Australian Government
Productivity Commission

Default Superannuation Funds in Modern Awards

Productivity Commission Draft Report

June 2012

This is a draft report prepared for further public consultation and input. The Commission will finalise its report after these processes have taken place.

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The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au) or by contacting Media and Publications on (03) 9653 2244 or email: maps@pc.gov.au

Opportunity for further comment

You are invited to examine this draft report and make written submissions to the Productivity Commission by **Friday 3 August 2012**. If you intend to appear at a public hearing, and have not already made a written submission, a summary of the points you wish to discuss should be lodged with the Commission at least two days before.

The final report will be prepared after submissions have been received and public hearings held, and will be forwarded to the Government by 6 October 2012.

Public hearing dates and venues

Location	Date	Venue
Melbourne	Monday 30 July 2012	Productivity Commission Rattigan Room Level 12, 530 Collins St, Melbourne
Sydney	Tuesday 31 July 2102	Adina Apartment Hotel Fitzroy Room 359 Crown St, Surry Hills

If you wish to appear at a public hearing, please contact Yvette Goss on (03) 9653 2253, fax (03) 9653 2199, email default.super@pc.gov.au or register online at www.pc.gov.au/projects/inquiry/default-super.

Commissioners

For the purposes of this inquiry and draft report, in accordance with section 40 of the *Productivity Commission Act 1998* the powers of the Productivity Commission have been exercised by:

Mike Woods	Presiding Commissioner
Angela MacRae	Commissioner
Paul Costello	Associate Commissioner

Terms of reference

PROCESS FOR THE SELECTION AND ONGOING REVIEW OF SUPERANNUATION FUNDS TO BE INCLUDED IN MODERN AWARDS AS DEFAULT FUNDS

I, Mark Arbib, Assistant Treasurer, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998* hereby request that the Productivity Commission undertake an inquiry into the process for the selection and ongoing review of superannuation funds to be included in modern awards as default funds.

The Commission will commence its inquiry on receipt of the terms of reference and report to Government within eight months of commencement.

Background

In May 2009, the Government commissioned a comprehensive and independent review into the governance, efficiency, structure and operation of Australia's superannuation system (the Cooper Review). The Cooper Review provided its final report to Government on 30 June 2010 and made 177 recommendations.

A key finding of the Cooper Review was that many consumers do not have the interest, information or expertise required to make informed choices about their superannuation. These consumers rely heavily on the default superannuation system to act on their behalf.

Superannuation originated in the industrial relations system and awards determined the funds which applied for each industry. Modern awards now list 'default superannuation funds' which apply if an individual fails to exercise their right to choose their own fund. Enterprise agreements can also set the default superannuation fund or funds for a particular workplace. Enterprise agreements must be approved by a majority of employees and must be approved by Fair Work Australia who can only do so if satisfied employees are 'better off overall' than under the relevant modern award.

The Government believes that default funds should continue to be included in modern awards, but there should also be a transparent set of criteria that such funds can be assessed against. This is in line with the Cooper Review, which recommended that the processes by which default funds are nominated for inclusion in modern awards be reviewed in 2012 to assess whether they are sufficiently open and competitive.

This review delivers on the Government's election commitment to ask the Commission to design a process for the selection and ongoing assessment of superannuation funds for nomination as default funds in modern awards. It seeks to develop transparent and objective criteria against which funds wishing to be eligible for default fund status in modern awards can be assessed, on an ongoing basis, to ensure that the best interests of members are met if their superannuation contributions are allocated to a default fund under the modern award.

Scope of inquiry

1. The Commission is to design criteria for the selection and ongoing assessment of superannuation funds eligible for nomination as default funds in modern awards by Fair Work Australia.

2. The criteria designed by the Commission should be transparent and objective. In considering criteria for determining whether a superannuation fund is appropriate to be nominated as a default fund in a modern award the Commission could have regard to the following:

- The appropriateness of the investment strategy of the default investment option of the fund in terms of risk and expected return
- The medium to long term net-of-costs investment performance of the default investment option
- The level of fees incurred by members
- The scale of the fund and the level of services provided to fund members
- The suitability and cost of insurance provided by the fund
- The governance of the fund
- The fees incurred and other impacts on members if they cease employment with an employer.

3. While the Commission is to focus on factors that optimise outcomes for members, it should also consider the administrative and compliance impact of its recommendations on employers and their representatives, unions, superannuation funds and decisions of Fair Work Australia.

4. In undertaking its inquiry, the Commission should have regard to the following matters:

- the interaction with the design and implementation of MySuper, including that only funds offering a MySuper product will be eligible to be included in modern awards
- modern awards will continue to be made and varied by Fair Work Australia
- modern awards will be subject to a comprehensive public review by Fair Work Australia in 2014, following an interim review in 2012.

Process

The Commission is to undertake an appropriate public consultation process including holding hearings, inviting public submissions and releasing a draft report to the public.

The Government will consider the Commission's recommendations, and the Government's response will be announced as soon as possible after the receipt of the Commission's report.

Mark Arbib
Assistant Treasurer

[Received 6 February 2012]

Contents

Abbreviations

ACAC	Australian Conciliation and Arbitration Commission
ACCI	Australian Chamber of Commerce and Industry
ACTU	Australian Council of Trade Unions
AFP	*Administradoras de Fondos de Pensiones* (Chile)
Ai Group	Australian Industry Group
AIRC	Australian Industrial Relations Commission
AIST	Australian Institute of Superannuation Trustees
AMWU	Australian Manufacturing Workers' Union
APRA	the Australian Prudential Regulation Authority
ASFA	Association of Superannuation Funds of Australia
ASIC	the Australian Securities and Investments Commission
ATO	Australian Taxation Office
Cooper Review	Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System
Corporations Act	*Corporations Act 2001* (Cwlth)
COSBOA	the Council of Small Business Organisations of Australia
CSSA	Corporate Superannuation Specialist Alliance
EPSSS	exempt public sector superannuation scheme
ERF	eligible rollover fund
Fair Work Act	*Fair Work Act 2009* (Cwlth)
FOFA	Future of Financial Advice
FSC	Financial Services Council
FWA	Fair Work Australia
IFF	Industry Funds Forum
ISN	Industry Super Network

Master Plumbers	Master Plumbers and Mechanical Services Association of Australia
MER	management expense ratio
PST	pooled superannuation trust
RSE	Registrable Superannuation Entity
SCT	Superannuation Complaints Tribunal
SDA	Shop Distributive and Allied Employees Association
SIS Act	*Superannuation Industry (Supervision) Act 1993* (Cwlth)
SMSF	self-managed superannuation fund
SPA	Swedish Pensions Agency
TPD	total and permanent disability
UTS	University of Technology Sydney

