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legalsuper submission – Super System Review – Phase Two: Operation and Efficiency

legalsuper is pleased to provide this submission to Phase Two – Operation and Efficiency, of the review into the governance, efficiency, structure and operation of Australia's superannuation system ('the Review'). We commend the Review on its stated intention of examining and critiquing Australia's superannuation industry from the ground up.

legalsuper is one of Australia's 50 largest industry super funds and the largest super fund for the nation's legal sector. Established in 1989 by the legal profession, it manages more than $1.3 billion for 36,000 members including judges, barristers, solicitors and legal support staff. The shareholders of legalsuper's trustee are the Law Institute of Victoria and the Law Society of New South Wales, and members of our board include experienced legal practitioners.

legalsuper has been nominated as a fund of choice in the newly created Legal Services Award 2010 that takes effect from 1 January 2010.

This submission is in two parts: a main contention, followed by three secondary points. We would welcome the opportunity to provide further details or meet with you or a representative of the Review.

Main contention: That minimum performance benchmarks be mandated for super funds

There has been much discussion in the media and the financial services industry more broadly about scale being needed to deliver reductions in fees. We submit that the focus of this debate should move away from scale and fees in isolation. The determination of whether a super fund is performing well and delivering the expectations of its members needs to be holistic. The debate should be about ensuring super funds deliver better net outcomes for members in key areas of performance including: a.) trustee governance, b.) costs and c.) investment returns.

If a fund is performing well in these key areas and meeting its members' expectations, we submit that the size of the fund – the total value of the funds under management – does not really matter.

Moreover, from our analysis of annual reports and product disclosure statements of other super funds, larger funds do not always deliver lower fees. Very large super funds (one million plus members) will also struggle to offer the personal service provided by small and medium sized funds. Through more personal service, small and medium sized funds can achieve better engagement with members and employers. This in itself delivers real value to members, including:

- As a medium sized fund, legalsuper has more field staff member per member (from examining publicly available information). This means that legalsuper can provide service that is more personal and responsive to our particular target market (including higher levels of face-to-face contact);

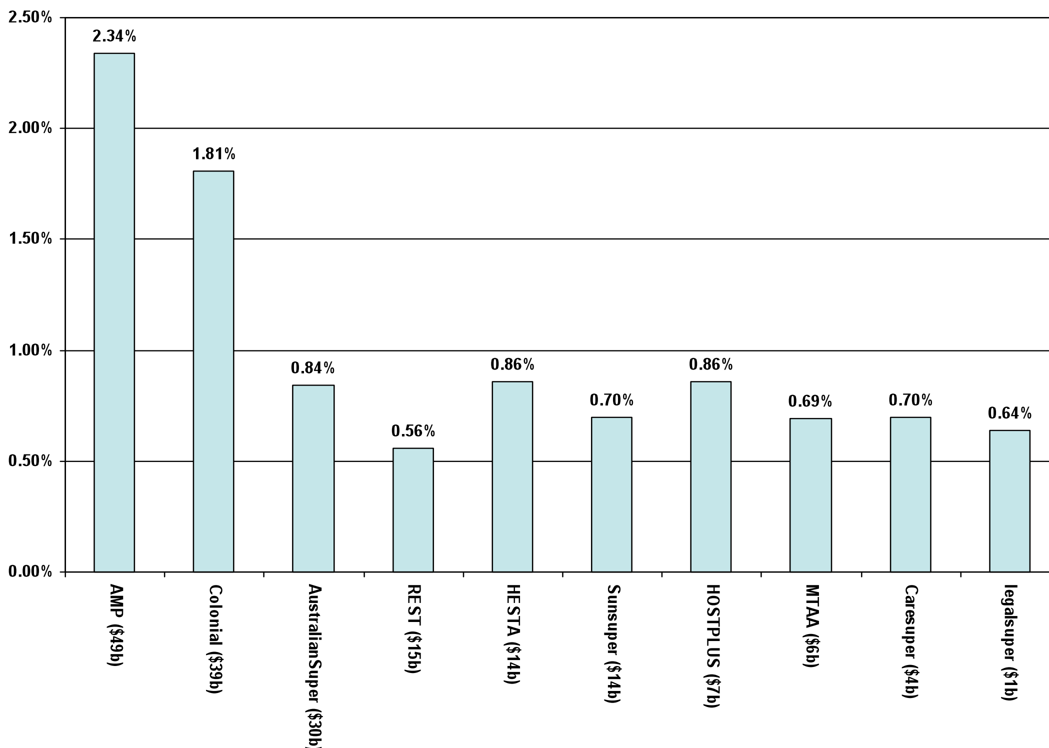
- Member communication can be better designed and tailored to suit the particular needs of smaller or more defined target audiences. This contributes to better understanding by members of their super and increases engagement; and

- Relative to large multi industry super funds, small to medium sized funds are better placed to maximise leverage off their respective industry networks and stakeholders to market themselves thereby generating cost savings for members.

