27 February 2009

AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

By email: AFTSretirement@treasury.gov.au

Dear Sir/Madam

Retirement income system consultation

CHOICE is a not-for-profit, non-government, non-party-political organisation established in 1959. CHOICE works to improve the lives of consumers by taking on the issues that matter to them. We arm consumers with the information to make confident choices and campaign for change when markets or regulation fails consumers.

Our comments to the Treasury's consultation on Australia's retirement income system are limited to some efficiency aspects of the second pillar of Australia's retirement income system – compulsory savings through the superannuation guarantee. We lend our full support to the retention of an adequately funded age pension. We also support in broad terms the voluntary savings component of Australia's retirement income system. Recent turmoil in financial markets has highlighted the integrated nature of these policy elements and the need for all three to maximise equitable and sustainable retirement incomes.

CHOICE is concerned that the compulsory system delivered through the superannuation guarantee is failing to meet community expectations because it does not maximise individual consumers' retirement income. Specifically, we are concerned that the default arrangements for the superannuation guarantee (SG) are not designed and/or regulated so as to minimise costs and mitigate investment risk. No doubt many in the superannuation industry will use the opportunity presented by the Henry Tax review to argue for an increase in the Superannuation Guarantee. We take a different view. We believe that consumers require better deal from the existing arrangements before the government mandates more savings to the care of the superannuation industry. Our concerns are not a knee-jerk reaction to the current period of financial turmoil. Rather, they arise from a systematic evaluation of the super guarantee as it has operated since its inception.

We recommend the Henry Review consider regulatory changes to default superannuation arrangements to provide a better environment for compulsory SG contributions.

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Default superannuation

The default superannuation fund that applies to each work place is either specified in the relevant Award or determined independently by the employer. Where the fund member has not specified an investment strategy, the superannuation fund will make available a default investment option. Throughout this submission we refer to default superannuation arrangements to address the situation where an employee has adopted the default fund and the default investment option within that fund.

Despite the fact that since 2005 the majority of employees have been able to nominate their choice of fund, evidence confirms that the great majority of employees remain in the default funds and default investment options. Ernst and Young, for example, report just 10% of workers exercising their right to choose a superannuation fund.[1] There are many reasons why pursuing such a default strategy may be rational for an individual consumer – for example, most people have relatively small balances to invest (less than $100,000) and trustees are required to manage assets in the best interests of their members. However, there is increasing evidence than many consumers remain in default options because the increasingly complex market for superannuation products is simply overwhelming.[2]

The superannuation market has failed to develop highly competitive dynamics. It remains a market characterised by captive consumers locked into products not of their choosing and with significant consumer inertia. The system has thrown up a number of market and regulatory failures including growth in multiple accounts, unnecessary costs and excessive risks faced by consumers.

Multiple Superannuation Accounts

At the end of June 2008, there were more than 30 million superannuation accounts, compared to a working population of 10.7 million people. That equates to nearly three superannuation accounts for each employed person. The structure of the compulsory superannuation system is largely to blame for the prevalence of multiple accounts. About one in four people in the labour force join a new default fund each year. Unnecessary multiple accounts arise because employees tend not to consolidate accounts at this time and are not obliged to consolidate accounts. Failure to consolidate accounts may occur because the fund makes it too cumbersome or costly to leave or because the consumer is unaware of the option to consolidate accounts. Either way it is clear that account consolidation is not routinely occurring.

In a period of financial market turbulence and plummeting superannuation returns you'd be forgiven for thinking that the main aim of superannuation is chasing returns. But it isn't. It's about maximising retirement income. Yet unnecessary multiple accounts erode retirement income by incurring extra fees, increasing the costs of fund management for all members and increasing the likelihood of accounts eventually becoming lost.

A report produced for CHOICE by Rice Warner Actuaries in November 2008 found that 13 million of Australia's 30 million accounts are unnecessary multiple accounts. These are inactive accounts that are not receiving contributions and are a duplication of another

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[1] Ernst & Young, *The Super Iceberg: What's beneath the Surface if Choice?,* October 2008
[2] Fear, J and Pace, G, *Choosing not to choose: Making superannuation work by default*, The Australia Institute Discussion Paper 103, November 2008

active account. The largest share of inactive funds ($66 billion) is managed by Industry Funds, followed by Retail superannuation sector ($42 billion).