OVERVIEW

Key points

- Default superannuation arrangements exist because many employees do not actively choose a superannuation fund. Default funds are currently listed in most modern awards.
- Current default fund arrangements have provided stability, and investment returns of default funds have generally exceeded those of non-default funds. However, the arrangements could be improved to promote the best interests of members.
  - The primary objective of default funds should be the best interests of members, and for modern awards that list default funds, the selection and ongoing assessment of those funds should be merit based.
- The criteria that the Australian Prudential Regulation Authority will use for MySuper product authorisation provide a sound basis for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.
- While the Commission does not consider there is a need for additional criteria, there are factors that should be considered as a second stage when selecting funds to be listed in modern awards. These are:
  - as primary factors, the appropriateness of the MySuper product's investment return and risk profile for employees to whom the superannuation provisions in that modern award apply, and the fund's expected ability to deliver on the MySuper product's investment objectives
  - the appropriateness of the fees charged by the MySuper product, given its stated investment return objective and risk profile
  - the assessment of governance structures to test if they are, as far as legislative requirements allow, consistent with meeting the best interests of members
  - the assessment of the mechanisms put in place by fund trustees to deal with conflicts of interest, and the transparency in disclosing those conflicts
  - the likelihood of members being switched to higher cost divisions of a fund, or facing significantly higher fees upon exiting employment ('flipping')
  - the compatibility of the fund's insurance offerings with the characteristics of employees to whom the superannuation provisions in that modern award apply
  - the quality of member- and fund-specific intra-fund advice
  - the administrative efficiency of a fund against a set of benchmarks.
- The process for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards also needs to be reformed. The Commission is seeking further comment on two alternative options.
  - Decisions being made by an expert panel within Fair Work Australia (FWA), and the selection process being opened up to allow all funds to present their case to be listed in awards to FWA, based on the factors identified by the Commission; or
  - Establishment of a new expert body independent of FWA, with the sole purpose of selecting and assessing the funds to be listed in modern awards, based on the factors identified by the Commission.
- Under either option employers would be able to choose a fund not listed in an award, provided they can demonstrate, upon request, that their employees are no worse off.

Overview

Australia's three-pillar retirement income policy comprises a means-tested and government-funded age pension, supported by both voluntary saving and compulsory superannuation contributions.

Superannuation effectively became compulsory in 1992 with the introduction of the superannuation guarantee. This guarantee now requires employers to make superannuation contributions for most employees at the rate of 9 per cent of ordinary time earnings. This rate will progressively increase to 12 per cent by 2019-20. At the end of 2011, total superannuation assets reached $1.3 trillion, which was equivalent to Australia's GDP in that year. Assets are predicted to reach 150 per cent of Australia's GDP by around 2040.

In 2009, the Australian Government commissioned an independent review into the governance, efficiency, structure and operation of Australia's superannuation system (the Cooper Review). The Government accepted many of the Cooper Review's recommendations, including the establishment of a new simple, cost-effective default superannuation product, MySuper. Under forthcoming legislation, only funds that offer a MySuper product or are an exempt public sector superannuation scheme (EPSSS) will be eligible to accept default contributions and be listed as a default fund in modern awards (that is, the 122 industry and occupational awards that commenced on 1 January 2010).

Also arising from the Cooper Review, the Government has asked the Commission to design criteria for the selection and ongoing assessment of superannuation funds eligible for nomination as default funds in modern awards by Fair Work Australia (FWA). Accordingly, this inquiry is assessing the range of criteria that could be used and the process by which the decision to list funds in modern awards is made.

Despite the growth of superannuation in Australia, many employees do not make an active choice about which fund, and/or which investment option in that fund, their compulsory superannuation contributions should be paid into. This can be due to a range of reasons, such as the complexity of investment decisions and apathy about superannuation given its compulsory nature (box 1). The failure of many employees to make an active choice is the primary rationale for having a default superannuation system, whereby a third party chooses a superannuation fund on their behalf.

Box 1 **Difficulties individuals face making investment decisions**

Individuals might encounter difficulty making investment decisions in their own best interests for a number of reasons.

- Lack of financial literacy, which limits people's ability to make informed financial choices.
- Complexity of investment decisions and difficulty matching risk preferences with the right products.
- High search costs in terms of time taken to research and understand what is often a large number of products.
- The 'endowment effect' where people value money that is lost more highly than money gained, causing them to be unduly conservative in their investment decisions.
- Lack of price awareness, as compulsory contributions, fees and other costs do not come directly out of members' pockets.
- Information asymmetries between superannuation providers and individuals.
- A long lag between the purchasing decision and the time when the benefits can be accessed, making consumers less likely to make decisions in their own best interests.
- An associated tendency toward procrastination and inertia in making retirement savings decisions.
- Mental rules or short cuts (heuristics) that people use when they have no clear preference for one option over another, or where the cost of acquiring information is too high, which can lead to persistent biases in decision making.
- Framing effects, where people make a choice based on how the available options relate to one another, how they are explained and what other information is provided at the same time, rather than which option is in their best interests.

The recent Stronger Super reforms announced by the Government (box 2) aims to promote a more effective and efficient default superannuation system. It will do this by better aligning the interests and incentives of agents (such as fund trustees) and their principals (employees), through promoting greater transparency and accountability in the conduct and ongoing governance of default funds. In addition, the reforms will make it easier to compare the performance of default superannuation products through better information disclosure.

Box 2 The Australian Government's Stronger Super reforms

The Government has announced a range of reforms that include:

- the ability of funds to offer a new superannuation product — MySuper — authorised by the Australian Prudential Regulation Authority. Only funds that offer MySuper products (or exempt public sector superannuation schemes) will be eligible to accept default contributions and be listed as default funds in modern awards
- requiring trustees to develop a single diversified investment strategy for their MySuper product which specifies the investment return target over a 10-year period and the level of risk deemed appropriate
- introducing rules governing fees which can be charged for MySuper products by:
  - limiting the types of fees that can be charged, restricting the circumstances in which performance fees may be charged, limiting certain fees to cost recovery and prohibiting the deduction of commissions from member accounts
  - requiring a fair allocation of costs between MySuper products and other products
  - requiring all fees to be disclosed to members
- requiring equal treatment of members by giving all members of a MySuper product:
  - access to the same options, benefits and facilities
  - equal attribution of gains, losses and beneficial interests
  - the same fees (except where a discounted administration fee is offered to employees of particular employers)
  - protection against fee subsidisation (since one employee should not be favoured over another where they have the same employer)
  - the assurance that, unless they have otherwise consented, MySuper members can only be transferred to another MySuper product within the fund
  - at least a minimum default level of life and total and permanent disability insurance on an opt-out basis.

