MySuper consultation working group

Issues paper on Exempt Public Sector Superannuation Schemes and MySuper products

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ISSUE

Currently, there are a number of Exempt Public Sector Superannuation Schemes (EPSSSs) which act as default funds for public sector employees. As part of the Stronger Super reforms, MySuper products will replace existing default funds after an appropriate transition period. Trustees of Australian Prudential Regulation Authority (APRA) regulated funds will need to be licensed by APRA in order to offer a MySuper product. However, EPSSSs (including Constitutionally Protected Funds (CPF)) are not regulated by APRA. Rather, the Heads of Government Agreement on superannuation provides an exemption for certain public superannuation schemes from the *Superannuation Industry (Supervision) Act 1993* (SIS Act) and the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) because they often have complex benefit structures and are publicly accountable for their administrative effectiveness, efficiency and performance to the States and Territories.

If the EPSSS is a defined benefit fund it may automatically qualify as a default product. In order for an EPSSS that is not a defined benefit fund to offer a MySuper product, the fund could become regulated by APRA. However, there may be consequences with an EPSSS becoming regulated that need to be considered. Therefore, it is proposed that EPSSSs unwilling or unable to become APRA regulated be allowed to continue as a default fund by updating the Heads of Government Agreement, so that EPSSSs are required to comply with the spirit of the SIS legislation in relation to Stronger Super including MySuper.

MYSUPER PRODUCT REGULATION

Trustees wanting to offer a MySuper product will be required to hold a 'MySuper' class of Registrable Superannuation Entity (RSE) licence granted by APRA. The MySuper class of RSE licence could be a variation to the existing RSE licence regime.

This class of RSE licence would ensure that trustees of MySuper products meet their new duties and offer products which meet the MySuper product standards. These new duties include:

- to formulate and give effect to a single diversified investment strategy, aimed at optimising MySuper members' best financial interests as reflected in long-term net returns (recommendations 1.6(a) and 1.7(c));

- to ensure a fair and reasonable allocation of costs between MySuper and other products (recommendation 1.7(d)); and
- to actively consider and declare on an annual basis whether the MySuper product has sufficient scale in both assets and membership to provide optimal benefits to members (recommendation 1.6(b)).

APRA will have the ability to revoke the MySuper class of RSE licence if trustees fail to sufficiently meet their heightened duties and offer products that meet the requirements of MySuper products.

The SIS Act and other relevant legislation would also need to be amended to ensure that the MySuper products have the following minimum fundamental features:

- a single diversified investment strategy (recommendations 1.6(a) and 1.7(c));
- restrictions on unnecessary or excessive fees, including[1]:
  - banning commissions in relation to retail investment products and group insurance[2];
  - new standards for the payment of performance fees to fund managers;
  - a ban on entry fees charged to new members;
  - exit fees limited to cost recovery; and
  - switching fees not payable to the trustee in their personal capacity or any other person.
- standardised reporting requirements written in plain English[3];
- a requirement to accept all types of contributions (recommendation 1.7(b)); and
- life and total and permanent disability (TPD) insurance (where available, depending on occupational and demographic factors) offered on an opt-out basis[4].

Exemptions for EPSSSs that are defined benefit funds

For the purpose of the SIS Act, a defined benefit member is a member with superannuation benefits defined, wholly or in part, by reference to salary or a specified amount. Members obtain a certain retirement benefit regardless of investment returns or fees.

Where the EPSSS is a defined benefit fund it may automatically qualify as a default product. However, as DB funds do not need to meet the standards for a MySuper product, it is proposed that these default products will not be able to label themselves as MySuper products. As such, where the EPSSS is a defined benefit fund, it would not be able to use the MySuper label.

[1] See separate issues paper on fees and costs
[2] See separate issues paper on financial advice
[3] See separate issues paper on data and disclosure
[4] See separate issues paper on insurance

The rationale for allowing defined benefit funds to qualify as a default product is that members of defined benefit funds are not exposed to the same risks in respect of costs and investment performance as accumulation fund members as the risks are borne by the employer.

The Government's Stronger Super supported the recommendation that defined benefit funds that meet the requirements of the *Superannuation Guarantee (Administration) Act 1992* (SG Act) automatically qualify as default funds, and hence MySuper (recommendation 6.13).

