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PROTECTING YOUR SUPER PACKAGE – SUBMISSION

The Financial Services Council (FSC) welcomes the opportunity to make a submission to Treasury's consultation on the 'Protecting your Super' package from the 2018-19 Budget.

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13 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.

We support the Government's policy intent of protecting Australians' superannuation savings from inappropriate erosion where possible. However, we urge caution to avoid unintended consequences from these significant changes.

We outline some practical considerations below in our submission including technical refinements to facilitate an orderly implementation as well as definitional clarifications. We include several recommendations for changes to the current legislation to ensure a smooth transition and implementation of the proposals.

Please contact me with any questions in relation to this submission on (02) 9299 3022.

Yours sincerely,

Allan Hansell
Director of Policy

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INTRODUCTION

The FSC supports the Government's goal of improving superannuation outcomes through the *Protecting Your Super* package.

We are supportive of measures to protect the superannuation balances of Australian workers, and we believe the proposed changes to account fees and an ATO-led consolidation program will have a positive impact by reducing the number of duplicate, low balance and inactive accounts in the system.

Importantly, in our opening section we outline issues common among all proposals in the legislation. A key factor is consideration of the mechanism for members who do not wish to be captured by these changes, including clarifying in legislation in which form trustees can obtain member instruction. We also outline issues with the definition of an 'inactive' account. We recommend the changes should not apply to pension accounts, risk-only accounts, annuities or innovative income streams, conventional products (whole of life and endowment policies) and non-severable insurance and investment products.

There are some technical considerations outlined in our submission regarding the fee cap and exit fees. One of our main recommendations is changing the legislation to allow a retrospective fee rebate mechanism, rather than the current forward-looking fee cap mechanism. In addition to this we recommend allowing trustees to calculate fees on an annual basis and clarifying the types of fees that are included in the cap and exit fee proposals.

On the insurance proposals, we are concerned that the proposal to change arrangements for insurance in superannuation from opt-out to opt-in for under 25s could lead to some younger Australians who need insurance, especially those in high risk jobs or those with young families, slipping through the safety net.

Conservatively, the FSC believes that the amount paid in claims will reduce by about $2 billion a year (+/- 20%). This estimate represents the combined impact of the 3 main limbs of the proposed legislation changes for insurance in super for people under 25, inactive accounts, and the minimum balance of $6,000. The responsibility for looking after newly uninsured members will fall to those people and their families, or to the Australian Government, adding to fiscal pressures.

We are also concerned for people who are on extended sick leave or who take a career break, perhaps on parental leave, and forget to tell their trustee to keep their cover beyond 13 months.

In the third section regarding ATO transfers, we provide some practical recommendations for how this may work in practice.

Our submission has been set out to follow the structure of the draft legislation, addressing:

- Common issues across the proposals;
- Fee proposals;
- Insurance proposals; and
- ATO consolidation proposals.

SUMMARY OF RECOMMENDATIONS

Key issues

1. Allow members to make a simple enduring choice to retain their account and/or insurance cover. Allow flexible forms of member consent.
2. These proposals should not apply to pension accounts, innovative income stream products, risk-only accounts, employer covered insurance policies, non-severable insurance/investment products, or conventional products (whole of life and endowment policies).
3. Ensure the definition of an 'inactive' account is consistent with other legislation.
4. Legislate for safe harbour for life insurers and trustees who, despite best endeavours to contact members, cancel the insured person's insurance cover in accordance with the legislation and without that person's instructions or consent.
5. That the implementation date for the insurance changes should be 1 July 2020.
6. Trustees should be able to apply to APRA for a facilitated compliance period if they are unable to develop the relevant changes by 1 July 2019.
7. Government should develop and publish a regulatory impact statement in consultation with stakeholders.

Fee Cap for low balance accounts

8. Allow superannuation funds to implement the fee cap for low balance accounts through a retrospective rebate mechanism, rather than a forward-looking cap system.
9. Allow superannuation funds to calculate fees based on an average balance over the period, rather than the balance at the start of the period.
10. Allow calculation of fees on an annual basis, rather than half-yearly (or alternatively allow trustees to choose based on their reporting periods to members).
11. Allow trustees to turn off flat dollar administration fees for MySuper accounts.
12. Clarify which fees are subject to the cap and more explicitly define which investment fees, administration fees and other indirect fees are included.
13. Increase the minimum remaining balance in SIS regulation 6.35 from '$5,000' to $6,000.
14. Align the thresholds 'up to $6,000', rather than 'less than $6,000' in the legislation.

Exit fees

15. Explicitly clarify in the explanatory memorandum that traditional life insurance backed products (savings/investment plans), member-elected fees (including where rolled over), innovative income streams (per SIS Regulation 1.06A), term and lifetime annuities and term deposits do not fall under this definition.

Insurance Requirements

16. Opt-in cover should be restricted to death cover only. Trustees should be able to retain TPD and IP cover on an opt-out basis, subject to application of the best interests test.
17. If the Government does not accept Recommendation 16, consideration should be given to retaining TPD cover on an opt-out basis for members under the age of 25.
18. The proposal to cancel or not offer insurance for accounts with less than $6,000 should only apply to inactive accounts.
19. Trustees should not cancel death and TPD insurance for inactive accounts unless the balance is below $6,000.
20. A clear definition of a default insurance member should be provided in the regulations.

21. Timings, practical considerations and parameters to be clarified in the regulations.

ATO Transfers

22. ATO should merge current unclaimed super accounts with active accounts prior to the commencement of this process.
23. ATO should sign up to a Service Level Agreement (SLA), if appropriate, and commit to uniting funds with active accounts within 20 days.
24. Alternatively, initiate direct transfer into active accounts using SuperStream.
25. Clarify that a transfer into a fund from the ATO should not entitle the member to automatic insurance.
26. Clarify that accounts that have elected to obtain insurance are excluded from compulsory transfer.
27. Consider and clarify the intent of the impact on Eligible Rollover Funds (ERFs).