Governance and fund administration reforms will also be introduced, including:

- a requirement that the trustees promote the financial interests of the fund members
- mandatory governance, investment and insurance covenants
- a requirement that the trustees determine annually whether or not MySuper members are disadvantaged by the scale of the fund
- the development of a product dashboard where funds must publish investment return targets and their achievement, expense ratios, targeted risk and return and liquidity information, as well as fees charged per member
- capital requirements, which now cover operational risk
- a requirement that proxy voting policies be published
- new data and e-commerce standards that will include electronic transmission of linked financial and member data using standardised formats
- the use of a member's tax file number as the primary identifier.

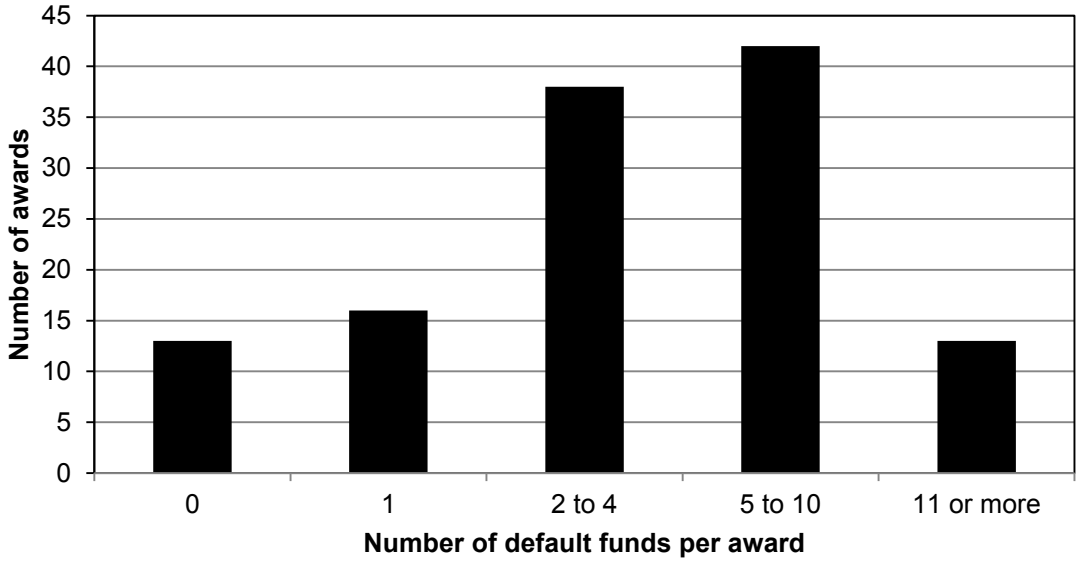
Current default superannuation system

Since 1 July 2005, most employees have been able to choose a superannuation fund, including employees to whom the superannuation provisions in a modern award apply. These employees encompass:

- award-reliant employees
- employees who receive above-award wages or conditions but rely on the award for their superannuation
- employees covered by enterprise agreements that incorporate the terms of the award by reference or are silent on a default fund, but not employees covered by enterprise agreements that specify a default fund.

Most employees do not choose a superannuation fund. In these cases, their employer is required to make superannuation contributions into a default fund and, where relevant, a fund listed in an award. Some awards cover a large and diverse range of industries and occupations, while others cover a smaller, more defined group. Of the 122 modern awards, 109 list at least one default fund, with some containing up to 18 funds (figure 1). For those modern awards that do not list a default fund, the employer may select any fund, provided it complies with the relevant superannuation legislation. Where there are grandfathering provisions in the modern award, employers can generally continue to make contributions to their previously selected default fund.

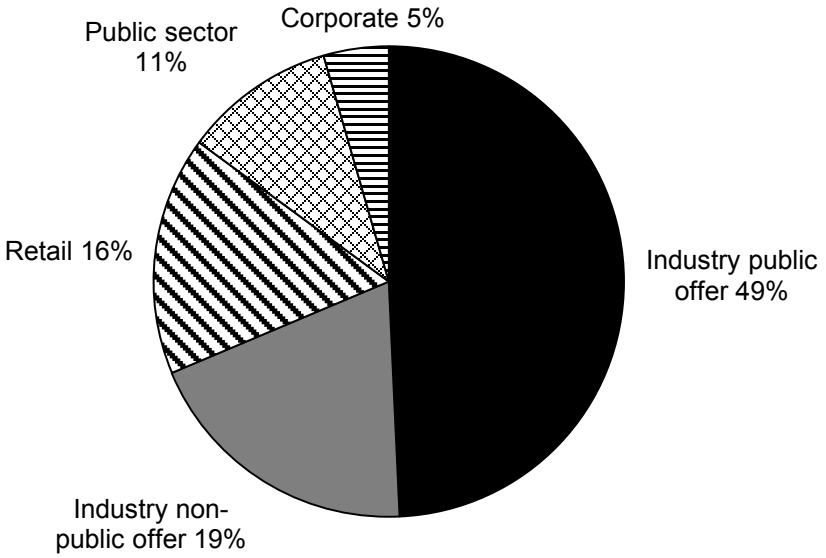
Figure 1 **Number of default superannuation funds listed in each modern award**



Default superannuation funds in Australia became embedded in most awards once superannuation was considered to be an industrial matter in national wage bargaining in the 1980s. Many industry-based superannuation funds were established to cater for employees in specific industries, and a number of these have since become public offer funds — that is, open to employees across all industries (figure 2).

Figure 2 **Indicative types of funds listed as default funds in modern awards**

67 identifiable funds, by APRA classification



With the development of modern awards during 2008 and 2009, the superannuation funds that were selected for listing in the drafts of modern awards (mainly industry funds, along with some retail and corporate funds) were largely those that were already included in the relevant award-based transitional instruments.

Following the commencement of modern awards on 1 January 2010, 23 applications have been made to list additional default funds in awards. Seventeen of these applications were granted by FWA on the basis that:

- the fund was listed as a default fund in an award-based transitional instrument relevant to the coverage of the modern award; or
- the representatives of the main parties covered by the award consented to the inclusion of the fund; or
- employers were making contributions to this fund for the benefit of employees covered by the modern award before 12 September 2008.

It is estimated that at least $7 billion, and potentially more than $10.5 billion, in superannuation contributions were made to default funds in awards in 2010 for employees to whom the superannuation provisions in a modern award apply. Award default listings therefore provide a relatively stable and predictable flow of new monies for many default superannuation funds.

How well does the current default superannuation system perform?

The Commission notes that the current default superannuation arrangements have delivered stability and above-average investment returns. Over the eight years to 2011, default funds in modern awards averaged an after-tax investment rate of return of 6.4 per cent, compared with 5.8 per cent for all funds.

While recognising this performance, the Commission has assessed the current arrangements in terms of how well they meet members' best interests. A system based on this principle would have the following features.

