Single default superannuation accounts: Stapling v Auto-rollover

Analysing an optimal approach

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Executive summary

Both the Productivity Commission Inquiry into Superannuation report, released in 2019, and the recommendations of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry concluded that superannuation members should only be defaulted once in the superannuation system, and that machinery should be developed to "staple" a person to a single default account. The objective of these recommendations was to address the proliferation of unintended multiple accounts, which erodes member balances.

In response, two possible models that meet these recommendations have arisen: either to stop the creation of new accounts and direct an employer to an existing account[1], which employers contribute to until such time as that member elects a new fund, or to automatically rollover balances to a new default account on each employment commencement, on an opt-out basis.

Financial modelling on the two proposed options is inconclusive as to which provides a better outcome for members or the superannuation system, particularly given the effects of reforms already underway to deal with multiple accounts and drive accountability for member outcomes are yet to have full effect.

This being said, there are a number of key issues that arise with the introduction, in particular, of an automatic-rollover model:

a) The Protecting your Super (PYS) measures already in place protect members from account erosion and manage smaller balances,
b) The growth of people holding multiple jobs means that automatic rollover is impractical, and drives unnecessary transactions and transaction costs, leading to increased disengagement and confusion over superannuation,
c) Rollovers undirected by a member will result in unintended loss of insurance cover, and problems with transition, and
d) Workplace agreements increasingly include choice of fund, and members are increasingly adopting choice, meaning that mandatory default arrangements are reducing, and any undirected activity will increasingly become disruptive to the system.

For these reasons, we believe that this type of change to the default mechanisms in superannuation at this time would not provide the outcomes sought over and above those expected from Protecting Your Super (PYS), and the possible benefits certainly do not justify the cost and additional disruption to the superannuation system.

[1] With a simple mechanism required for all first-time new entrants to the workforce

1. Background

The creation of multiple accounts as a consequence of default superannuation has long been a problem within the system. When combined with the low level of member engagement exhibited within default superannuation, the creation of multiple accounts has been rightly connected with account erosion.

This issue has been getting increasing focus and public policy debate. The 2018 Productivity Commission[2] noted that members should "no longer be defaulted into a new super fund whenever they change jobs or industries. Members should only be defaulted once, if they do not have an existing super account and fail to make a choice of their own." Commissioner Hayne in the more recent Royal Commission arrived at similar findings[3], concluding "a person should have only one default account. To that end, machinery should be developed for 'stapling' a person to a single default account."

Over time, the government has taken regulatory steps and has built capability to address this issue, including: the transfer of lost, insoluble and inactive accounts to the ATO, obligating RSEs to combine duplicate accounts, leveraging the ATO's systems to make the identification of multiple accounts and consolidation of accounts easier. More recently, the implementation the Protecting Your Super package (PYS) in early 2019 has significantly accelerated efforts in reducing the number of duplicate accounts. Under this legislation, from 1 July 2019 RSE licensees are obligated to identify inactive low-balance accounts, report and transfer these accounts to the ATO commencing 31 October 2019, with the process repeating on a six-monthly basis[4].

2. Machinery for ensuring a person only has a single default account

Many within the industry had assumed that the logical solution would be to stop the creation of new accounts. It was also broadly assumed that such a fundamental change to the dynamics within the system would need to be coupled with other changes to the default superannuation more broadly, including reforms on the selection of default funds, which would require a level of industry consultation and debate. Most expected that this consultation would commence in 2019/2020 along with other changes foreshadowed.

