Mercer Consulting (Australia) Pty Ltd
ABN 55 153 168 140
Collins Square
727 Collins Street Melbourne VIC 3008
GPO Box 9946 Melbourne VIC 3001
+61 3 9623 5464
Fax +61 3 8640 0800
david.knox@mercer.com
www.mercer.com.au

Manager, Regulatory Framework Unit
Retirement Income Policy Division
The Treasury
Langton Crescent
Parkes ACT 2600

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Subject: **Exposure Draft Legislation – Protecting Your Super Package**

Thank you for the opportunity to comment on the exposure draft legislation relating to the Protecting Your Super package announced in the 2018-19 Federal Budget.

Mercer understands and supports the motives behind the proposed changes and agrees that they would have some valuable benefits, particularly in reducing the number of unwanted multiple accounts and unwanted insurance.

However there are also some negative consequences. These include additional administrative complexity and costs (which will generally be borne by members), likely increases in insurance costs for members who retain insurance and more members who will not be able to obtain cover.

In fact the majority of members are more likely to notice the negative consequences rather than the positives:

- Annual administration fees charged to the majority are likely to increase as a result of the removal of exit fees and the 3% cap
- The insurance premiums charged to members with insurance (which will still be the majority) are likely to increase as a result of greater expected anti-selection (e.g. opt-in is more likely for members in poorer health), more underwriting costs and the spreading of fixed costs over a smaller premium base.

We have set out our detailed comments in the attachment. These include our recommendations to modify the proposed 3% fee cap to reduce the implementation costs and inappropriate outcomes.

In terms of the feasibility of a start date of 1 July 2019 for the changes, in our view this should be achievable for the exit fee ban and for the transfer of small inactive accounts to the ATO for pro-active consolidation - provided that the legislation and associated regulations are finalised by 30 June 2018.

However implementation of the proposed 3% fee cap and the insurance changes will be major projects which are not feasible to complete across the industry within a 12 month period.

- We recommend that that the fee cap changes be deferred 12 months i.e. a start date of 1 July 2020 rather than 1 July 2019; and

- The commencement of the insurance changes needs to be at least two years from the date the legislation and associated regulations are finalised. We recommend that the timeframe be amended to allow funds to implement the changes in an orderly manner having regard to when their insurance contract is next renewed (by 30 June 2021 at the latest), in line with the Insurance in Superannuation Code. The will allow sufficient time for funds across the industry to renegotiate their insurance contracts, with competitive testing of the terms and rates offered, as well as for the major changes required to fund administration systems and processes to be completed. If there is not enough time to allow for competitive pressure to be created, then funds are likely to be forced to accept higher premium rates and/or poorer terms and conditions than they would otherwise obtain.

Who is Mercer?

Mercer is one of the world's leading firms for superannuation, investments, health and human resources consulting and products. Across the Pacific, leading organisations look to Mercer for global insights, thought leadership and product innovation to help transform and grow their businesses. Supported by our global team of 22,000, we help our clients challenge conventional thinking to create solutions that drive business results and make a difference in the lives of millions of people every day.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $150 billion in funds under administration locally and provide services to over 2.4 million superannuation members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 239,000 members and more than $22 billion in assets under management.

Please contact me on 03 9623 5464 or by email if you would like to discuss this submission.

Yours sincerely

Dr David Knox
Senior Partner

ATTACHMENT – DETAILED COMMENTS

1. 3% cap on administration & investment fees on accounts with balances of $6,000 or less

Proposal

Whilst the measure is described as a 3% cap on the annual administration and investment fees charged to members with account balances of $6,000 or less, the draft legislation provides for a *half-yearly cap* of 1.5% of the balance at test dates of 31/12 and 30/6. If the balance is $6,000 or less at a test date, the fees for the next 6 months will be limited to 1.5% of the opening balance. An exception applies at the first test date for a new account – in this case the cap for that partial month period is calculated on a retrospective basis as a pro-rata proportion of 1.5% of the end balance.

