First State Super - Submission

Protecting Your Super package

Treasury Consultation package, announced in the 2018-19 Budget

29 May 2018

Issued by FSS Trustee Corporation ABN 11 118 202 672 AFSL 293340

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1 Introduction

First State Super is one of Australia's largest profit-for-members superannuation funds, responsible for accumulation and pension savings of over 785,000 members. As at April 2018, the First State Super group manages over $90 billion in funds, includes the savings of members and retirees ($19 billion are retirement assets supporting over 85,000 people in retirement).

We work to achieve a better financial future for our members, the people whose lives are dedicated to helping others - nurses, teachers, emergency services workers and public servants. We are committed to our member community and to the national interest as they are intrinsically linked.

We submit this response to the Government's comprehensive package of regulatory reforms designed to protect Australian's superannuation savings from undue erosion by fees and insurance premiums, "Protecting Your Super" (Consultation package), announced in the 2018-19 Budget.

In general, we support the principles of the Consultation package, particularly reducing the incidence of multiple accounts and steps towards minimising account erosion for members with lower balances. In this submission we highlight our concern about the potential for a gap between what we see as the intent of the draft legislation, and the potential for operational missteps.

2 Risks to proposed reforms

The challenges for this Consultation package are associated with operationalising the changes, to ensure better outcomes and service for members. We argue that changes should be designed and introduced in a considered manner; and that any untested measures should have in-built buffers or stages to allow for development of solutions that will deliver the desired outcomes.

There are significant gaps in the design considerations that we have reviewed and provided feedback in the following broad themes:

- implementation of the fees cap;
- poor outcomes arising from increased numbers of uninsured members; and
- potential for operational issues arising from high demand on ATO's capacity inside a very short development, testing and delivery window.

2.1 Fees cap

The introduction of a fees cap should result in improved protections for low balance accounts and we support the measure in principle. However, we are concerned with the suggested approach to calculating the fee cap.

Current state - administration fees

In the case of our fund, the fixed $52 p.a. fee is the primary cause of fees for low balances exceeding 3%, even though it is only a $1 per week charge. It is a low amount but causes accounts under approximately $1733.34 to exceed the 3% cap.

In contrast, the fees charged as a percentage of assets (account balance) deliver a small fee for low balance members – and conversely, increasing fees for members with higher balances. Some funds have implemented fee caps to reduce impact on higher balance members; we are currently reviewing fees.

We think it likely that the 3% cap on fees will encourage a shift to increased use of percentage based fees by super funds – for simplicity of implementation, and for re-shaping revenue profiles.

The following table demonstrates the approximate “break-even” point below which the proposed 3% cap on fees would cut in for a member in our largest (default) Growth option. (For the highest percentage asset based fee of 0.8% for the Property option, the threshold would be closer to $2,550.)

	Fee	**$2,500 invested in the default Growth Option**
Admin asset based	0.15%	$3.75
Investment fee*	0.66%	$16.50
Combined % fees	0.81%	**$20.25**
Impact of adding flat $52 admin fee	$ 52	**$ 72.25**
Combined fees ratio	% paid	**2.89%**

* Not “taken” from a member’s account, but incurred as a cost of investing and taken from the assets of the fund.

We note that most of the fixed $52 p.a. fee goes to paying the actual costs incurred of opening and operating a member’s account, through our outsourced administration provider. If we shift the balance more towards percentage based fees, we think this may result in a cross-subsidy across the membership.

Members currently see a line for “Direct fees (net of tax)” in their annual Account summary – these are the fees taken directly from a member’s account. (In a separate section, members can also see the breakdown of both direct fees and indirect costs of investment.)

Your account summary

Opening account balance on 1 July 2016[1]
Plus
Super guarantee (SG) and award contributions
Salary sacrifice and optional employer contributions
Personal contributions
Investment earnings
Less
Insurance premiums (net of tax)
Direct fees (net of tax)
Tax
Equals
Closing account balance on 30 June 2017[1]

Current state – investment fees

Under the new RG97 disclosure requirements, investment fees reflect a broad range of fees and costs associated with the purchase/sale and ongoing management of the investments of the fund and underlying investment vehicles. This includes fees paid to investment managers; amounts paid to a variety of third parties such as our custodian, brokers and government authorities; and the cost of running the Investment team. (The pre-mixed options include the 0.04% direct trustee charge.)

None of the investment costs are deducted directly from members’ accounts, but rather are paid from the assets of the investment option or underlying vehicles.

The investment fees we disclose (e.g. currently 0.66% fee for our default Growth fund) reflect the estimated investment-related fees and costs incurred for the previous financial year.