However, in mid-2019, Industry Super Australia (ISA) engaged KPMG to look at the feasibility of two possible options for stapling. The two options explored included:

Option one – Having new employers contribute to an existing account when changing employment[5], or
Option two – Having a new account created on changing employment and automatically rolling over existing balances to the new account created (on an opt-out basis)

Neither of these options provide complete or simple solutions. Both have significant implications for the stability of the superannuation industry and create a number of unanswered questions:

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[2] Superannuation: Assessing Efficiency and Competitiveness; Productivity Commission Inquiry Report – 21 December 2018
[3] Final Report: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry: Recommendation 3.5
[4] The full impact of implementing this change will not be understood for a number of years
[5] The KPMG report describes this solution as being tied to a single fund for life. Account holders would be tied to these accounts until such time as they choice to make an active choice, selecting a fund that meets their specific needs

Option one – Maintain existing account	Option two – Create new account and auto-rollover
• Would this sufficiently address existing multiple accounts without some other 'one-off' intervention to combine any remaining duplicate accounts? • What would you do with new entrants to the system? • Are there sufficient differences in the needs of superannuants across vocations/industries to make industry-based funds a significant driver in outcomes (including insurance)? • Would maintaining an existing account positively impact engagement when compared with auto-rollover to a new account established when changing jobs?	• Is there sufficient merit in the existing default system to warrant its maintenance under a new model (including competition for default status) or are we moving to a more consumer-based choice model? • Within the superannuation system what percentage of superannuants are currently (or will be) defaulted into vocation/industry-based funds? • What other developments would be required within the default superannuation framework to support this model? • Would the transaction-related and other operational costs by sufficiently covered any benefits created in additional to the improvement already delivered by PYS? • Do we understand the data sharing and infrastructure development required to support such a model? • Is the impact of loss of investment, insurance and other elections made within an existing fund on auto-rollover to a new account understood?

KPMG did not suggest they had answers to these issues, but it is worth noting that both of these options would create a significant shift in the dynamics of the current default superannuation framework and have a high likelihood of creating unintended consequences, particularly in the emerging economy where traditional industry-based work patterns are changing (e.g. increasing numbers of part-time workers, workers with multiple jobs, seasonal and self-employed workers).

3. KPMG's conclusions

In terms of multiple accounts, the conclusion reached by KPMG was that either model would equally resolve this issue going forward. It also concluded that the PYS changes already implemented will likely account for the majority of the projected benefit associated with existing account consolidation under both models (upwards of 80 per cent).

The report also suggested that there would be some additional benefits of Option two, including:

- A slightly higher level of existing account consolidation (as expected given the nature of the two models). KPMG estimated that Option two delivered an additional fee and insurance premium saving over Option one of around $3.9 billion over 25 years, or $156 million per annum on average. While the absolute value seems high, this only equates to a less than 0.01 per cent saving per annum on total superannuation assets.

- 'Stronger momentum' for the emergence of improved member outcomes through a '*performance dividend*' as members move to higher performing funds over time[6]. This is based on the assumption that lower performing funds will either lose their eligibility to receive default contributions or employers will choose new defaults that are higher performing. This removal of lower performing funds from the default system combined with the continued flow of employees into new default funds will result in members progressively being moved into better performing funds as they change jobs or industries. KPMG suggest that assuming a consolidation period of three years and a performance dividend of one per cent per annum would see an uplift in total superannuation assets of $416 billion during the same 25-year timeframe (or $23,000 per member when averaged across all industry participants).

Overall these conclusions drawn by KPMG are not compelling, they note that either model could deliver material benefits to the superannuation system, and that the majority of these benefits are attributed to PYS. They also conclude that the *performance dividend* would also be delivered through Option one, through other mechanisms such as fund consolidation.

[6] It was also suggested that this would help accelerate the removal of underperforming funds out of the system

4. Our observations

Rest commissioned Rice Warner to help work through these options with a view of understanding the impact more broadly and test some of the thinking. The key conclusions we drew include:

4.1. Inconclusive results

The estimated difference in impact from the reduction in unintended multiple accounts from the two options by KPMG is less than 0.01 per cent per annum on assets. We do not disagree with the high-level savings estimates provided by KPMG, but do note that the differences between the two policies are marginal and should be considered inconclusive given the sensitivity of the assumptions made over a 25-year projected period.

4.2. Reliability of the *performance dividend*

An uplift in superannuation assets of $416 billion over 25 years is compelling, however that this performance dividend is unlikely to be achieved (in full) for a number of reasons including:

- Past returns are not indicative of future returns. Performance may not be persistent and the bottom-quartile funds may achieve higher returns in future years.
- The performance dividend measured by KPMG is based on a simplified model that assumes all members are in a 'balanced' option using the SuperRatings Fund Crediting Rate Survey.