DEFINITIONS

Risk-only account: a superannuation account set up predominantly for the purposes of obtaining life insurance (whether death, TPD, IP or trauma).

Conventional products: (that is whole of life and endowment policies) are where the trustee holds a whole of life policy issued by a life company, which provides the superannuation benefit for the member.

Non-severable insurance and investment products: a life insurance contract where the risk and investment components are bundled, and cannot be modified or extracted separately.

Pension accounts: these do not receive contributions.

Innovative income streams: Products facilitated under SIS Regulation 1.06A

KEY ISSUES

Making it simple for members to provide instruction

The proposed changes are intended to protect fund members and improve member outcomes.

However, there will be members who may wish to 'opt-out' of the rollover to the ATO or the cancelling of insurance.

Under the current proposals, these members might find their account inadvertently transferred to the ATO, or their insurance cancelled without their knowledge, with resultant loss of investment returns or cover.

The legislation should specifically set out provisions for members to make a single enduring choice to retain their insurance even if their account balance falls below $6,000 or becomes inactive and to retain their account within the fund (i.e., not have their account transferred to the ATO). Such an election should not lapse e.g., when a new trigger event occurs. Members who make this choice will be engaged with their superannuation accounts, and therefore not the key target of these reforms. For example, applying for specific types and levels of retail insurance in super requires underwriting which indicates clear member engagement and choice.

Making such an election should be considered to be enduring. Members should not have to make repeated requests to avoid their chosen superannuation arrangements being changed, or risk unintended consequences, such as having money transferred to the ATO or requiring insurance to be re-underwritten (which may result in new loadings or exclusions being applied).

The legislation should also facilitate and be clear about the ways in which a member can engage and provide instruction – this would be postal, email, online elections via member portals, text messages and phone calls that are recorded with appropriate identification checks.

1. **Recommendation:** allow members to make a simple enduring choice to retain their account and/or insurance cover. Allow flexible forms of member consent.

Ensuring only appropriate accounts are captured

There are several types of product that would currently be captured by the proposals, despite it being inappropriate to apply the proposed actions to these accounts.

These include:

- Pension accounts: these do not receive contributions, nor do they have insurance premiums deducted. These will fall below $6,000 and not be "active" under the current definition i.e. not receive contributions or rollovers. The legislation needs to include income payments made for pension accounts as active where balance is under $6,000. Pension accounts should not be considered for low balance consolidation and a trustee also shouldn't be expected to restrict fees or investment options available to a pensioners account to avoid breaching the fee caps. This includes innovative income stream products.
- Risk-only accounts (that is, insurance only products) – setting up these products is a conscious choice made by members to manage their insurance arrangements, and will likely have low balances and/or inactivity. The insurance should not be removed, nor should these accounts be

transferred to the ATO, nor should a fee cap apply (particularly as the balance of these accounts is usually zero for significant periods).

- Where the member is not charged any insurance premiums – for example, where the cover is provided by employers, or where the employer makes a specific additional contribution to pay for insurance.
- Members who make an active choice to take out, keep or vary their insurance.
- Retail insurance policies involve applying for specific types and levels of retail insurance in super and underwriting. This shows clear member engagement and choice. They are also often set up with part of the cover in, and part outside, superannuation with the two parts being co-dependent on each other. If the superannuation cover was required to be cancelled, this would be to the significant detriment of the customer who would continue to be paying for the cover outside super which could be rendered pointless and ineffective without its co-dependent policy. In addition, fees paid by the member for the advice would be foregone.
- Conventional products (that is whole of life and endowment policies) – Conventional products are where the trustee holds a whole of life policy issued by a life company, which provides the superannuation benefit for the member. In many cases, these products/policies are fully paid up so members are not required to make any further contributions and they must hold the product/policy until its maturity date. These products should therefore be excluded from the proposed opt-in requirements because they are not required to receive contributions and/or do not accept contributions. These products are often intentionally not a member's primary superannuation account, however the product is held for future benefit rather than consolidating.

2. **Recommendation:** these proposals should not apply to pension accounts and innovative income stream products, risk-only accounts, employer covered insurance policies, non-severable insurance and investment products and conventional products (whole of life and endowment policies).

Defining an "inactive" account

The draft legislation links the definition of an inactive account solely to whether or not a contribution or rollover has been made within a 13-month timeframe. This new definition is likely to create unnecessary complexity and have unintended consequences.

By linking the definition solely to contributions, rather than other forms of engagement, some individuals not making contributions but otherwise engaged with their superannuation (for example by adjusting their investment or insurance options) may have their accounts deemed inactive.

This could impact individuals who are not currently making contributions for an extended period but wish to retain their account, including workers on parental leave, career breaks, self-employed, those who have intentionally retained a small balance account for the purposes of insurance, people between jobs who haven't accrued sufficient balance in their new employer's default fund to obtain cover, and others on extended leave of absence for health or other reasons.

The new definition of inactive will also make the existing definitions of "lost member account" and "lost member" in the *Superannuation (Unclaimed Money and Lost Members) Act* and the *Superannuation Industry (Supervision) Regulations 1994* largely redundant. These should be amended to reflect one consistent definition and reduce complexity.

3. **Recommendation:** ensure the definition of an 'inactive' account is consistent with other legislation.

Safe Harbour requirements

The industry would not want unintended adverse consequences to arise from communications not being received by the customer.