- Place the best interests of members as the explicit overarching objective in any criteria for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.
  - The current system is based largely on precedent and the consent of industrial parties.
- Promote contestability — all funds with MySuper products and EPSSSs have an equal chance to put their case.
  - The current system favours funds that are supported by industrial parties.
- Promote transparency — relevant information is made publicly available and actual, perceived or potential conflicts of interest are declared.
- Be procedurally fair — all parties have the right to put their case to an unbiased umpire.
  - The current system does not provide for full procedural fairness, with significant impediments for some funds to have their case to be listed as a default fund heard by FWA.
- Impose a minimum regulatory burden — each party involved should incur the minimum cost and inconvenience compatible with achieving the aims of the process.
- Promote stability in the superannuation system as a whole and hence confidence among all stakeholders.
- Be consistent with other policies — alignment with other relevant policy directions, including the Stronger Super and Future of Financial Advice reforms.

- Have scope for regular assessment — all default funds must earn their listing in a modern award on a regular basis.
  - Currently, there is no requirement for the funds listed in modern awards to be regularly assessed.

In summary, Australian employees would benefit from a default superannuation system that ensures decisions are merit based rather than primarily precedent based.

Defining selection criteria for listing default funds in modern awards

In considering potential criteria for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards, the Commission is mindful of the recent introduction of a significant number of reforms to the superannuation system. From July 2013, in addition to MySuper, there will be significant disclosure, governance and administrative reforms which are intended to make default superannuation products more transparent and comparable (box 2 above).

The Commission considers that the criteria that will be administered by the Australian Prudential Regulation Authority (APRA) for MySuper product authorisation provide a reasonable level of prescription and a sound basis for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.

That said, while the Commission does not consider there is a need for additional criteria, there are several factors that should be taken into account, as a second stage, when a decision maker is selecting funds to be listed in awards. This is for two main reasons.

- The Stronger Super reforms serve largely to standardise features and promote disclosure to improve comparability between funds, rather than filter out any fund which may not represent the best interests of members. Hence, there is a need for a 'quality filter' to distinguish between funds seeking listing in modern awards.
- There is an administrative burden for employers in being required to choose from a potentially wide range of superannuation funds. Superannuation compliance, particularly the complexity of the legislation, timing requirements for superannuation payments, and the cost of paying small amounts for casual employees, are all of concern to business. Having all funds that offer a MySuper product being listed as default funds in awards (or the practical equivalent, of not listing any funds in any awards) would add to this compliance burden and create additional search costs for employers.

The factors identified by the Commission that should be considered when assessing whether a superannuation fund should be listed as a default fund in a modern award are not overly prescriptive and nor are they exhaustive. For the most part (with the notable exception of the factor relating to a fund's administrative efficiency), they apply filters to the underlying MySuper criteria used by APRA. A decision making body will need to make an 'on-balance' judgement and may wish to also consider other factors that are of particular importance in specific cases.

The Commission is proposing that the following factors be considered in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.

Investment performance (primary factors for consideration)

- *The appropriateness of the MySuper product's investment return objective and risk profile for employees to whom the superannuation provisions in that modern award apply*: The Commission considers that the likely variation in MySuper product investment strategies — for example, in terms of asset allocation — is desirable, as it will provide a diversity of products which can match the diverse needs of employees to whom the superannuation provisions in a modern award apply. Accordingly, particular types of investment strategies should not be prescribed for default funds. Instead, consideration should be given to the appropriateness of a fund's investment return objective and risk profile for these employees.
- *The fund's expected ability to deliver on its MySuper investment return objectives*: Net investment performance (returns after fees, taxes and charges) is central to meeting the best interests of members. Nonetheless, it is widely acknowledged that past performance is no guarantee of future performance and hence the Commission does not support the setting of an explicit relative or absolute rate of return target as a criterion. However, consideration should be given to a fund's expected ability to deliver on the investment objectives outlined for their MySuper product, and past performance will give some useful insight into that ability.

Fees charged to members

- *The appropriateness of the fees charged by the MySuper product, given its stated investment return objective and risk profile*: The imposition of fee caps beyond the cost recovery limits already legislated for some fees is not recommended because of the distortions that would be introduced. However, fees should be considered in the context of the fund's stated investment return objective and risk profile for its MySuper product.

Governance and transparency

- *An assessment of whether governance structures are, as far as legislative requirements allow, consistent with meeting the best interests of members*: The Government should consider assembling a panel of corporate governance experts and relevant regulators to assess the appropriateness of board structures of default superannuation funds, including any limitations contained in the *Superannuation Industry (Supervision) Act 1993* (Cwlth). In the meantime, when considering the governance arrangements for default funds, the legislative constraints relating to the composition of some boards should not be a barrier to their selection.
- *The mechanisms put in place by fund trustees to deal with conflicts of interest, and the transparency in disclosing those conflicts*: These decisions should be made on a fund-by-fund basis.
- *The likelihood of members being switched to higher cost divisions of funds, or facing significantly higher fees for features of their policies (such as insurance), upon exiting their current employment ('flipping')*: The Commission considers the best approach for dealing with 'flipping' is to consider the likelihood and consequences of members being flipped, as assessed against the objective of meeting their best interests.

Insurance, financial advice and administrative efficiency

- *The compatibility of a fund's insurance offerings with the characteristics of employees to whom the superannuation provisions in that modern award apply*: The Commission recognises that workers in different occupations and different awards have different characteristics and face different risks, thus requiring different types of insurance. While the Stronger Super reforms will require trustees to have a duty to manage insurance solely for the benefit of members, consideration of the insurance needs of employees to whom the superannuation provisions in a modern award apply is important.
- *The quality of member- and fund-specific intra-fund advice:* The Commission considers that intra-fund advice is important in equipping members to make decisions about their superannuation.
- *The administrative efficiency of a fund*: The Commission considers funds applying to be listed in modern awards should be assessed on their administrative efficiency — in terms of minimising transaction and time costs faced by members and employers in interacting with the fund — against a set of relevant benchmarks. As the primary regulator of superannuation funds, APRA might be best placed to determine the benchmarks, in consultation with the industry.

Applying the selection criteria — an open, contestable and transparent process

Given the limitations of the current selection system outlined earlier, the Commission considers that the selection process itself needs to be reformed. To this end, the Commission has identified and assessed four options that it considers are representative of the views put to it by participants and that cover the feasible range of alternatives.

- Option 1 involves each employer choosing a fund from all of those that offer a MySuper or other approved default product.
- Option 2 represents a minimal change, where the industrial parties assess all potential funds and nominate a subset of five to ten funds to FWA for listing in awards.
- Option 3 represents a more significant change to the current industrial process, with decisions being made by a FWA panel — comprising full-time members and part-time experts — and the selection process being opened up to allow all funds to present their case to FWA to be listed in modern awards.
- Option 4 is similar to Option 3, but decisions would be made by a new expert body independent of FWA, with FWA playing a minimal role in administering the decision.