Rice Warner analysed the 10-year default product returns for a sample of 97 products for which Rice Warner holds performance data as at 30 June 2018. Rice Warner conducted this analysis by splitting the returns into two rolling five-year periods and measuring the persistency of performance (by quartile) between the two rolling five-year periods (shown below).

		1 July 2013 - 30 June 2018			
		1st quartile	2nd quartile	3rd quartile	4th quartile
1 July 2008 - 30 June 2013	1st quartile	4%	4%	10%	8%
	2nd quartile	11%	4%	3%	5%
	3rd quartile	7%	9%	5%	3%
	4th quartile	4%	6%	6%	8%

The results present insufficient evidence to conclude that there is statistically significant persistence in performance between the quartiles over the two five-year rolling return periods, meaning that it is questionable as to whether you could assume a one per cent per annum uplift throughout the 25-year period used in the projection.

Furthermore, we note that a *performance dividend* would be achieved generally or under Option one via raised standards for existing products (and consolidation of underperformers) using APRA's powers under the member outcomes framework as also outlined by KPMG.

4.3. Transaction costs incurred under Option 2

Though exit fees when members switch funds are banned, there are a number of transaction costs that are incurred under Option two, including:

- Buy-sell spreads
- Crystallisation of investment losses (depending on the option and phase in the investment cycle)
- Tax, including the payment of capital gains and the loss of any pension transfer bonus on movement to the retirement phase
- Time out of the market
- Opportunity cost of carrying additional liquidity required in to held in the system

4.4. Alignment of product terms and options

Should members be defaulted to a new fund as they change jobs, as envisaged under Option two, they may be subject to disadvantageous product terms or changes in product terms, which do not match their needs.

There are differences in investment profiles across different MySuper offerings in the superannuation system. A member being transferred from one fund to another may be invested into quite different investment options, and this is likely to lead to both differences in experience and a reduction in engagement.

In addition, clarification would be needed on the treatment of any member who had made an investment choice in the default fund, ie would these members be excluded? If this were not the case, there are considerable implications for those members.

Under Option two members may also be at risk of losing important insurance benefits that they may wish to keep, be provided with new insurance cover where they may have previously opted out, or face a rise in insurance premiums for similar cover if they do not *opt-out* of any automatic rollover.

Some examples include:

- Voluntary cover for which the member has previously undergone underwriting, noting that up to 10 per cent of members within default superannuation funds take out voluntary cover[7] and our experience is a similar percentage would modify their default insurance in some way (reduce or cancel).
- Income protection coverage which may not be offered by default by many funds.
- Coverage for pre-existing conditions (PECs).
- Members may lose full coverage for all allowed causes of claim with limited cover on joining, for example accident only cover.
- Changes to other terms and conditions, for example disability definitions, exclusions.

Similarly, members who have made a beneficiary nomination may find that their superannuation insurance is not directed according to their wishes on death if the balance is rolled over to another fund under Option two.

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[7] https://assets.kpmg/content/dam/kpmg/au/pdf/2017/default-group-insurance-superannuation-review.pdf

4.5. Practical considerations of the emerging economy

The changing nature of work patterns creates challenges across many aspects of the superannuation system. The increase in part-time, casual and 'gig' working arrangements means that the traditional experiences of a linear movement from one full-time job to the next over the course of career is only one possible working pattern.

There are a number of practical considerations that would also need to be considered on implementation of Option two relative to Option one in the interests of consumer protection.

- Multiple jobs
  - Part-time work represents 32 per cent of employment in Australia and, in 2017, 1.5 million workers held two concurrent jobs and more than 400,000 held three.[8] Given trends in employment, these numbers would be higher now.
  - If a member starts a second job while continuing to work at the first occupation, would the original balance be consolidated across to the new quality-checked fund? If so, what would happen to the existing (first) employer's contributions? Failure to address this could still result in duplicate accounts being created.