Many of the measures involve cancelling cover and/or transferring funds to the ATO without the member's explicit consent. Despite best endeavours by trustees, communications might not reach the affected person, for example, if a member changes their contact details and does not inform their trustee. We note that there may be a correlation between people on parental leave or career breaks and changed contact details, for example, if people were using their work physical or email address.

We are concerned that this might result in trustees facing lengthy legal disputes about communications after cover was cancelled without consent where the person subsequently becomes disabled, or from the beneficiaries of someone who has died. It would therefore be helpful to legislate a safe harbour for trustees who have taken all reasonable steps to contact the people whose cover is to be cancelled. This would be similar in nature to the proposed safe harbour provisions proposed as part of the Retirement Income Covenant.

This should also protect trustees from situations where insurance has been cancelled due to a delay with the expected receipt of contributions from an employer, such as where there is a delay by an employer in processing an employee's choice of fund request, or an employer's failure to meet SG obligations. These situations might result in an inactive account, even where an individual is engaged in work and would have expected their account to be active and receiving contributions.

4. **Recommendation:** Legislate for safe harbour for life insurers and trustees who, despite best endeavours to contact members, cancel the insured person's insurance cover in accordance with the legislation and without that person's instructions or consent.

Implementation timetable

The administrative changes and commercial considerations associated with implementing the proposals are significant. Crucially, there could be detrimental implications for members.

The proposals involve cancelling people's cover without their consent. Despite best endeavours by trustees, communications might not reach the affected members, for example, if someone changes their contact details or is not reachable due to parental leave, career breaks or working/travelling overseas.

Most group insurance arrangements will need to be re-priced. As part of the commercial arrangements, many have rates locked in for up to 3 years. Without time for detailed analysis, conservatism will be built into the premium rate. Additional implementation costs will also be incurred for additional staff and outsourcing. All these are likely to result in additional costs and premium increases which would ultimately be borne by members to their detriment.

FSC notes that, if the implementation date remains unchanged, the 13 month cancelation period, and therefore procedures, would need to begin on 1 June 2018 – a date which is now in the past.

Trustees will need to:

- Redesign their opt-out insurance (for example, the basis for opting-in) when the legislation and regulations are final
- Consult with employers and members
- Renegotiate insurance contracts
- Take actuarial advice
- Re-write insurance contracts and governing rules
- Roll out new PDSs
- Communicate with members (for example, issue Significant Event Notices)
- Re-design administration systems and processes

Given the usual processes, it is unlikely that the legislation and associated regulations will be finalised before late 2018. After that, trustees would normally need at least 2 years or more for a project of this scale.

The FSC notes that the Insurance in Superannuation Voluntary Code of Practice has a last implementation date of 1 July 2021. However, we understand that the implementation considerations need to be balanced with the urgency the Government is seeking.

5. **Recommendation:** The implementation date for the insurance changes should be 1 July 2020.

Other Recommendations

6. **Recommendation:** Trustees should be able to apply to APRA for a facilitated compliance period if they are unable to develop the relevant changes by 1 July 2019.

7. **Recommendation:** Government should develop and publish a regulatory impact statement in consultation with stakeholders.

SCHEDULE 1 – FEES CHARGED TO SUPERANNUATION MEMBERS

Fee Cap

We support this proposal in principle. However, the current drafting will result in several unintended consequences and practical implementation issues.

We have provided recommendations below that will allow these issues to be rectified without impacting the intended consumer outcomes.

Retrospective rebate of fees

The proposed forward-looking system for determining whether an account is subject to the annual fee cap creates unnecessary complexity both in implementation and operation.

The current drafting may have unintended consequences or may allow members to game the system. For example, a member could have two accounts and, after the fee cap is calculated on an account under $6,000, transfer a large balance into the low balance account. It will not be an uncommon occurrence for a new member to roll-in their previous account (which could be sizeable) in the months following joining a new fund.

Under the proposal as drafted, a fund charging a combined investment plus administration fee of 0.5% pa and no dollar-based fees would not automatically meet the cap – and in fact would frequently have to rebate some of the 0.5% pa fee to meet the cap. See Appendix A for calculation and example.

Fee capping in a family fee aggregation situation would also be a challenge because there may be an unintended consequence of remaining account(s) being charged a higher fee when an inactive or low balance accounts is split out from the group due to them being transferred to the Commissioner. Fees grouped together receive the benefit of a discount. This is often because the whole group results in higher Funds Under Administration (FUA) and so the FUA fee tiers have lower fees in the higher tier. This benefits the group as the lower fee is then passed onto all members of the group. If an account is removed, the marginal fee increases as less FUA is charged at the higher balance / lower fee rate.

We therefore propose using a retrospective fee rebate system which will allow trustees to calculate a rebate and apply in arrears on an annual basis to continuing members as well as to exiting members. This would also greatly enhance accuracy and efficiency and limit 'gaming' of the cap. A similar rebate mechanism was used in the 'Member Benefit Protection' system.

A rebate mechanism will also simplify transition in the first year, as the fee rebate will only need to be calculated and applied to members who exit the fund. The rebate will still be applied to all impacted members in the first year but trustees and administrators will have more time to build and implement annual processes to support this with only an exit process being required from the start of the first year.

Allow the trustee to calculate the cap on average balance over the period

Super funds should have the <u>option</u> to calculate the fee cap based on the average balance during the period, rather than the starting balance (or end balance for a new account), where the average balance is calculated on a reasonable basis determined by the trustee. It is not uncommon for trustees to calculate and charge fees on an average account balance basis rather than a point-in-time balance so this added flexibility would assist trustees to reduce implementation complexity.

Calculate cap on an annual basis

The cap should also be applied on an annual basis, rather than half-yearly. Or alternatively, based on a trustees reporting period (whether annually or half-yearly).