In the Commission's assessment, Option 1 would neither protect the best interests of members nor address the need of many employers for simplicity in making a choice of default fund for their employees. Under Option 2, there remains a risk that the process will not be, or will not be seen to be, sufficiently open and contestable, and that the outcomes may not be in the best interests of members. Therefore, Option 2 is not supported by the Commission.

The Commission considers that Options 3 and 4 are most aligned with the best interests of members while also addressing the needs of employers when they are choosing a default fund. Under either option the list of funds in modern awards would be limited, with a sufficient number to promote competition but a reasonable upper bound to avoid excessive search costs for employers. A range of five to ten funds per award is recommended.

Under Option 3, all superannuation funds that seek listing as a default fund in a modern award would, on application, be given independent standing before FWA in order to make their case based on the factors for consideration.

Following the receipt of applications there would be a period in which any party with standing or sufficient interest (including a superannuation fund) would be able

to make a submission to FWA. The industrial parties could still put forward a collective view on their preferred short list of funds, but these views would not be formally given any more weight than other submissions. Moreover, any party making a submission would need to disclose any actual, perceived or potential conflicts of interest.

To ensure relevant expertise in FWA, it would establish a specific purpose panel to assess the applications. The panel would comprise full-time FWA Commissioners and part-time members with expertise in a range of areas, which could include finance and superannuation. The part-time panel members would be appointed in their own right, through a transparent process, rather than as representatives of particular organisations. The panel could operate similarly to the existing FWA Minimum Wage Panel. A secretariat with some expertise in superannuation would also need to be established within FWA.

To strengthen procedural fairness, the selection process would take place in two stages. First, the FWA panel would consider the applications and responses to those applications, and would issue a draft decision. This decision would be based on the panel's best assessment of which funds are most suitable for listing in a particular modern award (or group of modern awards), using the factors for consideration identified by the Commission and being guided by the overarching objective of meeting the best interests of members.

Second, following the release of the draft decision, there would be a period for further submissions from any party with standing or sufficient interest, including the applicant superannuation fund(s). At this point, the FWA panel could hold a hearing to gather more evidence, if it deemed it necessary. The FWA panel would then release and publish its final decision, and the reasons for that decision.

Under Option 4 the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards would be undertaken by a newly established expert body which is independent of FWA. The independent body would be established with the sole purpose of performing the task of selecting and assessing funds to be listed in modern awards. The body would be made up of a panel of experts with the necessary skills (such as in finance and superannuation) and experience. These experts would be appointed in their own right, through a transparent process, rather than as representatives of particular organisations.

The stages of the process would be very similar to Option 3, the key difference being that the consideration and decision would be made by the independent body rather than FWA. In this option, FWA (in its current form) would play a minimal

role — it would essentially administer the decision by way of inserting the list of funds in the relevant awards.

As with Option 3, the independent body would make its assessment based on the factors for consideration and its reasons for selecting particular funds would be published. It would need to consider all applications and be guided by the objective of making decisions in the best interests of members where a superannuation provision in a modern award applies. There is merit in the independent body having the research and administrative support of a secretariat and this function could be provided most efficiently through an existing organisation, such as APRA.

The Commission is seeking further feedback from participants on the relative merits of Options 3 and 4.

Irrespective of the reform option chosen, the Commission considers that in any reformed process:

- all funds that have MySuper authorisation from APRA (as well as EPSSSs) are able to apply to be listed in a modern award and have the application considered on its merits
- existing grandfathering provisions relating to superannuation funds would be removed from modern awards
- there is an ongoing assessment that would enable the removal of funds in exceptional circumstances
- a wholesale reassessment takes place every eight years, at which time the full selection process would be repeated and all funds that wish to be listed in awards would need to apply or reapply
  - mid-way between each wholesale reassessment, a light handed assessment is undertaken at which time funds could be removed from, but not added to, awards
- there is an appeal mechanism that strikes a balance between allowing parties the right to appeal where there are sufficient grounds to do so, while discouraging vexatious claims.

As the obligation to pay superannuation contributions rests with an employer, it is reasonable that employers who wish to do so be given some scope to choose a default fund outside of those listed in awards. This would add a competitive element to the system which will enhance incentives for all superannuation funds to meet the best interests of members. Moreover, it has the potential, in some circumstances, to allow for closer tailoring of superannuation to the needs of particular workplaces than is possible under a system based on awards.

Given this, the Commission recommends that under any reform option chosen, employers who wish to choose a fund other than one listed in the applicable modern award should be able to do so, provided they can demonstrate, upon request, that their employees will be at least no worse off than if the employer had chosen a listed award.

While the focus of this inquiry is on funds listed in awards, the Commission considers that the factors for consideration outlined earlier could also be useful in the decision-making process for all default fund members. For example, the factors could provide useful guidance for employers where an award does not list default funds, and for parties who negotiate default fund arrangements under enterprise agreements.

Implementation and transition

The Commission acknowledges the significant reforms already underway through Stronger Super and that the industry is undergoing a significant transition period to the new regime. Nonetheless, given that the Commission's reforms build on the foundations of the Stronger Super reforms, a commencement as soon as practicable during 2014 would be ideal.

The reforms will affect stakeholders in different ways.

- Default fund members will benefit from the increased competition in the default fund market. However, some members may need to change funds or may find themselves with multiple accounts.
- Some employers will benefit from the improved administrative efficiencies of the funds they deal with. Some employers will incur additional costs, as they will be required to change default funds or select a fund that is in their employees' best interests.
- The addition and removal of funds from default listings will mean that the reforms will not affect all funds in the same way. However, all funds that wish to be listed as a default fund in awards (including those that are currently listed) will need to submit an application.
- The body that becomes the default fund decision maker will have a range of responsibilities and functions, and will need to be resourced appropriately.

The Commission's preferred Options 3 and 4 propose, respectively, that FWA or a new independent body would be the default fund decision maker. Under either option, the affected body (with the assistance of experts and a secretariat) would need to perform a range of new functions (such as assessing submissions against the

issues for consideration identified by the Commission), and will require additional resourcing to undertake this role. The additional resourcing will need to be sufficient to obtain the necessary breadth of expertise to conduct the functions in a professional and rigorous manner.

The Commission also considers that there is merit in conducting an independent public review after the first wholesale reassessment of funds, to ensure that the criteria for default fund selection remain useful and relevant and that the selection process is working as intended. Ideally, such a review would occur in 2023.