We submit that through a process of consultation with industry, APRA formulate minimum benchmarks for key aspects of super fund operation. Funds that are below the benchmarks would receive APRA's closer attention and in the event that their performance does not lift they would be asked to justify their ongoing role in the industry.

These benchmarks would create a mechanism whereby the retirement savings of Australians would over time be moved into higher performing super funds to the benefit of improved retirement savings for members.

APRA could be responsible for monitoring and assessing super funds' performance against these benchmarks. Quite possibly this would change, if not eliminate, the role of the various super fund rating houses, which would also deliver savings for members. APRA could centrally issue ratings based on performance against each benchmark for each fund, which in turn could be used by consumers seeking to decide which fund to join. In support of our comments about larger funds not necessarily having lower fees, we present the following chart showing the default investment fees of ten industry and retail super funds. The funds are ordered from largest (AMP) to smallest (legalsuper). With one exception (REST) the larger funds all have higher investment fees than the smallest fund (legalsuper). By focusing on investment costs, this analysis deals with the largest component of super fund fees. This is often claimed as being the main area where there is potential for large funds to have lower costs as they are said to have stronger negotiating powers.



N.B. For larger employers, some funds may reduce their fees below those stated in publicly available disclosure documents.

APRA data for the 5 years to 30 June 2008[1] also shows that many larger super funds (with $1 billion or more under management) had bottom quartile investment returns. Significantly, together these funds hold around 20 per cent of funds included in APRA's data. The largest fund in the bottom quartile had $30 billion of funds under management. This indicates that larger funds do not in all cases deliver stronger net returns, supporting our contention that attention needs to be paid to a wider range of factors than scale alone.

[1] 'Superannuation Fund-Level Rates of Return – December 2008, issued 20 August 2009' – see Schedule 1

Very substantial consolidation has already occurred in the super industry. According to APRA the number of super funds (excluding small funds) has reduced by almost 90 per cent, from around 4,000 at 30 June 2000 to just 463 at 30 June 2009.

As the industry continues to consolidate and super funds grow, we submit there needs to be checks and balances that encourage funds to return the dividends of increased scale to members.

It is worth considering another sector of the financial services industry where significant consolidation has occurred – the banking sector – and that fewer and bigger banks have not necessarily delivered lower fees and better services to their customers. One other example is supermarkets, which are dominated by two main players and yet Australian groceries are reported as being among the most expensive in the world.

legalsuper submits that as a first step APRA set benchmarks in each of the following areas.

a.) Trustee governance – at least every three years funds commission an independent review of the overall effectiveness of the governance of their board <u>and</u> provide clear evidence that recommendations have been appropriately considered and adopted;

b.) Costs – the total management expense ratio (MER) (i.e. including investment and administration costs) of all super funds be set at a prescribed amount, potentially with a view to a further reduction over a set time-frame; and

c.) Investment returns – funds to generate returns that are third quartile and higher. Bottom quartile funds would receive the closer attention of APRA.

As deemed necessary, additional areas of benchmarking could be added at a later time.

We also note that a super industry with a small number of dominant funds will have new and different risk and prudential management challenges, and will concentrate risk in a reduced number of entities.

In the event of a serious issue with a smaller number of larger funds, there would be serious consequences for a very substantial proportion of working Australians, for the super industry, and/or indeed for the economy.

APRA would need to refocus and tighten existing governance and regulatory requirements to manage these risks in what would be a very different landscape.

For example, in a scenario where more Australians' savings were managed by fewer funds, fund failure or poor performance would be magnified significantly. In the corporate world we have the relatively recent collapse of HIH as a reminder of how serious and wide the implications of business failure can be for the community.

Having endured two consecutive years of negative super fund returns, it is worth considering the possible impacts for consumer and investor sentiment if a mega-fund with membership of say 10 per cent of Australians were to deliver very poor investment performance, or even worse incur significant losses due to poor investment decision making. Also, who would bail out such funds (and their members)? Would it be the Federal Government or other super funds?

Other risks could arise from the increased influence that mega-funds would wield over the financial services industry. Mega-funds could exert substantial power and influence over other industry intermediaries which would reduce competition. The fund choice regime has lifted competition in the industry and made super funds work harder to sign up and retain members. We submit that this competitiveness is a healthy influence and there is some risk that a few large providers could become complacent and less accountable to their membership.