Implications

The proposed approach will require very substantial system changes and will be difficult and costly to implement for many funds, as well as to communicate to members, and will produce anomalous and inequitable treatment in many cases. Issues include:

- The capping period will not correspond with the review period for funds that produce annual rather than six monthly statements, or for funds that have statement periods that do not end at 31/12 or 30/6
- The prospective application of the cap (based on the balance at the prior 31/12 or 30/6) will produce anomalous and inequitable treatment in many cases:
    - For example, the test date balance could be $5, $50 or $500 - meaning a cap of $15 or less would apply - but a large contribution or rollover (e.g. $50,000 or $500,000) could be made soon after, so that the average balance during the subsequent six month period is much higher than $6,000. So this approach would mean that a cap of $15 or less would apply to an account for a 6 month period in which the average balance was $50,000 or $500,000.
    - 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 for all accounts – and in fact would frequently have to rebate some of the 0.5% pa fee to meet the cap i.e. whenever the balance at the test date was less than $6,000 and the average balance in the subsequent 6 month period exceeded 6 times the test date balance. Surely this is not an intended outcome.
    - It would be inequitable and at odds with the policy intent for other members (including those with lower average balances than the capped account) to have to subsidise such an account. Note these cases will frequently occur as 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, which in many cases would be in the six months following the first test date.

- The draft legislation appears to require the trustee to apply the cap precisely, whereas it may be more practical and administratively efficient to use an approximate approach which results in the fees of something less than the maximum e.g. charging a combined investment plus administration fee of less than 3% pa and no dollar-based fees
- The cap applies retrospectively for a new account (the first time only) and then prospectively. This makes explaining how the cap works in member communications more difficult.
- It is currently common practice for the joining date of a new default member to be backdated to the date they joined their employer, with insurance commencing from that date, even though the first contribution may not have been received until later. Where a test date falls between the date they joined their employer and the date the first contribution was received, the member's balance at the test date will be zero. Under the prospective application of the cap as proposed, a zero cap would appear to apply to the fees for the next 6 months.
- Given the complexity and the expectation that different funds will take different approaches to how they implement the cap, we do not think the changes can be implemented across the whole industry within 12 months.

Recommendations

To address or mitigate the above issues we propose that:

- The changes be deferred 12 months i.e. a start date of 1 July 2020 rather than 1 July 2019
- Funds be permitted to apply the cap based on their statement period i.e. (i) annually for a yearly statement or six monthly for a fund providing six monthly statements and (ii) the statement period would not have to end at 31/12 or 30/6.
- The explanatory material confirms that a rebate process to apply the cap is acceptable i.e. standard fees can be charged during the 6 or 12 month period (or until exit) and a fee rebate made at the end of the period (including on exit) where necessary to comply with the cap. The fee rebate would not have to make any adjustment for the impact of investment earnings during the period as this would generally be small and the substantial additional complexity of determining such an adjustment would not be justified. *Note it is critical for administrative efficiency that this approach is permitted.*
- The cap be applied retrospectively 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. The cap would not apply if the average balance exceeds $6,000.

- The fee cap provisions clearly ensure that a trustee would not be in breach of the MySuper or capping rules if it capped fees for protected balances at something less than the cap e.g. for simplicity a trustee would be permitted to decide to only apply asset-based administration and investment fees totalling less than 3% pa and no dollar-based fees to protected accounts.
- If our recommendation to apply the fee cap retrospectively (based on the average balance during the period) is not accepted, a new account with a zero balance at the first test date should (for the purpose of the cap) be treated as starting at the date the first contribution is received, even if membership is backdated for other purposes.

We would also suggest that:

- The minimum balance in SIS reg 6.35 be increased from 'less than $5,000' to $6,000 to align with the 3% fee cap balance limit. (Currently SIS reg 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 the 3% cap cut-off balance with the cut-off balance for compulsory transfer of inactive accounts to the ATO and insurance opt-in. The 3% cap is to apply to balances up to $6,000 whereas transfer of inactive accounts to the ATO and insurance opt-in applies to accounts with balances less than $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?'.
- The requirement to include a $6,000 account balance in PDSs be reconsidered, on the basis that it adds considerable complexity and is likely to be mis-read as being indicative of fee levels for accounts in the region of $6,000 (i.e. above as well as below) rather than only being relevant to accounts close to but not exceeding $6,000.

Matters requiring clarification

Please confirm or clarify the following matters:

- That the cap also applies on exit but no pro-rata calculation is required. Again, if trustees wish to apply a lower cap, this should be permitted
- That the fees subject to the cap do not include buy-sell fees
- That the fees subject to the cap do not include indirect costs
- Whether the cap is to apply to fees gross or net of allowance for any related tax deductions
- That where an employer pays some or all of the fees, the cap would apply to the fees not met or reimbursed by the employer
- That the cap would not apply to any fees charged to an insurance only member.

- That trustees would not be prevented from restricting the investment options available to members with capped fees. It is noted that the costs of managing some investments (e.g. direct property) are much higher than the costs of managing other investments (e.g. Term Deposits or Cash). Greater subsidies will be required (from higher balance members) to meet the fee cap for members who have chosen to invest in higher fee investment options.
- 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’.