Draft recommendations, findings and information requests

Factors for consideration in the selection and ongoing assessment of default funds in modern awards

DRAFT FINDING 7.1

There is no case for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards to involve any prescriptive criteria over and above those used by the Australian Prudential Regulation Authority in authorising MySuper products.

DRAFT RECOMMENDATIONS 4.1, 4.2, 4.3, 5.1, 5.3, 5.4, 6.1, 6.2, 6.3

The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should have the best interests of members as the primary objective. The following factors should, at a minimum, be taken into consideration, but not as prescriptive criteria.

- ***The appropriateness of the MySuper product's investment return objective and risk profile for employees to whom the superannuation provisions in that modern award apply (as a primary factor) (4.1).***
- ***The fund's expected ability to deliver on the MySuper product's investment objectives (as a primary factor) (4.2).***
- ***The appropriateness of the fees charged by the MySuper product, given its stated investment return objective and risk profile (4.3).***
- ***Whether governance structures are, as far as legislative requirements allow, consistent with meeting the best interests of members (5.1).***
- ***The mechanisms put in place by fund trustees to deal with conflicts of interest, and the transparency in disclosing those conflicts (5.3).***
- ***The likelihood of members being switched to higher cost divisions of the fund, or facing significantly higher fees for features of their policies (such as insurance), upon exiting their current employment (5.4).***

- ***The compatibility of the fund's insurance offerings with the characteristics of employees to whom the superannuation provisions in that modern award apply (6.1).***
- ***The quality of member- and fund-specific intra-fund advice (6.2).***
- ***The administrative efficiency of the fund, according to a set of benchmarks determined by the Australian Prudential Regulation Authority (or another appropriate body) in consultation with the industry (6.3).***

DRAFT RECOMMENDATION 4.4

The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should not include scale as a specific criterion over and above the MySuper 'scale test'.

DRAFT RECOMMENDATION 5.2

The Australian Government should consider assembling a panel of corporate governance experts and relevant regulators to assess the appropriateness of board structures of default superannuation funds, including any limitations contained in the Superannuation Industry (Supervision) Act 1993.

Principles for designing a selection process

DRAFT RECOMMENDATION 7.1

The process used in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should adhere to the following principles.

- ***Best interests of members — there is an explicit focus on members' interests.***
- ***Contestability — all funds have an equal chance to put forward their case for consideration.***
- ***Transparency — relevant information is made publicly available and potential conflicts of interest are declared.***
- ***Procedural fairness — all parties have the right to put forward their case for consideration to an unbiased umpire.***
- ***Minimum regulatory burden — each party involved incurs the minimum cost and inconvenience compatible with achieving the aims of the process.***
- ***Avoidance of instability — the broader superannuation system is not destabilised.***

- ***Consistency with other policies — the process aligns with other relevant policy directions, including the Stronger Super and Future of Financial Advice reforms.***
- ***Regular assessment — all default funds must earn their listing in an award on a regular basis.***

DRAFT FINDING 7.2

The process currently used in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards has the following strengths. It:

- *has generally led to the listing of funds that have delivered above-average returns for members*
- *has a measure of transparency*
- *imposes few regulatory burdens and fosters stability in the superannuation system.*

The process has the following shortcomings. It:

- *does not explicitly require decision makers to act in the best interests of default fund members, or to consider the regulatory and administrative burden that may result from their decisions*
- *does not give equal access to all superannuation funds and therefore lacks contestability*
- *is insufficiently transparent*
- *lacks important elements of procedural fairness*
- *has inadequate mechanisms for the ongoing assessment of funds.*

Reforming the selection process

DRAFT RECOMMENDATION 8.1

All funds that are authorised to offer a MySuper product (and exempt public sector superannuation schemes) should be able to apply to be listed in an award and have the application considered on its merits. An applicant's case should be outlined and assessed against the factors for consideration identified by the Commission. Other factors could be taken into account for individual awards at the decision maker's discretion.

DRAFT RECOMMENDATION 8.2

Employers selecting default funds for employees to whom the superannuation provisions in modern awards apply should be able to choose a fund not listed in the relevant award. However, in this circumstance, employers should be required to justify their choice, if called upon, by demonstrating that:

- ***the factors for consideration identified by the Commission were taken into account when making the decision***
- ***their employees are at least no worse off than if the employer had chosen a fund listed in the relevant award.***

INFORMATION REQUEST

The Commission is seeking feedback on which body, under each of the options presented below, would monitor compliance with the requirement that employers choosing a fund not listed in the relevant award justify their choice if called upon, and how they would do so.

DRAFT RECOMMENDATION 8.3

Grandfathering provisions relating to superannuation should be removed from all modern awards.

DRAFT RECOMMENDATION 8.4

Modern awards that list default superannuation funds should list no fewer than five and no more than ten funds.

DRAFT RECOMMENDATION 8.5

There should be an ongoing assessment of the list of superannuation funds in modern awards to ensure that any demonstrably unsuitable, unauthorised or non-existent funds are removed as required. In addition, a wholesale reassessment should occur every eight years at which time the full selection process would be repeated and all funds that wish to be listed in awards would need to apply or reapply. Mid-way between each reassessment, a light-handed interim assessment should be undertaken, at which time funds could be removed from, but not added to, awards.

DRAFT RECOMMENDATION 8.6

The process used in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should allow for appeals. Appeal mechanisms should strike a balance between allowing all parties with sufficient interest the right to appeal, where there are sufficient grounds to do so, while discouraging vexatious claims.

DRAFT PRINCIPAL FINDING 8.1

The Commission has identified and assessed four options for reform to the process for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.

- *Option 1 involves all employers choosing from all funds that offer a MySuper product or other approved default product.*
- *Option 2 represents a minimal change, where the industrial parties assess all potential funds and nominate a subset to Fair Work Australia (FWA) for listing in awards.*
- *Option 3 represents a more significant change to the current industrial process, with decisions being made by an expert panel within FWA, and the selection process being opened up to allow all funds to present their case for inclusion in awards to FWA.*
- *Option 4 is similar to Option 3, but decisions would be made by an expert body independent of FWA, with FWA playing a minimal role in administering the decision.*

Option 1 does not, by itself, sufficiently protect the best interests of employees and would result in high search costs for employers. Option 2 does not sufficiently open up the process by which funds are listed in awards to greater contestability or ensure that, in perception as well as in reality, the best interests of members are taken into account. Therefore, Options 1 and 2 are ruled out by the Commission.

The Commission considers that Options 3 and 4 best adhere to the principles for an effective process for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. In particular, Options 3 and 4 are most aligned with the best interests of members while also addressing the needs of employers when they are choosing a default fund.

INFORMATION REQUEST

The Commission is seeking feedback from participants on the relative merits of Options 3 and 4.