These very real possibilities suggest that having a small number of very large super funds could have serious implications that would be amplified in the event of fund failure or loss.

From a political and policy perspective, we submit these potential implications are also significant. With superannuation already being the second largest financial asset of Australians, each Australian has a valuable and very real interest in the safety of their savings.

We also suggest that the community would look to the Federal Government and regulators, placing even higher expectations on them to protect their super by ensuring any new risks of a significantly consolidated industry are addressed.

Other secondary contentions:

1. Selection of default fund

6.2.1: How do employers select a default fund?

Fund choice has now prevailed for some years and to ensure the best outcomes for employees we believe there is a need to tighten requirements for the selection of default funds by employers.

We submit that the Government should legislate to install clear guidelines for employers when they choose their default fund. It needs to be remembered that ultimately, superannuation is an asset accumulated by employees and not by employers.

In our view these guidelines would increase transparency and ensure greater consultation with employees about the chosen default fund. Ultimately, they would also increase the likelihood that the chosen default fund was appropriate for employees and more in line with employee expectations.

According to research commissioned by legalsuper, employees assume that a level of due diligence is undertaken by employers when choosing a default fund, but that is not actually occurring. Our research showed that many legal firms perceived super as an employee responsibility and placed relatively low importance on their selection of the default fund. Some legal firms spent very little time choosing their default fund and did not periodically review their selection. Most legal employers interviewed tended to adopt a 'set and forget' approach and still used the same default fund initially selected and had no intention of reviewing their default fund in future. Further, their selection process was in most cases quite limited with the primary objective being to satisfy their legal obligation of having a default fund and with little emphasis placed on determining whether the default fund was well run or performing strongly, either at the point of being initially chosen or over time.

Around 80 per cent of employees accept the default fund chosen by their employer and our research would suggest they do so on the expectation that their employer has applied suitable and rigorous due diligence when selecting the default fund. The high reliance by employees upon their employer's choice of default fund means that employers have a significant role to play in determining whether employee superannuation is invested with a sound fund. In these circumstances, we submit that it is only reasonable that employers be required to be transparent and to make their decision solely in the best interests of their employees.

legalsuper recommends the following broad principles be used to establish a new set of employer guidelines:

1. Employers are required to use a default fund selection process that is transparent and objective including open and upfront communication to employees about the default fund selection process and disclosure of the general rights of employees in terms of fund choice;

2. Employers are required to demonstrate that they have consulted with their employees and involved them in the default fund selection process;

3. A ban should be placed on employers choosing a default super fund with which they have a commercial relationship;

4. Larger employers (more than 100 employees), should be required to engage independent consultants to manage their default fund selection process; and

5. Employers are required to periodically review their default fund selection (we suggest at least once every five years).

2. Inducements to employers

7.2.4: Are there instances where super fund trustees or their associates provide discounts to employers on other products and services in order to influence the employer's selection of default fund?

legalsuper has seen corporate deals in the legal profession where a super fund has secured nomination as default fund by offering a special deal on fees or insurance.

While we recognise that these types of 'deals' have a place in a competitive market, we submit that they should be more clearly and more fully disclosed to employees. In many cases employees changing jobs are unaware that when they change jobs they lose the benefit of the corporate deal and are hit with higher fees and/or may forfeit their insurance.

The level of turn-over in the legal profession is high. People will change jobs several times over their careers. For example, young lawyers could have four or five jobs in the first ten years of their careers therefore many in the profession are prone to being caught out.

This practice is eroding employee's superannuation savings. It also makes comparing super funds more complex and is another obstacle in the way of employees understanding and engaging with their super.

We submit that employers should be required to be transparent and disclose to their employees the nature of any corporate deals including the potential for loss of benefits if they leave their employ. The practice of super funds increasing fees or lapsing insurances when individuals leave an employer with whom a corporate deal has been struck should be banned.

3. Salary sacrifice

7.2.5: Under current rules, if an employee makes an effective salary sacrifice, the employer's SG contribution is required to be made only on the reduced salary amount. Does this discourage employees from salary sacrificing, particularly when the employer could be seen to benefit?

legalsuper has noted two legal loopholes that allow employers to unfairly reduce an employee's salary sacrifice super entitlements. Both these loopholes must be closed.

The two loopholes include:

i. At the expense of their employees, employers are able to lower their SG obligation by using an employee's post-salary sacrifice income rather than their higher pre-salary sacrifice income to calculate their SG obligation; and

ii. Also at the expense of their employees, employers can use an employee's salary sacrificed contribution and count it toward their own SG obligation. This could be tempting for some employers when cash flow and profit pressures arise.