An annual, retrospective rebate approach would be a more efficient means of implementing this measure, as all fee outcomes for the account would be known at that time. To further simplify this annualised process, a reasonable estimate of investment fees charged to a member account (similar to the approach allowed under the calculation of Other Management Costs within periodic statements) should also be permitted, rather than having to determine the precise value of investment fees charged to an account that holds multiple investment options and/or has moved between investment options of the fund during the period. This measure would allow for the prompt rebating of any fees as part of a funds normal end of year activities.

Allow trustee to remove flat dollar administration fees

Further, to allow compliance with the measure, the MySuper fee rules should be changed to allow a trustee to 'turn off' flat dollar administration fees for cohorts of consumers at the trustee's discretion. The effect would still be that the total fees paid by consumers could be no higher than the 3% cap, but it would provide a potentially far easier option to implement for, we consider, most of the target members of the policy.

Platform fees

Platforms charge an administration fee to customers (usually FUA based). Investment options from fund managers are then provided where the fee is deducted out of the return. The investment fee is not managed by trustee and so can vary significantly (especially where there are performance fees) and these fees are retained by the investment manager – it is not reasonable the trustee pay this where the overall fee is greater than the cap.

Clarification of included fees

We would like Treasury to consider and clarify which fees should be included or not included in the fee cap to provide certainty to industry. We believe that the included fees should not cover buy-sell spreads, indirect costs, investment fees such as performance based fees, the investment component of the Indirect Cost Ratio (ICR) or other member-directed investment fees.

We also request Treasury clarify the following:

- Whether the cap is to apply to gross fees or fees net of allowance for any related tax deductions;
- That where an employer pays some or all of the fees, the cap would apply only to the fees not met or reimbursed by the employer; and
- The Summary of Proposed regulations indicates that periodic statements must tell members "when their account is or has been subject to the cap and the maximum fees that they could be charged" – please clarify what is meant by 'the maximum fees that they could be charged'.

Alignment with existing regulation

We would also recommend the following changes to align the fee cap with other regulations:

- The minimum balance in SIS regulation 6.35 should increase from 'less than $5,000' to $6,000, to align with the 3% fee cap balance limit. (Currently SIS regulation 6.35 allows a trustee to refuse a partial withdrawal benefit request if the remaining balance would be less than $5,000 after the withdrawal.)
- Alignment of 3% cap cut-off balance with the cut-off balance for compulsory transfer of inactive low balance accounts to the ATO and insurance opt-in. The 3% cap is to apply to balances up to $6,000 whereas transfer of inactive low balance accounts to the ATO and insurance opt-in applies to account <u>less than</u> $6,000. We suggest that they be aligned to simplify communication e.g. so they could be combined under a heading 'What special rules apply to accounts with up to $6,000?'

Recommendations:

8. Allow superannuation funds to implement the fee cap for low balance accounts through a retrospective rebate mechanism, rather than a forward-looking cap system.
9. Allow superannuation funds to calculate fees based on an average balance over the period, rather than the balance at the start of the period.
10. Allow calculation of fees on an annual basis, rather than half-yearly (or alternatively allow trustees to choose based on their reporting periods to members).
11. Allow trustees to turn off flat dollar administration fees for MySuper accounts.
12. Clarify which fees are subject to the cap and more explicitly define which investment fees, administration fees and other indirect fees are included.
13. Increase the minimum remaining balance in SIS regulation 6.35 from '$5,000' to $6,000.
14. Align the thresholds 'up to $6,000', rather than 'less than $6,000' in the legislation.

Exit Fees

We support the removal of exit fees from superannuation accounts, as it removes disincentives for members to consolidate their super and facilitates competition in the superannuation industry. We would like some further clarity, however, on which fees are included under the definition of an "exit fee". We note that trustees may need the ability to change the fee structure of current members to comply with this proposal.

Early termination in contractual arrangements

While early termination on products such as term deposits, annuities and traditional life insurance-backed products are not under the definition of an exit fee and are not exit-fee "like", we include them below for clarity. Features of these products that occur when they are terminated by the member before maturity are not a fee but rather are contractual arrangements for that early termination. As they are not fees and therefore not exit fees, we seek clarification that these products' terms are exempt from this section of the legislation via the explanatory memorandum.

These types of early termination contractual arrangements are a feature in several kinds of accounts that may be captured under the current proposals, including:

- *Term deposits*: many super funds offer the purchase of term deposits to their membership. The redemption of an underlying term deposit prior to its maturity may in some cases triggers a lower interest rate for the deposit levied by the banking institution and members would be aware of this lower interest rate applies through the disclosure they receive. These early termination arrangements have typically not been disclosed as a sell spread, even though they are a true cost of transacting on the asset that is levied by the issuing institution. In other cases for some super funds, the early termination of a term deposit prior to its maturity results in a reduced crediting rate and therefore lower level of interest being paid to the member and members would be aware of these terms through the disclosure they receive.

- *Term and lifetime annuities*: by their very nature, commutable term and lifetime annuity products have a discounting methodology applied for early withdrawals. Whilst disclosure regimes have changed over time, the discounted nature of an early withdrawal was typically disclosed to the member at the point of application and this discounted value is linked to the realisable value of the underlying assets backing the income stream (frequently held by a life insurance company) well before their intended liquidation date.
- *Other traditional life insurance-backed products and innovative income stream products*: These products pre-date the modern superannuation system and have been closed to new businesses for over two decades. A number of traditional super offerings (especially savings/investment plans) have a withdrawal benefit value that is contingent on the member meeting certain obligations, such as making a set number of contributions to the product over an agreed term set at the point of application. If these obligations are not met by the member, the withdrawal value is reduced in line with the policy terms and the superannuation trustee will only be able to recover the reduced withdrawal value from the life insurance company supporting the product. As the premium and term are set, the investment segment of the premium and the underlying fees and charges are also fixed for the policy term. The benefits, which include Terminal Bonuses paid at maturity of the policy, can be fairly substantial. The terminal bonuses are actuarial calculations based on profitability of the underlying investment pool. When a policy is terminated prior to its maturity date, under existing contractual arrangements these Terminal Bonuses may not be payable to the policy holder. Given many of these products have been closed for a couple of decades, the average age of members would also be fairly mature. Similar principles apply to innovative income stream products recently facilitated by the Government to manage longevity risk.