Transition issues and future review

DRAFT RECOMMENDATION 9.1

The legislative and policy changes necessary to give effect to the Commission's recommended reforms should ideally be put in place in 2013 and 2014, so that the new process, together with the consideration of factors relevant to the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards, can be conducted during 2014, and potentially coincide with the review of modern awards.

DRAFT RECOMMENDATION 9.2

The superannuation fund names and identifying numbers used by the Australian Prudential Regulation Authority should be used by Fair Work Australia to list superannuation funds in modern awards.

INFORMATION REQUEST

The Commission seeks further information on the way that default products offered by exempt public sector superannuation schemes and non-public offer funds should be treated as part of its proposed reforms.

DRAFT RECOMMENDATION 9.3

An independent public review of the arrangements for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should be conducted in 2023. Amongst other things, the review should examine whether:

- ***the factors considered in selecting funds for listing in awards remain useful and relevant***
- ***the selection process is working to deliver outcomes that are in the best interests of default fund members***
- ***there is an ongoing need to list default funds in awards.***

1 About the inquiry

The Australian Government has asked the Productivity Commission to design criteria for the selection and ongoing assessment of superannuation funds eligible for nomination as default funds in modern awards by Fair Work Australia (FWA).

1.1 Background to this inquiry

Compulsory superannuation is a core element of Australia's retirement income system. Since the introduction of superannuation guarantee legislation in 1992, employers have made compulsory superannuation contributions on behalf of most Australian employees. Employers must currently contribute 9 per cent of an employee's ordinary time earnings. This will rise to 12 per cent by 2019-20. Superannuation contributions, superannuation earnings, and withdrawals from the superannuation system receive concessional tax treatment.

In May 2009, the Australian Government commissioned the *Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System* (the Cooper Review). The Cooper Review provided its final report to the Government on 30 June 2010. Arising from the Government's response to the Review, the superannuation industry is in the midst of implementing major reforms, with many details still to be finalised.

A key finding of the Cooper Review is that many consumers do not have the interest, information or expertise required to make informed choices about their superannuation. Therefore, consumers rely heavily on default superannuation arrangements. The Review recommended the establishment of a new default superannuation product, MySuper. The Government accepted this recommendation, and superannuation funds will begin offering MySuper products from July 2013.

The Cooper Review also recommended that the Productivity Commission conduct a review of the processes by which default funds are nominated in awards to assess whether those processes are sufficiently open and competitive.

At present, there are two main ways in which superannuation funds are selected as defaults for those employees who do not choose a fund.

- Most of the 122 modern awards contain a list of default superannuation funds, selected primarily on precedent and the consent of industrial parties. Employers must use one of the listed funds as a default fund for employees, for whom superannuation provisions in modern awards apply. Where more than one fund is listed, employers choose among those funds. This means employers may need to choose different default funds for workers reliant on different awards. If no default fund is listed in an award, employers are free to choose a default fund, provided it complies with the relevant superannuation legislation.
- Many other industrial instruments, such as enterprise agreements and state awards, also list default funds. Depending on the industrial instrument, employers choose the default fund in consultation with employees, and industrial parties may also have a role.

The Government has stated in the terms of reference for this inquiry that it believes that default superannuation funds should continue to be included in modern awards.

1.2 The Commission's approach to the inquiry

In keeping with the *Productivity Commission Act 1998* (Cwlth), the Commission has conducted this inquiry using open, transparent and public processes, with an overarching concern for the wellbeing of the Australian community as a whole.

The Commission published an issues paper in February 2012 and met with a range of interested parties, including: industry and union bodies; industry and retail superannuation funds; academics and Australian Government officials.

A total of 54 submissions have been received since this inquiry was announced. Appendix A provides details of the individuals and organisations who have participated in the inquiry to date, through submissions and visits.

The Commission now invites comment and submissions on this draft report. Following a second round of submissions, public hearings and further consultations, a final report will be provided to the Government by 6 October 2012.

1.3 What has the Commission been asked to do?

The Commission has been asked to design criteria for the selection and ongoing assessment of superannuation funds eligible for nomination as default funds in

modern awards by FWA. While the Commission has been asked to focus on factors that optimise outcomes for members, it is also to also consider the impacts on other stakeholders.

The Government has asked the Commission to consider the interaction of this inquiry with the design and implementation of MySuper, which introduces a range of new standards for default superannuation products. Once MySuper is in place, only superannuation funds that offer a MySuper product will be eligible to accept default contributions, or to be listed as a default fund in modern awards (though there are exceptions for certain public sector superannuation schemes).

Accordingly, the Commission has considered whether there is a net benefit to members, and to other stakeholders, in designing criteria over and above those that will be required by the Australian Prudential Regulation Authority (APRA) to authorise a MySuper product. In conducting its analysis and proposing its recommendations, the Commission has taken the best interests of default fund members as the primary goal, but has also been mindful of the administrative and compliance impact on employers and their representatives, unions, superannuation funds, FWA and APRA.

2 Default superannuation funds in modern awards

Key points

- Australia's superannuation system managed $1.3 trillion in assets at the end of 2011 (which is equivalent to Australia's GDP). This is predicted to reach 150 per cent of Australia's GDP by around 2040.
- Between 1996 and 2011, the number of superannuation funds regulated by the Australian Prudential Regulation Authority (APRA) decreased from 4747 to 386. Significant fund consolidation is expected to continue, but the rate at which this will take place is uncertain. Between 2000 and 2009, the number of self-managed funds doubled, and these funds now hold about 30 per cent of total superannuation assets.
- Employers' obligations to make superannuation contributions evolved as part of the industrial relations system. In 1992, employer contributions were extended to almost all employees by the superannuation guarantee legislation. Within this compulsory superannuation system, since 1 July 2005 most employees have had the right to choose a superannuation fund.
- Default superannuation funds are listed in modern awards, and one of the listed funds must be used for employees to whom the superannuation provisions in a modern award apply. These are award-reliant employees, above-award employees, and employees covered by enterprise agreements that incorporate the terms of the award by reference or are silent on the default fund, but not employees covered by enterprise agreements that specify a default fund.
- There are 122 modern awards listing 103 default funds, although there are only 85 distinct funds listed. Of these 85 funds, 18 are not included on APRA's list of active funds (because of mergers, name changes or closures). Of the remaining 67 default funds, 46 are classified by APRA as industry funds, 11 are classified as retail, seven are public sector and three are corporate funds.
- It is estimated that at least $7 billion, and potentially more than $10.5 billion, in superannuation contributions were made to default funds in awards in 2010 for employees to whom the superannuation provisions in the modern award apply.
- Limited data and anecdotal evidence suggest that the superannuation funds chosen in awards also influence the funds chosen in collective agreements.

