Super merger insights

An overview of superannuation fund mergers for industry participants

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Introduction

In the past year, increasing numbers of superannuation funds have initiated informal and formal merger discussions. Merger discussions are likely to further increase in 2019 as both the regulatory and political landscape continue to shift in favour of consolidation.

KPMG has produced this overview of superannuation fund mergers to provide insights, and help to inform thinking amongst industry participants considering merging with another fund.
2018 is likely to go down in the annals of Australian superannuation history as the year that sowed the seeds for the most significant transformation of the industry in a generation. Whether the Royal Commission into Misconduct in Banking, Superannuation and Financial Services ("the Royal Commission"), the Productivity Commission’s review of the efficiency and competitiveness of the super system, or changes announced in the 2018 Federal Budget, all are likely to influence the industry landscape for years to come.

Perhaps the most significant outcome of this myriad of inquiries, reviews and proposed changes to superannuation will be a major consolidation of superannuation funds through fund mergers. Currently there are 24 corporate funds, 18 public sector funds, 38 industry funds and 118 retail funds regulated by APRA. In the 2018 Super Insights Report, KPMG projected that the industry would halve through industry consolidation over the next decade.

Due to the inquiry findings, recommendations and proposals made since this projection, KPMG believes this level of industry consolidation may occur sooner than previously forecast. A number of tailwinds supporting industry consolidation have developed, or increased in likely impact, over the past year and are worthy of note.

**Key industry consolidation tailwinds**

**Member Outcomes**

APRA’s Strengthening super member outcomes package released in December 2018 will become the primary way in which the regulator assesses the long-term sustainability of funds. Featuring a new Prudential Standard SPS 515 Strategic Planning and Member Outcomes and amendments to existing Prudential Standard SPS 220 Risk Management, the package focuses on factors including: net investment returns, fees and operating costs, cost of insurance, net cash flows, outflow ratios, net rollover ratios, member growth or decline, and other benefits or services provided to members.

From 1 January 2020, funds will be required to undertake an annual member outcomes assessment as part of their business planning cycle. How the results of this annual member outcomes assessment are used by the regulator to remedy the poor performance of some funds is open to speculation. What is clear, is that APRA will be using the results to take action:

“APRA’s engagement with poorly performing RSE licensees is focused on determining the cause of shortcomings and then requiring them to develop a robust and implementable strategy to address these weaknesses within a short period.”

The member outcomes assessment, which will take a holistic view of what funds are delivering for their members, will almost certainly be a key driver of merger activity in the short-to-medium term. This can already be observed in the market, as funds seek to improve their long-term sustainability through mergers and merger discussions.

In parallel to the upcoming member outcomes assessment, an increased focus on fees, changes to inactive accounts, default arrangements, and increased regulatory scrutiny are contributing to a surge in merger discussions.

**Increased focus on fees and costs**

Fees paid in relation to superannuation account administration, investment costs and insurance have always attracted scrutiny. However, this focus has intensified in recent times due to factors including:

- **The introduction of RG97 by ASIC** increasing the level of fee and cost disclosures related to investments made by superannuation funds;
- **A strong focus on fees during Royal Commission hearings** has increased public attention on fees;
- **The Productivity Commission draft and final report into superannuation** focused significant attention on both the levels of fees within superannuation, as well as gaps and inconsistencies in how funds report on fees and costs; and

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1 APRA Quarterly Superannuation Performance Statistics - September 2018
APRA’s member outcomes assessment requires an assessment of fees and costs.

This focus on fees, costs, and member value provides a strong tailwind for industry consolidation. While fees and costs are one element of any net benefit or outcome analysis, their inherent structure (generally fixed and known upfront) compared to benefits (investment returns or member experiences which are experienced in the future), fees and costs continue to receive disproportionate attention.

While scale by no means automatically drives reductions in costs (there are many small funds that have low fees and costs) the size of a fund is positively correlated with a reduction in cost per member as fixed costs are spread across a greater number. Whether through increased buying power with service providers, or the ability to deliver internal efficiencies, the desire to reduce costs and fees will be a key driver of merger activity.

Inactive accounts, fee caps and bans

The 2018 Federal Budget put forward three proposals which provide further motivation for industry consolidation:

1. All superannuation accounts with balances below $6,000 that have not received a contribution within the past 13 months will be classified as inactive and auto-consolidated to the ATO;
2. A ban on all superannuation fund exit fees; and
3. A cap on admin and investment fees at 3 percent for accounts with less than $6,000.