As noted previously, members currently see investment fees as “Indirect costs of your investment” under *Fees and costs* in their statement.

> **Indirect costs of your investment**
> This approximate amount has been deducted from your investment and includes amounts that have reduced the return on your investment but are not charged directly to you as a fee.

Issues with proposed requirements

We submit that the proposed design is likely to generate unintended operating costs which will be spread across the membership of the fund. This is evident in some of the practical considerations noted in the following issues.

Administration fees issues

The fixed date of a “balance test day” does not allow for fluctuating account balances during the period, apart from the reduction factor for new members, and will not reflect account balance changes in the following six months.

The most significant impact of the proposed fees cap will occur with the six-monthly assessment of account at balance test days; we expect this to require significant system design, a processing impost, and manual adjustments to accounts, which will reduce operating efficiency and potentially increase the risk of errors where manual intervention is required.

Our preference is for a continuous system based process and the ability to stop certain fees for a period, rather than having to make continuous adjustments. This would require a change to the MySuper provisions for equal charging of fees.

- For example, in our case, one possibility would be to introduce the $1 per week fee, only after an account had reached a level above the threshold at which the account fees fell below the maximum of 3%;
- We suggest setting an upper margin, over the precise threshold, to allow for fluctuations in balance arising from market movements; and to avoid constant fee adjustments where account balances could slip below the threshold.

While small in effect, we expect there will be some gaming at the margin as lower balance members attempt to shift balances from period to period to limit fees payable (the effect will be limited by size of account, requirement to shift to another fund, and the effort involved in switching accounts).

We consider that the proposed fees cap will create a very complex and costly administrative problem for funds with fixed fees and may require extensive manual workarounds in the short term as a minimum.

We are also mindful of the need to make changes easy for members to understand, especially at a time when the industry is trying to reduce product complexity and fee design. We would prefer to implement a design which was simple to help members understand their fees, and we are concerned that the current proposals will be both difficult to implement and difficult to explain.

Investment fees issues

The only component of investment fees that is “charged” by the trustee is the 0.04% charge on pre-mixed options.

All other items reflect costs incurred, so that the 0.66% shown as an Investment fee in the PDS predominantly reflects the cost of investing on behalf of members. We do not deduct any component of the investment fees directly from members’ accounts. Rather, all amounts are paid/deducted from the assets of the relevant investment option or underlying investment. (We are aware that retail funds and platforms operate differently.)

Investment fees are calculated at the beginning of each financial year for the previous financial year and may vary from year to year as a result of asset allocation changes, variability in performance fees, manager changes, and any significant transactions.

The application of the proposed fee cap would therefore require us to estimate investment fees for future periods.

In addition, investment fees differ by investment option (e.g. for FY17 they were estimated to range from as little as 0.05% for the Cash option to 1.34% for the Property option). The application of the cap is therefore problematic as it assumes members do not switch options through the six month period following the balance test day.

Finally, while we have chosen to disclose all investment related fees and costs as “investment fees”, some other funds disclose an indirect cost ratio (ICR). The distinction between “investment fees” and ICRs can be somewhat arbitrary, and we argue that it does not make complete sense to only include investment fees.

Suggested fees approach

Considering the complexities of the current design, we propose a staged introduction of the changes to fees be considered. We also suggest the following approaches be considered and implemented:

1. Provide guidelines for trustees to determine and develop a framework on how they will meet the 3% fee cap.
2. Limit the cap to administration fees but reduce the threshold (e.g. from 3% to 2%) as appropriate.
3. Permit funds to set account thresholds, under which they would not charge a fixed fee amount for low balance accounts. This would require an amendment under *s99E SIS Act (1993) Act* to allow different fees for specified threshold amounts.
4. Move away from the notion of “balance test day” to a systematic daily approach – easier for members to understand and potentially simpler to implement.

We suggest allowing the superannuation industry sufficient time, 18 months rather than 12 months, to develop an operational solution that is both effective and easily understandable for the members.

2.2 Insurance Coverage

While acknowledging the government’s focus on reducing multiple accounts and unnecessary insurance, the purpose of insurance in superannuation should be considered; which is to provide for a safety net either upon illness, disability or death for the individual and his or her family, where the person does not have sufficient savings for the necessary financial support in times of adversity.