Member-elected exit fees

Some legacy products allowed members to make an election at the time of commencement to pay an exit fee imposed on withdrawal in return for having other upfront or ongoing transaction fees, such as contribution fees, being waived. We would contend that these fees should not be classified as exit fees for the purposes of proposed s99BA. If these fees are included, these members will receive an advantage over other members holding interests in the same product who did not elect to pay an exit fee and as a result have already paid upfront and/or ongoing transaction costs.

It should be noted also that where the trustee does not impose the exit fee on withdrawal from the product but allows the member to carry the exit fee to another product (i.e. deferring its payment), the successor product can charge the exit fee.

15. **Recommendation:** Explicitly clarify in the explanatory memorandum that traditional life insurance backed products (savings/investment plans), member-elected fees (including where rolled over), innovative income streams (per SIS Regulation 1.06A), term and lifetime annuities and term deposits do not fall under this definition.

SCHEDULE 2 – INSURANCE FOR SUPERANNUATION MEMBERS

The provision of death and disability insurance benefits to Australians on a default opt-out basis is a critical component of the superannuation system. Default insurance within superannuation is an important part of affording millions of Australians with cover and provides a safety net to those who would have otherwise not chosen, or been able to take out insurance individually. Group insurance, therefore, plays an important role in providing an economic and social benefit to Australia.

Removing a class of individual from the risk pool undermines the basis for underwriting insurance as a group arrangement. Group insurance provides better value to individuals across their lifetime, particularly for those who may not be able to access affordable insurance outside a group arrangement due to their level of health or occupational risk.

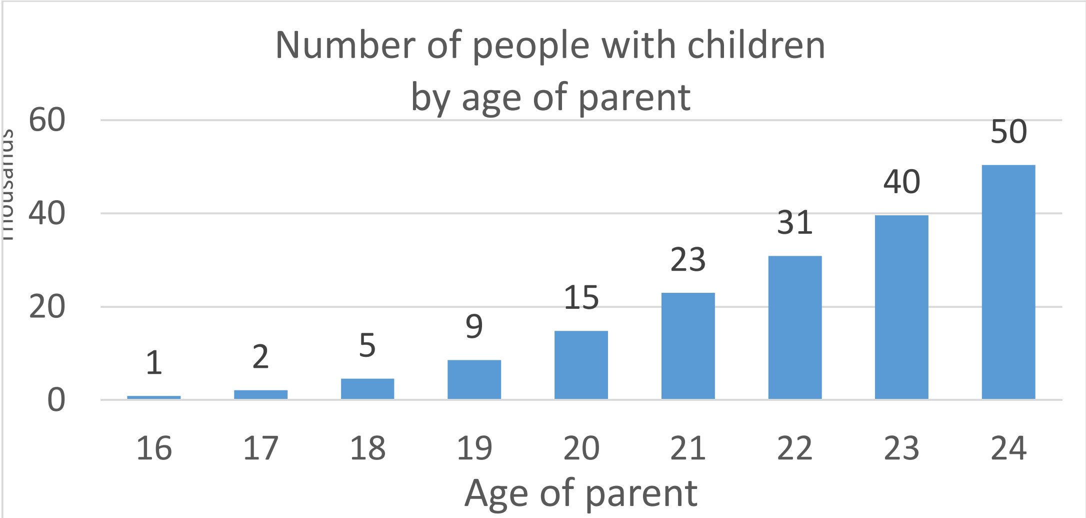
Changes to the current arrangements may result in premium increases for all individuals remaining in the pool. This is due to the change in risk profile for the expected pool of those taking up insurance, and increased anti-selective behaviours both on lapsing and opting in. These impacts are outlined in the 2017 KPMG report 'Review of default group insurance in superannuation[1]'.

Types of Cover

There is a case for restricting opt-in cover just to death benefits for people aged under 25.

The main argument for not automatically insuring young people is based on the assumption that many people under 25 do not have financial dependents, and therefore money from a death claim is likely to go to their parents rather than a dependent. However, a substantial number of people aged under 25 do have dependents (see data below) and therefore benefit from death cover.

FSC notes that data from the 2016 Census shows that about 88,000 Australian women under the age of 25 have had at least one child, equating to about 176,000 Australians under age 25 having at least one child.[2] By contrast, only about 32,000 Australians under 21 are parents. The numbers are shown in the graph below.



Source: ABS Census Table Builder for 2016 Census, Number of Children Ever Born by Age (of parent)

[1] https://home.kpmg.com/au/en/home/insights/2017/09/default-group-insurance-superannuation-review.html
[2] Making the broad assumption that the total number of people in total aged under 25 who are parents is about double the number of females aged under 25 who are parents.

Reducing the age that death cover changes from opt-in to opt-out from 25 to 21, would provide important death cover for up to 144,000 Australians with children. We estimate that these numbers will have increased by approximately 6.6% since 2016 due to population growth. [3]

However, while there is an argument that young people are less likely to receive value from death cover, the same arguments do not apply to TPD and IP insurance. These types of insurance can still provide a vital safety net to financially support young people in the event they become seriously ill or injured and cannot work.