Following minor amendments in the Senate, these proposals were passed by both houses of Parliament in February 2019. As they are implemented from 1 July 2019, they will have a material impact on a number of superannuation funds. In particular, account consolidation of inactive accounts under $6,000 will result in a significant reduction in membership numbers for many funds. The impact of a significant reduction in membership and hence, revenue, without a commensurate reduction in operating costs is likely to provide further incentive to explore inorganic growth through fund mergers.

Increased regulation and prudential oversight

We have already seen an increase in regulatory and prudential oversight within superannuation in recent times. This regulatory scrutiny will almost certainly increase following recommendations made by the Royal Commission which have sought to enhance supervision and increase enforcement effectiveness. In this environment, some trustees and shareholders of superannuation entities will question whether their members may be better served in a larger merged entity, which has the scale, processes, and functions to effectively manage an increased regulatory obligation.

Changes to default arrangements

The Productivity Commission’s final report into the efficiency and competitiveness of the super system maintained its recommendation that a ‘Best in Show’ shortlist of up to 10 funds should be established and used to automatically default new workforce entrants who don’t make their own selection.

If this proposal was adopted it would undoubtedly drive massive industry consolidation. Based on the reaction of legislators, the majority of industry participants, and numerous expert commentators, it seems highly unlikely that the ‘Best in Show’ proposal will be adopted.

However, the Productivity Commission and, more recently the Royal Commission, have re-ignited debate surrounding default arrangements and multiple accounts in superannuation. Proposals for a government fund to become a default provider, or the establishment of an ‘elevated’ MySuper licence reducing the number of funds able to accept default contributions, are among changes being suggested to the existing default system.

Additionally, the final report of the Royal Commission has further focused attention on default arrangements within superannuation by recommending that a person have a single default account for life. While the report did not put forward any specific implementation recommendations, public debate has begun on differing models which would ensure that individuals are only ever defaulted into one superannuation account, thus reducing multiple account proliferation.

What is clear, is there will soon be significant changes to default arrangements which will reduce the number of superannuation accounts in the system, and the number of funds eligible to receive default contributions. Both provide additional motivation for industry consolidation.
Motivation to merge

The motivation for funds to merge is driven by an obligation to optimise the benefits (competitive products and services) provided to members. Given that, in many respects, member benefits can be improved through scale in assets under management (AUM), member numbers and organisational capability, trustees are increasingly focused on potential mergers.

In considering a merger, the sole test trustees must apply is whether member’s interests are best served. However, there are a diverse range of positive outcomes for members that trustees may seek to achieve through a merger.

Four primary outcomes by which a merger may deliver positive benefits to members are:

1. Reducing costs associated with member administration and overall fund operating costs;
2. Improving value through more comprehensive or lower cost insurance;
3. Improving investment outcomes; and
4. Improving member services and engagement opportunities.

These direct benefits for members can often be achieved solely through an increase in scale, as member numbers and AUM allow a fund to negotiate better supplier terms and allow fixed costs to be shared amongst a greater number of members.

Often, in addition to the natural increase in members and AUM achieved through a merger, funds will specifically consider additional factors that have the potential to further deliver lower costs, improved investment outcomes and better products or services. The additional strategic benefits arising from a merger may include:

- Obtaining exposure to new member cohorts (age, industry, occupation);
- Expanding the geographic area over which a fund services members;
- Enhancing the organisational capabilities by combining executive and board skills;
- Diversifying exposure of defined contribution, defined benefit and pension accounts; and
- Expanding and diversifying products and options to better meet member needs.

Each potential merger requires trustees to navigate the challenges that each partner may bring unique cohorts of members, geographic coverage, organisational capabilities and often governance structures. In this respect, funds must clearly define why they want to merge and address the question: Who to merge with?
Who to merge with

In considering who to merge with, it is imperative trustees have well defined criteria for assessing a merger opportunity and have clearly articulated the attributes sought in a potential merger partner. As with most complex undertakings, there are generally no right or wrong answers, but rather a need to consider the strategic objectives of funds seeking merger partners. Key considerations include:

Relative size

Having regard to the AUM and number of members is a key merger consideration.

Larger merger partner

A fund considering a merger with a materially larger fund would generally expect that the additional scale will provide a greater capacity to invest in new products and services for their members and a potential to reduce fees. However, merging with a larger fund may reduce brand presence and result in less tailored services for specific membership profiles.

Equivalent or smaller partner

Funds considering a merger with an equivalent or smaller sized fund may expect existing tailored services and branding (albeit potentially in a refreshed manner) to continue. Depending on the size of the new merged entity, potential fee reductions may be less material and there may be a more limited capability to invest in new products and services in the future. The question also arises as to whether the merging of two small funds will create a sufficiently sustainable fund or whether another merger will be required to provide appropriate scale.