We maintain that group insurance, when appropriately designed for the membership, should always be offered in superannuation as it is a cost-effective wholesale offering. The pooling of lives under a group insurance policy allows insurers to more effectively price risk, which means members typically pay less for cover under a group policy that they would in the retail insurance market. As our members include nurses, teachers and emergency services workers these benefits are not always attainable on the same terms outside of the fund. The removal of insurance will open up risks for members and their families, which in turn may increase risks to the Government in the form of funding additional social security payments or costs.

We note that not all injuries or illnesses can be covered by WorkCover or motor vehicle accident cover. Further, young people who do suffer an injury or illness that affects their ability to earn an income are likely to face a lifetime requiring financial support, which may not be adequately met by social security payments. Time lost from the workforce or permanent under-employment will reduce retirement savings.

Caution needs to be taken with the perception that members do not require insurance cover, and we believe that the risks of unintended underinsurance should be addressed in the proposed changes.

Gaps in insurance cover

In the Consultation package's proposed design, insurance cover will cease following 13 months inactivity. This is particularly detrimental for new members (and job changers), who are transitioning between funds, given the long time it can take to build $6,000 balances:

- People who earn less than $70,000 will take longer than 13 months to reach account balances of greater than $6,000 and qualify for opt-out insurance[1] (if available);
- On an income of $50,000, a member would require 18 months of SG contributions to accrue an account balance of $6,000;
- For low-middle income job changers, there are likely to be repeated periods where they are completely uninsured (see example), including those:
  - whose accounts have exceeded $6,000 so their accounts are not consolidated by the ATO, and
  - who neglect to opt-in to insurance cover, and /or
  - do not consolidate accounts;
- The proposed definition of inactivity at 13 months, for any balance, means that job-changers who do not contribute, consolidate or opt-in may find themselves without cover; and
- The proposed design does not accommodate the rapidly changing employment landscape, where multiple casual jobs, job changes and flexible working conditions (people returning from family leave etc) are more prevalent.

> Sam earns $50,000 and takes 18 months to exceed $6,000 in super with Fund A and is un-insured during this time.
>
> At 24 months, he takes a new job, but does not direct his SG contributions into Fund A, or opt in to keep his insurance.
>
> On the same salary, his new super with Fund B also takes 18 months to reach $6,000; however, his insurance in Fund A is stopped at 13 months of inactivity.
>
> As Sam's account balance in Fund A is greater than $6,000 his account is not auto consolidated to Fund B by the Commissioner.
>
> Fund B is unable to insure him until another 5 months pass – and he is unaware that he is not covered for death or disability until he tries unsuccessfully to make a claim.

As the commencement of employment has typically been used as a risk control for the issuing of cover on auto acceptance terms, the later issuing of cover based upon an account balance reaching $6,000 (which could be 2-3 years after commencing employment for some members) is likely to result in additional unfavourable risk controls or limitations on cover for members by insurers.

Our preference is for the removal of the requirement for cover to commence once a balance reaches $6,000, on the grounds that:

- it creates an inefficiency in the system (opt-in anti-selection, potential underwriting);

[1] Calculated internally, on 9.5% SG (after contributions tax), not considering fees or investment earnings

- runs the risk that members may never end up insured at all if insurers are unwilling to offer cover on an auto acceptance basis.

We note that the duplicate insurance issues ultimately get addressed by the cessation of cover after 13 months of inactivity (or a slightly longer period of 15-16 months).

Members working in high risk industries

The proposed design also does not provide additional consideration for members who have started their career in professions which are prone to be exposed with high-risk to injuries or illnesses situations:

- Our membership includes emergency services workers and nurses, most of whom are in permanent employment earlier than age 25;
- These professions are frequently subjected to high risk situations;
- It is possible for new members who have just begun their careers in these field to be exposed to high risk situations;
- Their insurance cover forms a valuable part of their superannuation benefit, often with employers subsidising components of the premium.

The essence of group insurance design relies on pooled premiums to support those who suffer misfortune and have a need to make a claim.

The proposed design for opt-in insurance will inadvertently introduce multiple segments of risk pooling, depending on how people entered the opt in model, or it may mean members are unable to attain cover on auto acceptance terms. This may distort the current risk pooling design, and may have an adverse impact on premium costs or access to insurance cover for members of all ages.

Auto cessation of voluntary cover

The Consultation package outlines requirements for automatic cessation of cover by trustees for members after 13 months of inactivity or where an account balance falls below $6,000.

These proposed reforms appear to apply equally to default insurance cover provided by trustees on an opt-out basis, as well as to voluntary cover applied for by the member as part of actively engaging with their superannuation to ensure the insurance benefits reflect their particular needs.