Table 1. Distribution of Superannuation Assets, 30 June 2008

Superannuation Market Segment		Distribution of Assets ($m)			
		Active	Inactive	Pensioners	Total
Wholesale	Corporate Funds	42,211	13,386	5,902	61,500
	Corporate Super Master Trusts	41,459	12,963	-	54,422
	Industry Funds	143,687	66,108	12,703	222,498
	Public Sector Funds	55,748	29,710	61,545	147,002
Retail	Corporate Super Master Trusts	27,139	8,485	-	35,624
	Personal Superannuation	147,582	42,602	-	190,184
	Post Retirement Products	-	-	86,913	86,913
	RSAs	834	366	-	1,200
	ERFs	-	6,357	-	6,357
Small Funds		243,458	45,072	73,970	362,500
Total Superannuation Market		**702,118**	**225,048**	**241,034**	**1,168,200**[3]

Rice Warner Actuaries *Consolidation of Super: Prepared for CHOICE,* November 2008

Consolidating 13 million unnecessary accounts into active accounts would put an extra $1.1 billion annually into Australia's superannuation savings. And any savings that can be made today will be worth significantly more upon retirement. The new lost super arrangement should remove around 6 million accounts from the system, but without further reform, the problem of multiple accounts is likely to continue.

The existence of an excessive number of accounts generates fee income for the industry, while eroding the wealth of fund members. With the exception of legacy products, we believe that for most consumers one superannuation account should be sufficient to provide for their needs. The problem of multiple superannuation accounts is indicative of the poor design of the default arrangements for superannuation.

Unnecessary costs in superannuation

Savings in default superannuation funds can be unnecessarily eroded as a result of excessive or unreasonable fees and charges and automatic deductions for unwanted services. We believe that both of these contribute to reduced retirement income and should be considered as part of the Henry Tax Review.

CHOICE is aware of considerable frustration from fund members that additional products, for example life insurance, can be included in their account on an opt-out basis. One member explains,

> *"The letter looked like just another piece of junk mail, until I read it carefully. What annoyed me is that I would be automatically charged for something that I never asked for, and most certainly did not want. In order to 'opt out' I had to fill in a form*

[3] This total does not include the unallocated reserves of $5 billion.

and send it in. Wasting my time. Does [the superannuation fund] have the right to 'sell' me something that I never asked for?"

A similar and perhaps even more serious situation arises where consumers may not be aware they are paying for a financial advice service that at some stage has been attached to their account. It is difficult to quantify the lost savings resulting from products and services attached to member's accounts. We believe that additional products and services should only be offered to fund members on an opt-in basis.

Investment risk

CHOICE was recently contacted by a consumer who was distressed by recent market events and what it meant for her retirement prospects. She noted;

> *"A wrong investment choice could delay our eventual retirement dates and quality of lifestyle"*

Her position reflects that of the great majority of consumers in accumulation-style funds who are left to manage investment risks entirely on their own.

In 1982/83 eighty-two per cent of fund members were covered by defined benefit schemes.[4] Under these schemes, the investment risk is borne primarily by the fund which is responsible for financing the member's retirement income to a pre-determined limit. Fast forward to 2006 and 97% of members are in accumulation funds under which the member bears sole responsibility for the investment risk attached to their retirement savings. The shift of investment risk from employer/fund to member has been observed around the world. However, while other social insurance schemes provide an avenue to mitigate or compensate for this, the Australian system does nothing to alleviate the risks faced by consumers.

The superannuation industry has responded to the increased investment risk on members by increasing investment options, spruiking the services of financial advisors and supporting law reform for simpler financial advice. Yet the solutions offered by the industry have failed to curb or limit the investment risk faced by individuals. According to the Australian Prudential Regulatory Authority, member investment choice has led to higher cost structures for the industry without necessarily maximising savings for most workers.[5] In many cases the increasing diversity of investment options in superannuation products has the perverse outcome of increasing consumer confusion and exposure to risk.

One problem rests with the fact that consumers don't believe financial advice is free from bias. One person, confused by the financial advice he had received recently asked CHOICE,

> *"Are super advisors under pressure to ensure investors steer clear of putting all their money into cash?"*

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[4] Australian Prudential and Regulatory Authority, *Celebrating 10 years of superannuation data collection 1996 – 2006,* Insight Issue 2, 2007

[5] Sy, Wilson, *Towards a national default option for low cost superannuation*, APRA Working Paper, August 2008

Until the financial advice industry comprehensively removes commissions and other sales-based remuneration, we do not believe that the advice channel can be confidently utilised by consumers to manage investment risk within the superannuation system.

We recommend the removal of commission and sales-based remuneration on financial advice and financial products, including superannuation funds. We also encourage the review to look for innovative ways to encourage the re-emergence of superannuation products that reduce the investment risk faced by fund members by offering, for example, tax breaks to defined benefit funds.

We trust these comments are a useful contribution to the reviews consideration of the Superannuation Guarantee. Should you have any further questions, please contact me on (02) 9577 3349 or efreeman@choice.com.au.

Regards

Elissa Freeman
Senior policy officer