice of fund.

Furthermore, employers have expressed the view to Cbus that they do not wish to make a choice in such an open market because of concerns about their ability (and potential culpability) in selecting the right fund for their employees.

That being so, the FWC architecture is ideally placed to perform the role. The FWC is a quasi-judicial body accustomed to applying the rules of natural justice, and making its decisions having regards to the substantial merits of the matter before it. Its processes are open, low cost and all the evidence before it is in the public domain. Its reasons for decision are made public, and its decisions are subject to judicial review.

Comments on certain features of the Commission's proposed models

Importance of long-term performance

In addition, if performance assessments or pre-authorisation selection criteria are not long-term, there is likely to be a shortening in investment horizons so that they more align with meeting or winning performance assessment.

11 *Section 156F*

There are different applications of 'long term' in the Commission's Draft Report. We note under the multi criteria model, a 'long-term' performance measure is described as a 5-year return measure. Cbus believes that 'long-term' measures should be no less than 10 years.

Superannuation funds are distinctively *very* long term in nature, investing over numerous time horizons. Using shorter term return outcomes does not encourage a longer term investing focus, and creates a peer focus that could impact investment innovation.

In turn, reducing the long-term investment focus will dilute the contribution that superannuation can, and should, be making towards productive capital and sustainable development.

Liquidity and investment

The proposed models will likely have the unintended consequence of reducing the length of investment horizons through reducing liquidity and/or creating liquidity uncertainty.

Liquidity considerations are a key component of setting investment strategy. Higher liquidity requirements would reduce the allocation made to illiquid assets, which include holdings in unlisted infrastructure.

Evidence suggests that illiquid assets contribute to strong long term risk adjusted return outcomes, both through diversification benefits and through the illiquidity premium.

Investing in unlisted Australian infrastructure strongly supports the broader Australian economy, and a distinct reduction in investment allocations would result in lower domestic funding for Australian infrastructure projects.

Unlisted property and infrastructure investment is a contributing factor to Cbus' top quartile performance over the long term. For example, Cbus holds a direct and pooled investment share of NSW Ports. This investment provides a steady flow of dividends to Cbus members and frees up the Government to reinvest capital into vital new infrastructure.

Through its investment in some of Australia's largest infrastructure projects, Cbus is generating returns for members, and creating jobs. For example, Cbus invested through IFM Investors in the expansion of the Brisbane and Melbourne Airports which are expected to create thousands of jobs over the next five years.[12]

Reducing exposure will also likely result in greater overseas ownership of key infrastructure assets in Australia.

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12 IFM Investors, 2015.

Passive not persuasive

An overemphasis on fees, such as would be anticipated in the auction model, will compromise investment outcomes as more passive, less expensive investment strategies are sought.

Default funds should not be designed in a sub-optimal way simply because members are young and disengaged. The Commission suggests that:

> *…putting young disengaged members into a low-cost passive fund may be a reasonable choice, which many overseas default models apply. (Page 17)*

This suggestion implies a Commission assumption that most members will move to a choice framework once they are no longer 'young'.

Industry experience around the level of disengagement that exists for a sizable portion of members would indicate that a large percentage of members do remain in the default fund for a considerable period of time, and many through to retirement.

We note that there is systemic risk should there be a significant number of people who remain 'disengaged' and stay in such default options. This is because inferior outcomes would place negative externalities on the government which would be required to pay more in the form of pension expenses.

Secondly, this statement sits in dramatic contrast to the requirement that other current members in the default option would be subject to the same low fees etc. upon winning the bid.

> *"A fund that wins default status for contributions of new members should be required to offer the revised winning fees and service terms to all current members of its default product. This would diffuse the benefits of competition to the broader system.*" (page 61)

In this instance, potentially all members would be subject to sub-optimal outcomes regardless of their age or longevity in the fund. This would not meet the Commission's criteria of meeting member's best interests and could be argued as a breach of a Trustee's fiduciary obligations.

Value of specialised funds not recognised

The Commission has proposed several models that do not appear to appreciate the value of funds, such as Cbus, who have a close affinity with their members' industry.

The proposed fund selection process for all the models may lead to homogenous default product offerings, and potentially discourage the creation of tailored products for particular sectors of default members. We believe that affinity with the industry is something that the Commission should consider when formulating its final report.

We note that the Commission excludes insurance and prefers to characterise it as a 'regulatory add-on'. We disagree with this approach and believe that insurance is an essential element of the system.

Industry specialisation, especially in areas such as the construction and building industry, can add value through tailored product design and insurance offerings that address the specific needs of employee's and employer's. For example, Cbus examined the insurance products associated with MySuper from five prominent retail funds and whether they would cover various occupations in the construction and building industry. A number of professions, such as dogman/rigger,[13] labourer or scaffolder would not be eligible for death or TPD insurance if they were with any of these funds. These can be dangerous jobs; however, that is precisely why a fund such as Cbus adds significant individual and public value by covering all these occupations with appropriate insurance products.