- Seasonal work, short term work and high turnover occupations
  - According to the OECD Employment Outlook 2019: *The Future of Work*, 25 per cent of workers in Australia are in casual employment, one of the highest rates in the OECD, with more than half having no guaranteed hours. These workers may have seasonal patterns, short-term or high-turnover employment.
  - Members who undertake seasonal or periodic work may have their accounts consolidated more than once a year as they change jobs frequently. Similarly, members who undertake short term work (for example, assisting with elections/census) would have new accounts created and balances rolled over from existing (active) funds. Lastly, members in high turnover occupations may be forced to switch funds very regularly, impacting on engagement and increasing transaction costs relative to Option one.

- Gig economy
  - In a large survey from June 2019[9] conducted by the Victorian government, 7.1 per cent of respondents had conducted some gig work, with 15.5 per cent of those indicating that it was essential for income needs, making this pattern of work an increasingly important segment.
  - Self-employed workers participating in the gig economy may also be affected by changes to default arrangements. Although superannuation is not compulsory for self-employed workers, many contractors work under arrangements where they may be paid superannuation. With potentially multiple employers, short tenures and high turnover, this group is at particular risk of incurring higher costs associated with the regular changing of superannuation arrangements.

- Unpaid contributions
  - Superannuation contributions are required to be paid at least quarterly, and therefore there would need to be a suitable lag (at least a quarter) before accounts are consolidated to ensure that all contributions are received. This is not a problem with the existing ATO rollover mechanisms as accounts must be inactive for at least 16 months.

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[8] '6160.0 - Jobs in Australia, 2011-12 to 2016-17', Australian Bureau of Statistics, released 1 August 2019.
[9] Victorian Department of Premier and Cabinet, *Revealing the True Size of Australia's Gig Workforce*, Preliminary Report, June 2019

4.6. Managing the orderly exit of smaller underperforming funds

The consolidation of superannuation funds, in particular the merger of smaller or under-performing funds with larger, better-performing funds, is a clear objective of the government and this is being driven through a number of regulatory and policy settings geared towards this outcome.

An automatic rollover mechanism as outlined in Option two is not a suitable way to exit smaller underperforming funds when compared to APRA using its supervisory powers, member outcomes and heatmaps reporting. The shortened time horizon in which to deal with this reduction in scale would have impacts on liquidity (and investment performance) and create difficulties for some funds to meet redemptions or manage long-term or illiquid assets. In the worst case, there could be a 'run on the fund' leading to the failure of a superannuation fund.

Consideration should be given to the protection of the interests of members *left behind* in this scenario, noting that under Option one, the risk to system stability will be more evenly spread and the application of APRA's regulatory powers could be a more effective mechanism for this.

4.7. Impacts on member engagement

We expect that the continual shifting of a member's primary superannuation account (Option two) is more likely to have a negative impact on engagement as opposed to leaving accounts where they are (Option one). For example:

- Regular changes in product provider without instruction from the member will result in confusion as to which fund the member belongs to driving further disengagement.
- Members will need to re-engage with new providers to get new logins and remember different addresses and passwords to engage with their funds.
- Funds may find it more difficult to maintain accurate records of members and contact information if they change funds more regularly.

Member engagement is arguably a root cause of some of the problems we see in the current system, and further changes to the system could further exacerbate these.

4.8. Fund and industry economics

We expect funds will need to adjust their administration systems to facilitate either option, the costs of which are difficult to quantify and estimate. There will also be differences in ongoing costs under either policy due to differences in the volumes of member movements between funds which will result in associated costs to process exits and onboarding of new members.

Based on Rice Warners' knowledge of the administration market and infrastructure, they expect administration or fund technology impacts to be in the hundreds of millions of dollars. Under Option two, funds could be expected to incur additional administration costs (relative to Option two) related to:

- Onboarding activities
- Processing of rollovers (both out and in).

The KPMG model includes estimates for the exit processing costs, but not the associated increases in fund expenses for onboarding or the development of systems required.