Operational alignment

A fund considering a merger partner with significant commonality across service providers may derive cost saving benefits more quickly given that:

- Investment mandates are rationalised to take advantage of tiered pricing and favourable performance payment arrangements;
- Member administration and custody arrangements are re-negotiated (in light of increased member numbers and portfolio size) to reduce cost and increase service outcomes; and
- Professional services (audit, tax, investment consulting etc.) arrangements are re-negotiated in light of rationalised stakeholders, processes and systems.

Industry alignment

Funds with members from a similar industry have a range of natural synergies which may be unlocked through a merger. An occupational commonality generally means tailored products can be maintained and enhanced. There is also likely to be high levels of consistency in benefit designs and insurance offerings.

Any combined fund could increase its presence with members and employers in their respective industry.

Strategic growth

In contrast to seeking merger partners from a similar industry, funds may seek merger partners with a different occupational or geographic footprint to their own. Such a growth strategy enables funds to diversify membership and potentially increase the range of services and products offered to all members.

Type of superannuation fund

The type of fund being considered as a merger partner is a fundamental consideration and often one of the first criteria specified when considering merger partners. In addition to the broad grouping of for-profit retail funds and profit-for-member funds, there are often considerable differences between funds within the profit-for-member group, with sub-groups of industry funds, corporate funds and government funds.

While the for-profit/profit-for-member models provide the greatest point of difference, differing membership dynamics, distribution channels and products all provide challenges and opportunities when considering a merger.

Trusted partners

Undertaking a successful merger is complex, requires extensive due diligence, negotiation and compromise. The relationship (whether pre-existing or developed during merger discussions at the executive or board level) between funds seeking to merge is a crucial success factor.

Funds with pre-existing relationships through common service providers, shareholders or trustee offices may find that this alignment facilitates a more rapid understanding of merger benefits.

If a merger appears to satisfy the criteria of both funds and provides tangible benefits to members, trustees should consider: What structure is best to adopt?
Merger structures - Successor Fund Transfer (SFT) or Extended Public Offer (EPO)

The two key structures available to superannuation funds seeking to derive benefit from merging or rationalising a trustee, fund and/or investment operation are the Successor Fund Transfer (SFT) and the Extended Public Offer (EPO).

**Successor Fund Transfer (SFT)**

A SFT is the direct transfer of a fund’s members (and respective assets) to an alternate fund on the basis that the member will have ‘equivalent rights’. The transfer is completed by the two fund’s trustees on behalf of their members. Both outgoing and incoming trustees are required to ensure that the transfer is in the best interests of members and that the members’ rights in the receiving fund are reasonably equivalent.

A SFT requires that the trustees of both funds obtain legal advice to ensure that the benefits and rights provided by the recipient fund are at least equivalent to those currently provided by the transferring fund.

Considerable work must be undertaken to facilitate a SFT that requires resources in addition to business as usual activities as well as the support of external consultants, legal and tax specialists.

A SFT generally takes between 9 to 18 months to complete and most SFT’s in recent years have been completed in this timeframe.

**SFT benefits:**

- Potential cost savings from consolidation/rationalisation (improved investment, member service, trustee office & corporate service arrangements);
- Provides certainty to both trustees that the transition will be completed by an agreed date;
- Provides a guarantee as to assets and members moving to the successor fund;
- Affords taxation relief in the form of rollover relief; and
- Proven record of successful SFTs may provide comfort to funds considering a merger.

**SFT risks:**

- SFTs are complicated and will impact both fund’s resourcing arrangements;
- The Equivalent Rights test must be met (potentially difficult to achieve if product/benefit design is not agreed or reasonably aligned);
- Governance matters (board composition and representation) can be complicated; and
- There is reputational risk to funds if a SFT is announced but does not proceed.

**Extended Public Offer (EPO)**

The Extended Public Offer (EPO) model is an alternative to the SFT model. An EPO allows superannuation funds to outsource key fund functions such as trusteeship, administration, custody and investment operations, whilst retaining control of their fund in other areas, such as strategy, brand development, member/employer relations and the appointment of key outsourced service providers.

An EPO model ordinarily leverages a service company that sits below the trustee and that maintains its own board, executive and staff. The costs associated with an EPO transition are generally lower than those associated with an SFT and there are several superannuation funds, including profit-for-member and retail funds that offer an EPO model.