Industry affiliation also brings other benefits such as targeted investment decisions within that industry that create employment outcomes. Cbus' investments in the building industry through Cbus Property are a good example of this and have created over 70,000 jobs over the last decade while delivering 15% p.a. returns.[14]

Research by Cbus consistently shows that our close affiliation with the industry is considered a major strength by our members and employers. Examples of this for members includes:

- Choosing Cbus due to its active involvement in the construction & building industry;
- Having a reputation as 'being a fund for people in the construction industry'; and
- Cbus understands member's needs.

Examples of this for employers includes:

- Being perceived as 'a fund for people in the construction industry';
- Choosing Cbus because it 'supports your industry'.

The 'value proposition' of Cbus is intrinsically linked to its affinity with the construction and building industry; however, this value would not seem to be recognised by the any of the proposed models.

This coupled with the culture and values of all profit to members and everything in members' interests should be essential ingredients for default fund selection.

13 A dogman or rigger specialises in the lifting/moving of large and heavy pipes and equipment. They must work together to ensure the slings are safely placed on the equipment to be lifted and that the slings are loaded onto the crane's hooking correctly. A dogman or rigger then directs the crane operator by either radio or hand signals to advise him when the load can be lifted and moved.

14 http://www.cbusproperty.com.au/

Multiple accounts

We acknowledge there is an issue with multiple accounts and that account proliferation caused by people changing jobs requires attention; however, the trend is in the right direction. Overall there has been a reduction from 30.7 million accounts in 2013 to 28 million in 2016[15] and this is likely to continue and accelerate as various other initiatives such as Single Touch Payroll, SuperStream and MyGov gain traction.

In addition, Cbus has extensive systems in place to reduce multiple accounts. As a part of our member engagement strategy we communicate the potential benefits of consolidation of their super funds into one account. Some of the key benefits that are highlighted include the reduction in administrative fees, removal of potentially duplicated insurance fees, and potentially better returns.

We have regular campaigns which aim to communicate with relevant members to convey the opportunities and benefits of account consolidation.

These campaigns include:

- Four key communications with members in their first 12 months which encourages them to consolidate their other super funds into Cbus;
- SuperMatch monthly campaigns which target members with relevant consents to inform them of the outcomes of the search of other super accounts in their name across the system (including ATO) and encourage consolidation.

In addition, we periodically communicate with members who have not provided a TFN to collect this information plus the consent to search for other funds and subsequent consolidation.

As a part of our standard processes managed by Link, our administrator, the following processes are followed to de-duplicate member accounts within the Cbus portfolio:

- Join – new members - at the point of setting up a new member existing accounts are checked to identify if a person with the same details exist within the database to prevent creation of a duplicate
- Monthly exception reporting – monthly process of checking entire member portfolio for a match due to personal details being updated to identify potential duplicates for merging.

In some cases, it should also be recognised that holding more than one account may be a matter of choice for some people. Reasons will vary but some individuals may wish to maintain or enhance their insurance coverage this way, they may also wish to diversify their investments across more than one account.

15 Annual Superannuation Bulletin – APRA, June 2016 (issued 01 February 2017).

Existing levers for sector consolidation need to be exercised.

Industry consolidation has begun to provide scale over the last few decades with the number of APRA-regulated institutional funds going from around 5,000 funds in 1996 to 225 in 2016.[16]

Mergers have driven much of this consolidation and Cbus is supportive of these, where it advances members' best interests. We also support greater transparency by super funds in relation to merger activity.

However, the Commission's options may have the unforeseen consequences of driving the industry towards oligopoly, lacking the culture and values of all benefits to members.

We note that consolidation mechanisms are already in place. APRA has a 'scale test'[17] which requires MySuper funds to determine annually whether their default members are disadvantaged in comparison with default member in other funds. It seems reasonable to expect that this will encourage lower performing funds to consider merger with higher performing funds

APRA has signaled that it will be increasingly vigilant in this area (which we support); however, there does not appear to be compelling evidence to change the current arrangements given the amount of consolidation that has already occurred, and is likely to occur going forward.

Any quality filter for default status should include arrears process

Funds seeking default status should be required to have a rigorous arrears collection process in place.

The level of non-compliance with payment of the superannuation guarantee, as estimated recently by the joint ISA & Cbus report is $3.6 billion.[18]

This is a staggering amount of unpaid superannuation that creates;

1. A delayed and detrimental impact on individuals' retirement savings, robbing them of the benefits of investment earnings and compound interest;
2. An immediate and negative effect on the collection of government revenue through lost taxation – eg 15% of $3.6 billion is $540 million;
3. A greater strain on the age pension and other Government services which leads to greater strain on the Federal Budget.

Given the problem of unpaid super across the economy it is important that any default fund have process and protections to ensure that superannuation contributions are actually paid.

16 *Annual Superannuation Bulletin* – APRA, June 2016 (issued 01 February 2017).
17 SUPERANNUATION INDUSTRY (SUPERVISION) ACT 1993 - SECT 29VN
18 *Overdue: Time for Action on Unpaid Super* – Industry Super Australia & Cbus 2016.

Conclusion

Cbus supports transparency, administrative efficiency and competition in superannuation where it enhances the net benefit to members. Cbus believes the current system should be given a chance to operate before further reforms are considered.

In conclusion, we submit that the default fund selection system, under the FWC should be allowed to perform its function, and that the default system, in the industrial framework, has served Australia well.