Individuals without access to insurance will only have access to their existing superannuation savings as a safety net (in the event that they meet a condition of release), and will otherwise be dependent on public benefits.

Disability cover is particularly important for young people in higher risk occupations as they are unlikely to be able to take out cover individually at an affordable price through the effects of underwriting. Even if they would prefer a group arrangement, the same underwriting considerations are likely to apply due to the anti-selective nature of opting-in.

Restricting the opt-in arrangement to death only and providing default disability cover also preserves the fundamental principles that allow group insurance to be offered without individualised underwriting.

Of course, trustees would still be required to meet their best interests' duty in deciding which disability benefits to offer – taking into account, for example, the occupations and the hours worked by their younger members.

16. Recommendation: Opt-in cover should be restricted to death cover only. Trustees should be able to retain TPD and IP cover on an opt-out basis, subject to application of the best interests test.

However, if the Government is still concerned about the impact of balance erosion for young members for both TPD and IP being retained on an opt-out basis, we suggest that there remains a strong case for retaining TPD cover by default for all young people.

This is because TPD cover:

- is generally cheaper than IP;
- provides vital coverage over a longer period in the case of a catastrophic illness or injury; and
- does not create the same level of concern in relation to duplication of policies, as there is less likely to be a restriction on claiming against multiple TPD policies.

17. Recommendation: If the Government does not accept Recommendation 16, consideration should be given to retaining TPD cover on an opt-out basis for members under the age of 25.

[3] The resident population of Australia is estimated to be 24,950,570 on 30 May 2018 Source: http://www.abs.gov.au/ausstats/abs%40.nsf/0/1647509ef7e25faaca2568a900154b63?opendocument
The population as at the 2016 Census was 23,401,892 Source: http://www.censusdata.abs.gov.au/census_services/getproduct/census/2016/quickstat/036

The $6,000 limit and active/inactive accounts

By definition, new accounts start with a balance of zero. However, once regular SG payments commence they are clearly active. Many new accounts would also exceed $6,000 relatively quickly if the ATO deposits funds from another inactive account.

There is no policy rationale for providing default insurance cover to these individuals who are actively contributing to their accounts only once their balance reaches $6,000. Creating a lag in insurance cover for new, active fund members appears to be an unintended consequence of the proposals.

Providing active members with cover from the time they join would make it simpler for individuals to know when their cover will commence, and avoid future underwriting issues.

This would also avoid the complexity that is involved in using an account balance to determine the start date for insurance. For example, for some investment options, the final rate/price is not immediately available. There is also the possibility that the $6,000 threshold could be “gamed” with rollovers or contributions, increasing the risk of anti-selection.

Allowing insurance to remain on an opt-out basis for members with active accounts will provide a simpler and more streamlined approach that prevents individuals from being inadvertently left without cover.

18. **Recommendation:** The proposal to cancel, or not offer, insurance for accounts with less than $6,000 should only apply to inactive accounts.

Some accounts become inactive because members either cease employment, or go on extended sick leave due to deteriorating health. An individual with a long-term illness (or their beneficiaries) may not be eligible to make a claim on their TPD or death cover until well after their account becomes inactive. However, this cover could provide a vital safety net at the time when they are able to make a claim.

The proposal needs to strike a balance between the erosion of superannuation balances and the value provided by an active insurance policy. This balance could be better reached by cancelling IP insurance for all accounts classified as inactive, but only cancelling death and TPD insurance for inactive accounts where the balance is below $6,000.

This is because an individual could reasonably be expected to have made an IP claim, if eligible to do so, by the time an account becomes inactive. However the time between being unable to work and being eligible to make a TPD or death claim could be much longer than 13 months. IP premiums are also higher than for death cover and TPD, so cancelling this cover will materially reduce account erosion.

The FSC notes that this aligns with the Insurance in Superannuation Voluntary Code of Practice.

19. **Recommendation:** Trustees should not cancel death and TPD insurance for inactive accounts unless the balance is below $6,000.

Default insurance members

Following from the above recommendation, there needs to be a clear definition of a default member.

We propose the following:

> *Default Insurance Member means a superannuation fund member who is provided insurance automatically through a default arrangement. This does not include a member:*
>
> *a) Who has told their superannuation fund that they want to maintain their automatic insurance cover.*
> *b) Who has specifically applied for their cover (including for additional or reinstated cover).*
> *c) Who has chosen to vary the cover in some way, such as cancelling, fixing cover or changing the benefit or waiting period.*
> *d) Whose insurance premiums are wholly paid for by their employer (whether through contributions to their superannuation account or otherwise).*
> *e) Whose insurance premiums are not paid by deduction from their super account.*
> *f) Who is an insurance only member.*
> *g) Who is a defined benefit member.*

> **20. Recommendation:** A clear definition of a default insurance member should be provided in the regulations.

Practical considerations

The structure of the proposals leaves ambiguity about when changes to insurance should apply.

For example, there is a lack of clarity around timeframes for certain insurer actions, including:

- timeframes around cancellation of insurance once a member becomes inactive; and
- the process for offering or defaulting an individual into insurance once they turn 25.

The regulations should address these issues and provide clarification around processes for insurers and trustees when changing members' insurance arrangements.

> **21. Recommendation:** Timings, practical considerations and parameters to be clarified in the regulations.

> **Summary of Insurance Recommendations**
>
> **16.** Opt-in cover should be restricted to death cover only. Trustees should be able to retain TPD and IP cover on an opt-out basis, subject to application of the best interests test.
> **17.** If the Government does not accept Recommendation 16, consideration should be given to retaining TPD cover on an opt-out basis for members under the age of 25.
> **18.** The proposal to cancel or not offer insurance for accounts with less than $6,000 should only apply to inactive accounts.
> **19.** Trustees should not cancel death and TPD insurance for inactive accounts unless the balance is below $6,000.
> **20.** A clear definition of a default insurance member should be provided in the regulations.
> **21.** Timings, practical considerations and parameters to be clarified in the regulations.