Other implications/issues

Most funds will need to increase fees for uncapped member accounts in order to make up the shortfall in cost recoveries from capped accounts. Overall costs will also increase due to the additional administrative and communication costs associated with the special rules for capped accounts. Therefore any short-term fee reduction for a member with a low balance may well be outweighed by higher fees levied when their account exceeds $6,000.

It is also worth noting that the 3% cap may provide some disincentive to members consolidating small accounts.

2. Banning superannuation funds from charging exit fees

Proposal

From 1 July 2019 funds will be banned from charging exit fees for any account. The ban is to apply to partial withdrawals as well as full withdrawals. Buy-sell spreads are permitted.

Implications

The change will reduce the cost of members consolidating accounts or transferring funds, although it is not clear to what extent exit fees have inhibited such member actions.

Most funds will need to increase other administration fees in order to make up the shortfall in cost recoveries from the removal of exit fees. The changes are not consistent with the activity-based fees philosophy that the costs arising from member initiated actions should be recovered from those members. Essentially this therefore will result in cross-subsidisation of members generating higher costs (through transactional choices they make) by other members.

Recommendation

Funds that wish to do so should be permitted to charge exit fees for members who make more than one withdrawal (either a rollover or a member payment) in a 12 month period.

Matters requiring clarification

Please confirm that the exit fee ban does not extend to fees such as term deposit break fees or pooled mortality product early exit fees.

3. Transfer of inactive accounts with balances below $6,000 to the ATO

Proposal

Superannuation funds will be required to transfer all ‘inactive’ accounts where the balances are below $6,000 to the ATO. Inactive accounts are those for which a contribution has not been received within the last 13 months (as at a 30/6 or 31/12). The first reporting date for these accounts will be 30 June 2019. The ATO will then seek to consolidate these amounts with a member’s active account (contribution in prior financial year) where possible.

Implications

This measure should significantly reduce the number of unwanted multiple accounts. The introduction of pro-active consolidation by the ATO is very welcome.

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 adding insurance to it or 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 (e.g. where the member intends to use it as an ongoing account but there has been a delay in transferring money in from other accounts).

Recommendation

We recommend that an account be excluded from compulsory transfer to the ATO where the member has elected to retain the account in the current fund and the trustee agrees to accept the member’s election.

Matters requiring clarification

We understand that the effect of proposed s20Qd(1)(d) of the SUMLM Act would be to exclude accounts that currently have insurance from compulsory transfer. 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 that accounts that currently have insurance will be excluded from compulsory transfer.

4. Restrictions on default insurance cover

Proposal

From 1 July 2019 superannuation funds will only be permitted to offer insurance on an opt-in basis for accounts:

- that have balances below $6,000; or
- for new members who are under 25 years old; or
- that have not received a contribution for 13 months or longer.

Implications

For most funds the proposed changes will have a major impact on both the terms and conditions of their group insurance policy and their insurance administration and underwriting processes.

The package would be expected to result in significant changes to the insured member base of most funds, as well as to how and when default cover is provided. Trustees will need to work with their insurers to re-negotiate the terms and conditions of their fund's group insurance policy. Increases in premium rates and changes to automatic acceptance terms are highly likely as a result of greater expected anti-selection (e.g. opt-in is more likely for members in poorer health), more underwriting costs and the spreading of fixed costs over a smaller premium base.

Other implementation challenges include the design and implementation of new insurance administration and underwriting processes, updating of disclosure material such as PDSs and communication of the changes to members – with much of this reliant on the revised terms and conditions of the fund's group insurance policy.

A start date of 1 July 2019 would require the group insurance terms and conditions to be reviewed for every large super fund by early 2019 at the latest. A one-size-fits-all approach is not possible as individual fund characteristics such as the proportion of new members under age 25 and the number of inactive accounts will vary significantly from fund to fund, as will their current terms and conditions. Doubts have already been raised about the capacity of the group insurers to conduct a thorough reassessment of risk for every fund within the necessary timeframe, as well as whether there is sufficient data available to allow accurate assessment of the impact of the changes on claim rates.

The changes in fact impact on most areas of fund operations and will require major changes to administration systems and procedures. To provide some indication of the size and breadth of the task, let us consider the Mercer Super Trust, which is a corporate master trust with around 230 employer sub-plans, many of which have a number of benefit classes with different insurance designs, resulting in more than 800 different insurance arrangements overall. For all these arrangements, the trustee will have to:

- work out what opt-in cover to offer to those
  - under age 25,
  - with an account balance of less than $6,000, or
  - with accounts where there has been no contribution for 13 months
- work out on what basis to offer opt-out insurance
  - when members who have or haven't opted in beforehand turn 25, or
  - their account balance hits $6,000, or
  - an inactive account above $6,000 receives a contribution
- consult with employers and policy committees
- renegotiate contracts with multiple insurers (noting that each of these insurers will also have to do this with multiple other trustees over the same tight timeframe, adding significant extra pressure to the process)
- rewrite insurance policies and governing rules
- roll PDSs
- communicate to existing members (some of them well in advance of the others as required by the legislation)
- re-design and re-configure administration systems and processes.