Hybrid funds are those that offer both defined benefits and accumulation benefits, or have members from both types of funds. The MySuper criteria must be met for accumulation members in order for the hybrid fund to be accepted as a default fund under the SG Act (recommendation 6.14). For the instance whereby a member has both defined benefits and accumulation benefits, and the fund's DB component satisfies the SG Act obligations of each employer making the contributions, the MySuper criteria do not have to be met in respect of those members (recommendation 6.15).

As a member's account balance in a DB fund is not determined by investment performance of the fund or the costs of the fund, the trustee duties and standards applying to a MySuper product are irrelevant for DB funds. For example, trustees of DB funds will not have to formulate and give effect to a single diversified investment strategy (aimed at optimizing MySuper members' best financial interests as reflected in long-term net returns) as net return is irrelevant for DB fund members since the benefit is not determined by the investment strategy. Similarly, banning commissions and entry fees is also not a factor for DB funds as the employer, not the employees, pays the costs of the fund. Therefore, as DB funds do not need to meet the standards for a MySuper product, it is proposed that these default products will not be able to label themselves as MySuper products.

ISSUES

Regulating EPSSSs' MySuper products

It is proposed that EPSSSs' accumulation funds be allowed to offer a default product provided the fund is operated in a way that complies with the standards for a MySuper product and the trustees comply with the heightened trustee duties. This will be facilitated by updating the Heads of Government Agreement to incorporate Stronger Super reforms, including MySuper reforms.

The alternative to this would be for EPSSS accumulation funds to offer a MySuper product. However in order to do so, the fund would need to become regulated by APRA. This may require EPSSSs to split their fund into regulated accumulated funds and unregulated defined benefit funds to offer a separate single MySuper product which meets the heightened trustee duties and MySuper product standards and is subject to the SIS legislation and is regulated by APRA.

This approach would make the system simpler and remove the complexities around having two default arrangements (one for EPSSSs and another for non-government funds) for members and APRA. It would allow APRA to apply the MySuper reforms universally across the industry and improve comparability of default investment options. This would improve the performance of MySuper products as it will facilitate member and employer comparisons of MySuper products. The fund would have to work closely with the state governments, Treasury and APRA in order to facilitate the transition and the work involved may impact on the timing.

However, there may be consequences for some EPSSS accumulation funds becoming APRA regulated as they would need to convert to taxed schemes, potentially making members worse off. In addition, allowing EPSSSs to separate their MySuper products (including members and assets) from the rest of the fund could increase the complexity of operating their funds. Requiring each EPSSS to operate a regulated MySuper product, 'choice' products and defined benefit funds could increase administration costs of the individual funds.

Therefore, it is proposed that EPSSSs' accumulation funds be allowed to offer a default product provided the fund is operated in a way that complies with the standards for a MySuper product and the trustees comply with the heightened trustee duties.

Question 1.1 How close are EPSSS accumulation funds to meeting the features and trustee duties for MySuper products? Are there any impediments to EPSSSs complying with MySuper arrangements under the SIS Act?

Self-insurance

Self-insurance creates risks for the ability of all APRA-regulated funds to meet member claims and the Government considers that it should generally not be permitted for either MySuper or choice products (response to recommendation 5.16). These risks also apply to EPSSSs.

There are significant risks associated with self-insurance as it is not subject to the same prudential requirements of life insurance companies. Therefore, it is proposed that EPSSSs that currently self-insure will have to transition to external insurance. A limited exception will be allowed for grandfathering existing self-insurance in respect to defined benefit members in defined benefit funds (or sub-funds) that are currently allowed to self-insure by APRA.

This transition may require existing reserves held for insurance purposes to be returned to member accounts or possibly used to fund future premiums. Both of these approaches entail member equity issues.

If EPSSSs transition from self-insurance to external insurance there may also be a need for trustees to make changes to trust deeds to avoid the possibility that members of the fund continue to bear the majority of the risks. For example, the definition of TPD under the trustee's insurance contract is limited to when a member can no longer work in any occupation for which they are suited by training, skills or experience but this gives benefits in a narrower range of circumstances than if the member was entitled under the trust deed definition to benefits when they can no longer work in their own occupation. It may not always be easy for a trustee to obtain replacement cover which matches the current cover provided by the trust deed.

Question 2.1 What impediments exist to the transition of EPSSSs that currently self-insure to externally provided insurance?

Question 2.2 Is there a risk of a potential mismatch between cover established in a trust deed and replacement external insurance? How is this best addressed?