The dangers for employees are compounded by the fact that employers are not required to disclose the terms under which they administer salary sacrificing.

We submit that both of these loopholes be closed to protect the rights and entitlements of employees who salary sacrifice and employers should be required to disclose how they administer salary sacrifice in their initial letter of employment and when employees may subsequently elect to salary sacrifice.

In conclusion:

Our main contention ('that minimum performance benchmarks be mandated for super funds') is seen by us as a constructive, workable and pragmatic way to move the super industry to the next level. While the Australian super industry has broadly operated well, there is always scope for improvement.

The other secondary contentions raised by us are areas where we perceive there to be scope to further protect the rights of employees who are ultimately the owners of the capital accumulated in the super industry.

We look forward to hearing the Review's recommendations on the superannuation industry.

Should you need any further information about the matters we have raised in our submission, please feel free to contact me directly on (03) 9607 9401 or at aproebstl@legalsuper.com.au.

Yours sincerely

Andrew Proebstl

Chief Executive

Schedule 1

List of super funds with fourth quartile investment return

The following table (an extract from APRA's Superannuation Fund-Level Rates of Return – December 2008, issued 20 August 2009) lists funds with 4th quartile returns for the 5 years to 30 June 2008. The list is sorted by assets under management.

The highest return in the funds listed was 6.7%. The lowest was 3.3%. The average return of the 191 funds in APRA's report was 8.0%.

A difference of 1% in return, could reduce a member's return by up to 20% over a 30 year period (for example, could reduce it from $100,000 to $80,000). Members invested in super funds with fourth quartile investment performance will accumulate significantly lower retirement savings.

Fund name	Assets ($M)	5 year return to 30 June 2008
Newcastle Permanent Superannuation Plan	191.3	4.9
Masterplan Managers Superannuation Fund	203.0	6.1
Lutheran Super	254.7	4.8
Smartsave 'Members Choice' Superannuation Master Plan	263.1	5.1
First Quest Retirement Service	263.1	6.4
The Bendigo Superannuation Plan	301.3	5.2
Uniting Church in Australia Beneficiary Fund	313.5	5.4
Premiumchoice Retirement Service	320.1	5.5
FuturePlus Super	321.4	6.3
Mars Australia Retirement Plan	349.8	4.6
Challenger Retirement Fund	357.5	4.2
National Preservation Trust	374.3	3.9
Nationwide Superannuation Fund	377.8	6.7
Ford Employees Superannuation Fund	387.2	3.9
Combined Fund	395.3	5.1
BP Superannuation Fund	405.8	4.1
Wealthpac Superannuation Service	416.4	6.6
Pinnacle Superannuation Fund	431.9	5.7
Tower Master Fund	445.2	3.7
Nestle Australia Group Superannuation Fund	451.2	5.2
National Mutual Tailored Superannuation Fund	594.0	3.8
Westpac Personal Superannuation Fund	608.5	5.8
Tower Superannuation Fund	637.9	5.6
The Tower Superannuation Fund For General Public	711.3	5.3
Macquarie ADF Superannuation Fund	812.4	3.3
National Mutual Simple Superannuation Fund	957.0	4.2
Avanteos Superannuation Trust	980.7	5.9
Australian Eligible Rollover Fund	982.5	5.7
IBM Australia Limited Superannuation Fund	1,198.4	4.1
Professional Associations Superannuation Fund	1,353.7	5.6

Fund name	Assets ($M)	5 year return to 30 June 2008
Symetry Personal Retirement Fund	1,382.6	6.4
Perpetual's Select Superannuation Fund	1,410.8	6.6
AMP Eligible Rollover Fund	1,432.9	4.1
SuperTrace Eligible Rollover Fund	1,557.1	5.5
ANZ Australian Staff Superannuation Scheme	1,771.8	4.3
Super Directions Fund	2,660.0	4.4
Suncorp Easy Super	2,682.5	6.6
Suncorp Master Trust	3,422.2	4.8
Norwich Union Superannuation Trust	3,426.4	6.4
Oasis Superannuation Master Trust	3,433.5	5.6
Spectrum Super	3,668.8	6.2
National Mutual Retirement Fund	3,696.4	4.2
AMP Personal Superannuation Fund	3,762.1	5.3
Westpac Mastertrust - Superannuation Division	6,014.3	6.5
Summit Master Trust Personal Superannuation & Pension Fund	11,525.7	5.8
Retirement Wrap	18,181.4	6.3
ING Masterfund	24,170.8	6.2
Colonial First State FirstChoice Superannuation Trust	30,177.5	6.4