This is at least a two-year project, with the two years starting from when the legislation is passed and the associated regulations are made.

A start date of 1 July 2019 is not feasible. It would be much better to link in with the sensible timeframes in the Insurance in Superannuation Voluntary Code of Practice, which recognises that most funds have three year contracts with their insurer, with premium rates locked in for three years, and that forcing funds to renegotiate these early may disadvantage members.

If the timeframe is not pushed out sufficiently, the likely outcome is that members will bear substantial extra costs due to:

- premium rates being increased more than they otherwise would because trustees will not have time to conduct tenders and insurers will not have time to confidently assess the risk and hence will build in higher contingency margins

- extra implementation costs because of overtime and extra staff needed to work to the required deadline.

In simple terms, the more rushed the implementation timetable, potentially the worse the outcome for the majority of fund members who have insurance.

Shorter timeframes also increase the risks of miscommunication to members and other unintended consequences or errors.

Recommendation

We recommend the timeframe be amended to allow funds to implement the changes in an orderly manner having regard to when their insurance contract is next renewed (by 30 June 2021 at the latest), in line with the Insurance in Superannuation Voluntary Code of Practice. Otherwise, the changes should be deferred by at least 12 months, so that there is an implementation period of at least two years from when the legislation is passed and the associated regulations are made.

Matters requiring clarification

(a) Paragraph 3.12 of the Explanatory Memorandum states:

3.12 The timing and frequency of assessing whether an account meets one of the criteria listed above is at the trustee's discretion. However, the requirements imposed on trustees to not offer opt out insurance to these members, as well as the notification requirements for inactive members, necessitate that trustees make these assessments at a reasonable frequency.

We seek confirmation that this means that, provided the trustee makes these assessments at a reasonable frequency, it will not be a breach and a trustee will be protected against any loss to a member that occurs because:

- opt-out cover premiums were charged on an account for longer than precisely 13 months after the last contribution was received
- opt-out cover was cancelled earlier than precisely 13 months after the last contribution was received
- opt-out cover was not provided immediately the member reached age 25 or a balance of $6,000 after age 25.

We request that the Explanatory Memorandum includes wording to make the above clear and to provide more guidance on what would be a reasonable frequency. In our view the assessments should not be required to be carried out more frequently than monthly, but would it be acceptable, in order to reduce costs, for the assessments to be carried out each 2 months, or quarterly, or half yearly?

(b) Paragraph 3.12 of the Explanatory Memorandum states:

3.22 A written direction by a member to maintain insurance will be valid indefinitely unless another criterion is met.

We do not see how the draft amendments prevent an election from continuing to be valid even if another criterion is met. It is important that the law is absolutely clear so that trustees do not inadvertently cancel cover in circumstances where this is not required by the law.

We also submit that the provisions should not make it cumbersome for members going on unpaid maternity leave or other unpaid leave to elect, at or around the time of beginning their unpaid leave, to maintain cover and <u>have this election remain valid throughout the period of unpaid leave</u> – in particular the law should not make this election lapse after 13 months of no contributions to the account.

(c) How does the legislation prevent cancellation of cover for a member who is in the claim process? We are astonished at the implication in paragraph 3.36 that a member contacting the fund to make a claim on their insurance should not be considered to have consented to having that insurance.

(d) There are some funds in which the employer pays additional contributions to meet some or all of the insurance costs. The legislation should exclude employer-paid cover from cancellation and should allow this to be opt-out for under 25's and those with account balances under $6,000. The treatment of cover that is partly paid for by the member and partly by the employer is less straightforward but will also need addressing.

(e) The draft material does not appear to cover what happens for new members joining in the June 2019 quarter who have a balance less than $6,000 at 1 July 2019. Does this mean they have to be provided with opt-in cover (generally from the date they joined the employer) which then has to be cancelled if their balance is less than $6,000 on 1 July 2019? The transitional arrangements also need to cover these members, allowing adequate time to notify the members and give them a chance to elect to continue the cover before it is cancelled e.g. identify such members as at 30 June 2019 and write to them by 31 July 2019 advising that cover will be cancelled on 1 October 2019 unless they elect to continue.