**EPO benefits:**

- A single trustee reduces the complexity of a potential subsequent SFT (rationalised functions may reduce the complexity of the equivalent rights test); and
- Scale benefits associated with investment/member administration (multiple funds can access scale benefits via an EPO platform without effecting an SFT).
EPO risks:
- Investment/member administration scale benefits may be more difficult to negotiate;
- Member and employer communications can prove difficult to manage (dissatisfaction may occur if the benefits of an EPO are not clearly articulated);
- Increased complexity given the trustee and underlying fund structures may move separately (in comparison to a SFT approach and requiring more regular interaction with regulators); and
- Potential reputational risk if a fund’s board sacks the trustee (a fund board may opt to exit an EPO arrangement or not to progress an SFT).

Key merger challenges

Cultural, philosophical or ideological differences
In some instances, it is evident that, subsequent to the respective funds undertaking due diligence, there are real reasons as to why trustees cannot commit to a merger being in the best interests of their members. Specific reasons include a lack of cultural alignment, materially different demographics, differences in investment philosophy, or concerns associated with underlying shareholder interests.

Conflicts of interest
There is no doubt that the self-interest of fund executives and trustee directors have, at times, impacted merger outcomes, and this is in spite of a view that the consolidation of two funds would have been in the best interests of their members. The Royal Commission also made certain observations regarding the conduct of fund mergers, and reminds trustees that matters of board composition and who nominates board and management positions should be determined by reference to serving the best interests of members rather than retaining control by other stakeholders.

Taxation issues
The existence of taxation roll-over relief has been critical in ensuring member account values are not diluted due to unnecessary tax leakage. With the tax relief provisions due to expire on 1 July 2020 and the Productivity Commission recommending that relief be made permanent, industry needs to pursue this matter with some urgency with government. In any event, relief has not been necessarily available for all tax matters. Specific tax considerations include stamp duty (particularly regarding property), franking credits and No-TFN Tax Offsets. Reference should always be had to the ATO’s Involuntary Superannuation Account Transfer (ISAT) Protocol for guidance.

Investment issues, challenges with custodians/managers
Numerous investment decisions affecting tax outcomes need to be made before the merger takes place regarding assets to be retained or sold and when in order to implement rollover relief. Trustees (existing and future) need to be clear on what decisions are made and the tax impact. Custodians do not always have the same underlying tax treatments in their tax policies, so any differences need to be identified and addressed.

Operations – administration, unit pricing, fees
Operational tax issues arise at the fund level and at the member option level when funds merge. It is critical that funds have clear decisions in place surrounding the treatment of numerous matters, for example; member notices of intention to deduct contributions (which affect the tax treatment of contributions), No-TFN Tax and Offset implications, accrued income (especially in respect of trust investment), franking credit holding period rules, differences in exempt current pension income proportions and unit pricing tax accrual true-ups.
Assurance

The establishment of a consistent assurance process provides confidence that a merger is delivered successfully. Member experience is key to the achievement of a successful outcome, therefore, it is essential to have a robust governance structure and framework in place. A targeted assurance review should examine the merger program at key decision points and aim to provide timely advice to the merging funds. It should aim to identify risks and issues that may hinder the successful achievement of milestones, as well as acknowledging existing good governance and practice.

The review should extend but not be limited to the assessment of the data migration strategy including processes and controls for extraction, loading and data integrity. This is to ensure the complete and accurate transfer of member data and ongoing administration system functionality. An independent assurance review supports the successful achievement of initiatives and aims to increase confidence in readiness for member service and benefits realisation.

Assessing the success of a merger

When a merger is completed, it is vital to monitor and track cost savings and strategic benefits in order to assess the success of the merger in delivering better member outcomes.

This assessment should ideally feature regular tracking of cost savings and strategic benefits. The tracking of cost savings should focus on cost savings realised across investments, member services, fund operations and the trustee office and how these savings are passed onto members. Tracking strategic benefits should include monitoring improvements in products and services, member services and experience, member engagement and the merged fund’s market position.

Conclusion

In the coming years, we are likely to see a wave of consolidation amongst funds within the superannuation industry. As increasing numbers of funds initiate merger discussions, it is vital that they have a clear understanding of what benefits they are seeking to deliver to their members through a potential merger.

While a successfully executed merger can unlock better products and services, as well as savings for members, a poorly conceived or under-resourced merger attempt can be detrimental to members and increase the reputational risk of fund executives and directors. Clarity and alignment of objectives, the prioritising of members’ best interests combined with appropriate resourcing, are essential to delivering better outcomes for fund members through mergers.