SCHEDULE 3 – INACTIVE LOW BALANCE ACCOUNTS AND CONSOLIDATION INTO ACTIVE ACCOUNTS

We support low-balance and inactive accounts being united with a member's active account – this will address an important issue with the current super system, namely duplicate accounts through the current default process. We therefore also support the Productivity Commission's proposal for members' entering the workforce to be defaulted only once. However, there are several implementation issues we would like for Treasury and the ATO to consider.

ATO Current Lost Super Accounts

Prior to the commencement of automatic transfers to the ATO, the current stock of lost super accounts should be united with an active account as soon as possible. This may mean some 'low balance' accounts are increased over the $6,000 threshold and therefore do not need to be transferred to the ATO.

The ATO should also sign up to a Service Level Agreement (SLA) and commit to a time period for matching and transfer of accounts back out to the market. We suggest a maximum 20 days for the balance to be united with a member's active account. The ATO could undertake the rollover within 3 days once they have identified the active account.

With the implementation dates for the Member Account Attribute Service and Member Account Transaction Service fast approaching, the ATO will have a near real-time view of which fund holds a members' active superannuation account. It is therefore appropriate to expect that the ATO will manage the repatriation of member balances promptly.

In addition, if the ATO has information that the members' only other superannuation interest is a retirement income stream product where the member has met a condition of release, the ATO should proactively contact that individual to determine whether they wish to establish an accumulation account to receive the benefit or have the benefit paid out to the member as a cash benefit.

Direct transfers between funds using SuperStream

The ATO could alternatively rollover directly between funds using SuperStream mechanisms.

The ATO could provide destination fund details directly via SuperStream to the current fund and then the transfer of the member benefit would be bound by the much tighter timeframes required of superannuation funds, delivering the best possible outcome for the member. This approach would significantly reduce the period members' funds are out of the market thereby minimising loss of potential earnings. Using existing systems and processes would also significantly reduce the complexity and cost of implementing and administering this initiative while delivering improved member outcomes.

Mechanism to opt-out of rollover to the ATO

There needs to be a clear mechanism to opt-out of an account being rolled over to the ATO if the member wishes to keep the account. There does not seem to be any provision allowing a member to elect to keep an 'inactive' account below $6,000 in the fund (except by making a contribution). There may be some circumstances in which the member may wish to retain the account for good reasons and the trustee is prepared to continue the account even though the fee cap would currently apply.

For the purposes of subregulation (1), and subject to subregulation (3), a member of a fund may be excluded from being a ‘lost’ member if:

(a) the member is an inactive member who has indicated by a positive act (for example, deferring a benefit in the fund) that he or she wishes to continue to be a member of the fund; or

(b) the member has contacted the fund at any time after the time at which he or she joined the fund and indicated that he or she wishes to continue being a member of the fund.

As mentioned above, an opt-out for a low balance account should not have to be made “in writing”. Dictating written approvals is not appropriate for modern member engagement models, especially digital channels such as online, smartphone apps, phone calls etc.

It is not clear whether the payment of inactive and low-balance accounts to the Commissioner should include or exclude accounts which are in the process of being paid out via early release, family law splits of having an insurance claims being assessed – please clarify.

Accounts with insurance cover

We understand that the effect of proposed s20Qd(1)(d) of the SUMLM Act would be to exclude accounts from compulsory transfer where the member has elected to have insurance. We support this provision as it enables members to retain such accounts for the purpose of maintaining the associated insurance cover (noting they will need to elect to do so under the *Protecting Your Super* insurance changes).

However on our reading paragraph 4.33 of the Explanatory Memorandum does not express it this simply and hence we seek confirmation accounts that currently have insurance are excluded from compulsory transfer.

Eligible Rollover Funds (ERF)

Any proposed measure to assist in the re-uniting of inactive members back to their active accounts is acknowledged and supported in this submission. This change, if implemented successfully, should also benefit trustees in operating their temporary repository obligation and supports member outcomes by consolidating multiple accounts.

However, some of our members would like more clarity on the intent and impact on the ERF market.

Some of our members believe, given the expertise and track record of ERFs in managing and reuniting small inactive accounts for the benefit of members under the existing system, we recommend government actively considers the role ERFs can play alongside the ATO under the new proposals

Few ERFs are held by under 25s and only a small component of any such accounts will come from this with balances under $6,000. Changes will almost all come from cancelling cover on inactive accounts that hold above a $6,000 balance.

In operating the product the Trustees of an ERF must ensure that:

- the only purpose of the fund is to be a temporary repository for amounts transferred to the fund from other regulated superannuation funds in circumstances allowed by the RSE licensee law; and
- a single diversified investment strategy is adopted in relation to assets of the fund.

Existing processes are in place to locate members and request up to date member address details through ATO reporting processes. This is currently subject to significant investment from the Industry through the ATO Projects MAAS and MATS and will continue to benefit members

During the year ended 30 June 2017, 90,000 new member accounts were opened by way of regulated superannuation funds transferring amounts to the ERFs in circumstances allowed by the RSE licensee law. However, the trustees of the ERFs closed 474,000 member accounts with the ERFs making outward rollovers of more than $650m and Condition of Release Benefit Payments of greater than $30m[4]. This clearly demonstrates the active steps that the ERFs are taking to reunite members with their inactive and/or lost superannuation.

Over the past 5 years to June 2017 ERFs weighted average returns (after fees and taxes) of 4.55% pa (or 2.61% above CPI)[5] added value for members while their monies held in the product.