Where members have actively tailored their cover through taking ***additional voluntary*** cover, reduced their cover or fixed their cover at a particular level, we believe the obligation for trustees to cease that cover in the same manner as default opt-out cover is counter intuitive for most members. It will be unnecessarily onerous and will lead to potential risks for trustees in ceasing the cover where members are unable to respond with an opt-in within the timeframes required.

Our suggested solution to this issue would be to utilise the definition of an 'automatic insurance member' that has been agreed across most parts of the industry in the recently released Insurance in Super Voluntary Code of Practice.

Operational challenges

There are also short term operational issues in implementing the proposed changes in a cost-effective manner within the timeframes proposed, because the reforms are expected to necessitate re-pricing of all group insurance arrangements within super.

In a normal repricing or tendering context, this would ordinarily take three to six months (exclusive of implementation) and place significant demand on limited actuarial resources. We understand the impact of all group insurance policies being repriced across the industry at the one time is unable to be absorbed by insurers and could result in a poor outcome or experience for members, a risk that pricing offered to Trustees may not be in the best interests of members and an opportunity cost for Trustees as other in-flight product design and pricing initiatives are put at risk due to resource conflicts.

Suggested insurance approach

1. Activation of Default Cover

In the interests of many of our members, who are likely to commence in a career where they are exposed to medium to high risk, and are in permanent full-time employment before the age of 25 years, we suggest a lower age for automatic insurance cover (i.e. 21 years of age) recognising that at this age members are typically making informed decisions in other aspects of their financial affairs.

We suggest a definition of "inactive accounts" which better reflects members' experience in accumulating savings (i.e. 15 or 18 months to reach $6,000 balances). This minimises the risk of unintended gap or loss in insurance coverage. (We recognise this is a longer period than the 13 month inactivity period recommended by the Insurance in Super Voluntary Code of Practice.)

For higher risk and harder to insure employment groups, we suggest that group insurance cover is always retained, and for other members where it is paid by the employer.

Our preference is for the requirement for cover to commence after reaching a $6,000 balance not to be imposed for the reasons we have outlined.

2. Cessation of Cover

Reforms for the ceasing of cover should be limited to default insurance which has been provided by a trustee on an opt-out basis and not voluntary cover that has been applied for by the member. We suggest the term 'automatic insurance member' as defined in the Insurance in Super Voluntary Code of Practice as an alternative.

3. Transition Provisions

Any changes to the current system should include adequate transition periods such that trustees are able to manage the change in a considered manner to avoid unnecessary negative member impact and sufficient flexibility if acceptance of terms offered by an insurer are not in the best interests of members. We would suggest a period of at least 24 months is reasonable.

2.3 Transfer of accounts to ATO

In an environment where the ATO's powers to consolidate accounts are strengthened and a narrower definition of inactive accounts have been introduced, there also needs to be greater acknowledgement of ATO's responsibilities to the industry and members.

In this instance, ATO's responsibilities would include ensuring that accounts are promptly transferred directly to a member's active account, rather than the ATO holding an account which attracts no investment return but minimal interest (calculated using CPI).

The Consultation package also does not appear to have considered allowing the ATO to test their capability and capacity to undertake the introduced changes in such a tight timeframe, and at a time when the ATO is also delivering considerable change with MATS and STP. Considering the breadth of activities undertaken by ATO, it is critical to ensure that the activity of transferring accounts is still undertaken in a timely manner to truly achieve the intent of the Consultation package.

Suggested implementation approach

We propose that the Consultation package should consider:

1. A pilot for transfer of inactive accounts: this allows ATO to ensure they have sufficient capability and capacity to undertake the role, as well as iron out any system payment issues not identified in the platform development stage. A staged approach for the first run of transferring inactive accounts to the ATO would mitigate the risk of Day One issues the first time all funds submit returns.
2. Implementing a service level agreement for the ATO to fulfil their responsibilities in transferring the accounts as stipulated would ensure that the intent of the Consultation package is monitored and transparent to the members and superannuation industry.

We believe that a considered and orderly approach will minimise system failure and reduce unintentional costs to members.

3 Conclusion

First State Super supports the Consultation package's commitment to facilitate a stronger protection mechanism for members by bolstering low balance accounts, and leading to a better retirement outcome.

However, experience shows that all changes will need to be undertaken with sufficient time and with a focus on simplification and efficiency. Further changes with unintentional adverse outcomes without sufficient consideration will only disengage the members further from the superannuation system.

This submission has suggested alternative solutions which we believe would achieve the intent of the Consultation package in a measured manner where all aspects of the superannuation system are considered.

We are happy to discuss this paper with Treasury and to provide further information to help design better solutions for all members.