Under Option two there are also potential development costs that would be incurred by the ATO. We are of the opinion that much of the existing infrastructure built to facilitate Superstream and the transfer of inactive low balance accounts to the ATO would be able to be reused. However, some new protocols for the definition of accounts that would be transferred to the ATO would need to be developed.

We expect the cost of developing any additional rules and implementation by the ATO would be lower than the expense required for the Protecting Your Super Package. The 2018-19 Budget reported a related expense from the ATO for this legislation of approximately $240 million. This could represent a theoretical upper bound on potential development costs but should the ATO need to adjust the mechanism by which accounts are consolidated to allow for investment choice we expect that the cost would be substantially higher. The level of complexity in rules designed to protect consumers could also impact on the development cost.

5. Rest's conclusions: A preferred approach

We believe that Option two would not create sufficient benefit in terms of addressing multiple accounts in additional to the impact PYS in the near term to justify the costs and disruption expected.

There are significant open questions as outlined in Section 3, which need to be worked through and a range of unresolved issues as outlined in Section 4 to understand and close out, including:

4.4 Alignment of product terms and options
4.5 Practical considerations of the emerging economy
4.6 Managing the orderly exit of smaller underperforming funds
4.7 Impacts on member engagement, and
4.8 Fund and industry economics

It is important to consider this in the context of the current environment, including digesting and implementing changes driven by the outcomes of the Royal Commission and Productivity Commission more broadly, and more recently the effects of COVID-19 and Temporary Release of Super (TERS). There is also an argument that structural changes in the underlying frameworks of superannuation tend to undermine consumer confidence.

The PYS reforms have significantly changed the nature and scale of the multiple accounts and default account proliferation problem. At end-June 2019, APRA data shows the number of members account to be 25.5 million[10], and ABS data shows the active workforce to be 13 million[11], which represents 1.96 accounts per Australian worker. As at December 2019, the ATO had received 2.3 million inactive low balance transfers, reducing the number of accounts per person to 1.78. This reduction builds on existing programs by the ATO, superannuation funds and eligible rollover funds, as well as member consolidation activity, including ATO's new ability to transfer benefits directly to account holders in certain circumstances.

In fact, the modelling done by KPMG suggests that $38.3 billion of the $43.5 billion saved under Option one (and $47.3 billion saved under Option 2) is directly attributable to the ongoing impact of PYS, roughly 80-90 per cent. In addition to this, while the *performance dividend* appears compelling, we are yet to see how more recently introduced measures influence fund consolidation, which is expected to deliver similar outcomes. These measures include APRA's member outcomes tests and heatmaps reporting as well as their additional powers. We believe that this will drive further industry consolidation, a position supported by the likes of KPMG[12]. The problem at the heart of this could be close to being resolved by the existing measures in place.

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[10] APRA, *Annual Fund-level Superannuation Statistics*, June 2019
[11] Australian Bureau of Statistics, *6202.0 - Labour Force, Australia*, Nov 2019
[12] https://home.kpmg/au/en/home/insights/2019/02/superannuation-fund-merger-insights.html

Further developments seen in 2020, including the TERS measure during the COVID-19 pandemic, have also disrupted the superannuation landscape, and resulted in unforeseen engagement with superannuation and the mechanisms available to members for account consolidation (the ATO MyGov portal) and choice of fund options. There may be further consequences of this period that may not yet be obvious, but changes like the significant number of lower balance accounts that have been closed as a result of these withdrawals are likely to affect fund economics for years to come.

Modelling and research detailed in this paper does not demonstrate that changes to the default process provide sufficient member benefit to members under either approach, and while we believe Option one (maintaining the existing account) has more merit in the current environment, Rest recommends that any further discussion of changes to the machinery of default accounts be postponed until 2022/23 at the earliest, in order for the effects of Protecting Your Super, Putting Members Interests First, ATO consolidation activity, APRA activity on fund underperformance and default-fund selection, fund mergers and the effects of the COVID-19 pandemic job losses and early release from superannuation in play are allowed to have their full effects on the superannuation default landscape.