To further illustrate the value add to an average ERF members balance, the table below outlines the recent crediting rates applied in the SuperTrace ERF product[6] versus the returns that would have been applied under transfer to the ATO:

	SuperTrace	ATO (CPI %)	Excess %
2013	5.80%	2.500%	3.30%
2014	5.90%	2.500%	3.40%
2015	4.11%	1.500%	2.61%
2016	2.24%	1.300%	0.94%
2017	2.66%	1.900%	0.76%
$2,000	**SuperTrace**	**ATO**	**Excess $**
2013	$2,116	$2,050	$66
2014	$2,241	$2,063	$178
2015	$2,333	$2,044	$289
2016	$2,385	$2,041	$344
2017	$2,449	$2,054	$394
	5 Year compound impact		19.7%

On the same 5 year compound return basis, **97% of all ERF accounts[7] recorded crediting rates in excess of what is proposed on transfer to the ATO**. Therefore, the ability of the ATO to reunite all transferred members more efficiently becomes even more essential.

[4] APRA Annual Fund Level Super Statistics Report June 2017
[5] APRA Annual Fund Level Super Statistics Report June 2017
[6] SuperTrace RTM, p 12 https://www.supertrace.com.au/pdf/Supertrace%20Annual%20Report.pdf
[7] APRA Annual Fund Level Super Statistics Report June 2017

Given the important role ERFs have played and value added services (growing superannuation balances and relocating lost and inactive members) we request that the Government consider:

- How ERF providers are currently working with the ATO, including the provision of TFN data matching services;
- How the ATO plans to use existing data and/or confirm whether new data matching functionality is to be rolled out to unilaterally reunite most if not all ERF accounts immediately upon transfer to the ATO;
- Whether historic issues associated with data matching within such accounts will continue to present a barrier to the ATO – no TFN; single account holders; part time/causal workers; transitory foreign workers etc.;
- Whether an opt-out option is warranted for members in the scenarios noted (e.g. no TFN) above and who have made an informed decision to stay in an ERF (some members may be working overseas or in a different structure are happy for their account to remain in a simple fund with no default insurance is applied);
- If other measures planned or proposed (e.g. fee caps and exit fee removals) will benefit members of ERFs and support informed account consolidation and protection from fee erosion; and
- Whether there are any risks or potential for unintended consequences in allowing superannuation monies to be held at the ATO over extended timeframes (e.g. future funding liability).

Across the market we estimate that a significant percentage of ERF accounts will be required to be transferred to the ATO by 31 October 2019. Some FSC members estimate that around 90 per cent of ERF accounts will need to be transferred to the ATO in the first year of this reform.

With the prospect of very low numbers of new ERF accounts being established (due to regulated superannuation funds in the future transferring accounts to the ATO that would otherwise have been transferred to ERFs), it is likely that ERFs will quickly become another category of ‘legacy products’.

Recommendations:

22. ATO should merge current unclaimed super accounts with active accounts prior to the commencement of this process.
23. ATO should sign up to a Service Level Agreement (SLA), if appropriate, and commit to uniting funds with active accounts within 20 days.
24. Alternatively, initiate direct transfer into active accounts using SuperStream.
25. Clarify that a transfer into a fund from the ATO should not entitle the member to automatic insurance.
26. Clarify that accounts that have elected to obtain insurance are excluded from compulsory transfer.
27. Consider and clarify the intent of the impact on Eligible Rollover Funds (ERFs).

APPENDIX A

CALCULATIONS AND EXAMPLES

FEE CAP

Example of how calculating at the start of the period causes an issue

Under the proposal as drafted, a fund charging a combined investment plus administration fee of less than 3% pa and no dollar-based fees would not automatically meet the cap – and in fact would frequently have to rebate some of the (less than 3% pa) fees to meet the cap. For example, say a new employee joins an employer in mid-November and is defaulted into a fund with a combined investment plus administration fee of 0.5% pa and no dollar-based fees; the employer pays their super contributions monthly so the employee's new account receives employer contributions of $1000 in December and $2,000 each month over the following 6 months. Ignoring contributions tax and fees for simplicity, let's say:

- the account balance at the 31/12 test date is $1,000, so that the fee cap of 1.5% pa for the next 6 months would be 1.5% x $1,000 = $15.00
- the average account balance over the 6 months is $7,000, so that the actual administration plus investments fees of 0.5% pa would be 0.5% * $7,000 * 0.5 year = $17.50
- therefore the fee cap has not been met even though the fees charged are much less than 3% pa.
- If the member rolled in $100,000 from their previous fund at 31 March, the average account balance over the 6 months would increase to $57,000, so that the actual administration plus investments fees of 0.5% pa would be 0.5% * $57,000 * 0.5 year = $142.50 compared with the cap of $15.00.
- In this case, other members whose account balances were over $6,000 at the start of the six month period would have to subsidise the fees on this account by $127.50 (i.e. $142.50 minus the cap of $15.00), even though the average balance on this account over the period is $57,000.

Calculating the fee cap based on the average balance during the period, rather than the start balance, would provide much fairer outcomes

Fee Cap Calculation Issue

The formula below for fee capping of low balance accounts (s99G(2)) is too prescriptive, we are concerned about its prospective nature:

Fee cap percentage x Member's account balance with the fund on the balance test day that relates to the product

This could allow some members to avoid paying the appropriate fees by fixing the dollar fee at a point in time irrespective of changes to the member account balance for the next 6 months. For example, a member has a small balance of $5,400 at balance test day, resulting in a fee cap of 1.5% for the next six months (or $162). If the same member transfers $200,000 to the account the day after the balance test day, their fee would still be capped at $162. This will mean that the member may not be paying an equitable fee amount during that 6 month period compared with other members who may be subject to different fee treatment.