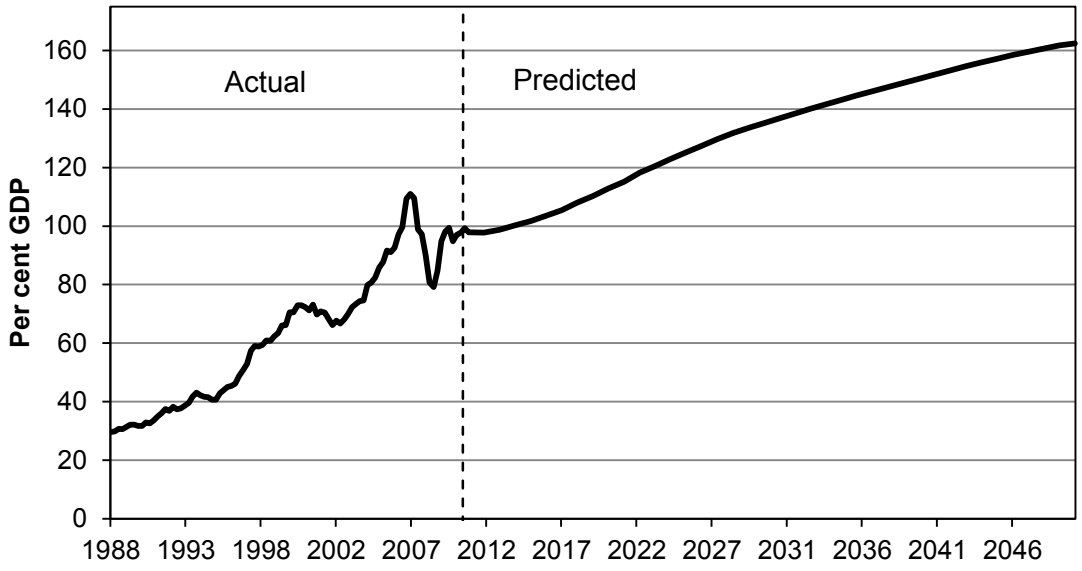
2.1 Default superannuation funds as part of Australia's superannuation system

Default funds are part of a large and growing compulsory system

Australia has a three-pillar retirement income system involving a government-funded and means-tested age pension, voluntary savings which are treated favourably for tax purposes, and compulsory superannuation. The focus of this report is the compulsory superannuation pillar, and in particular the default arrangements that are in place for 'employees to whom the superannuation provisions in a modern award apply' and who do not choose a fund into which their compulsory superannuation contributions will be paid.

Assets in the superannuation industry have grown rapidly since 1992. At the end of 2011, total superannuation assets reached $1.3 trillion (APRA 2012d), which was equivalent to Australia's GDP (ABS 2012d). This growth is expected to continue, and it has been estimated that superannuation assets will reach 150 per cent of GDP by around 2040 (figure 2.1).

Figure 2.1 **Predicted superannuation assets as a percentage of GDP**



Source: Gruen (2011).

Superannuation effectively became compulsory in 1992 with the introduction of the superannuation guarantee legislation. This guarantee now requires employers to make superannuation contributions for most employees at the rate of 9 per cent of ordinary time earnings. This rate will progressively increase to 12 per cent by 2019-20 (DEEWR 2012b). The superannuation guarantee applies to almost all

employees, except those earning less than $450 a month (with limited exceptions), part-time employees under 18 years of age, and employees over 70 years of age (though this age limit will increase to 75 by 1 July 2013) (ATO 2012a). A maximum contribution base ($43 820 per quarter in 2012) also applies (ATO 2012b).

Within the compulsory superannuation system, since 1 July 2005 most employees have had the right to choose a fund. In the event that an employee does not choose a fund (box 2.1), an employer must make superannuation contributions for employees to whom the superannuation provisions in a modern award apply into one of the default funds listed in the award. Where the award does not list a default fund, employers can make superannuation contributions to any complying fund under the *Superannuation Industry (Supervision) Act 1993* (Cwlth) (the SIS Act) (ATO 2011a).

Box 2.1 How many employees exercise choice of fund?

There is a wide variety of estimates of how many employees exercise choice of superannuation fund in any given year.

Choice of fund refers to whether or not an employee actively chooses a superannuation fund. There are a range of estimates.

- 44 per cent of employees do not take any active role in determining the fund to which their contributions are made, and a further 26 per cent select the default fund offered by the employer, which means about 70 per cent of employees are in the default fund (ABS 2007).
- Projections indicate that, over time, about 90 per cent of employees will not choose a fund (Clare 2006; Fear and Pace 2008).
- 50 to 70 per cent of employees use the default fund (Colmar Brunton 2010a).

Measures of whether or not a member is in the default investment option might also provide some indication of choice of fund, although a member who chooses a fund might also choose to be in the fund's default investment option.

- Of those who default into the superannuation fund chosen by their employer, roughly 80 per cent are in the default investment option. Anecdotal evidence suggests that about 20 per cent of these actively chose to be there, meaning that about 60 per cent of members do not make active choices about their superannuation (Australian Government 2010a).
- 18 per cent of employees do not accept the default investment position within their fund (Super Ratings 2006; Gallery, Gallery and McDougall. 2010).

Regulation of the superannuation industry

The Australian superannuation industry is highly regulated, with a number of agencies having a role (box 2.2). The Australian Prudential Regulation Authority (APRA) has the primary regulatory role, as it regulates industry, retail, corporate and some public sector funds (APRA 2005).

- Industry funds, which have traditionally drawn members from a range of employers across a single industry, are generally established under an agreement between parties to an industrial award. These funds are increasingly public offer, and thus accept members from across all industries. The boards of these funds have an equal number of employer and employee representatives, and sometimes one or more independent directors.
- Retail funds, which offer superannuation products to the public on a commercial public offer basis, are usually run by large financial institutions.
- Corporate funds, which are sponsored by one or more employers.
- Public sector funds, which have a government agency or government-owned corporation as their sponsoring entity. Although some are regulated by APRA, there are also a number of public sector funds that are exempt. Exempt public sector superannuation schemes (EPSSSs) are subject to a heads of government agreement between the Commonwealth and State Governments under which the schemes are operated (to the extent practicable) in accordance with core legislative requirements.

Trustees of APRA-regulated funds must be licensed under the SIS Act. Each licensed trustee must comply with a number of ongoing requirements, including proper and prudent performance of their duties, compliance with fit and proper standards, and registration with APRA of each superannuation fund of which the trustee is a licensed trustee (APRA 2004). In addition, the SIS Act requires equal numbers of employer and employee representatives on the boards of employer-sponsored funds, subject to certain exceptions. There is also a requirement for default products offered by superannuation funds to include a minimum level of life insurance.

Box 2.2 **Regulatory arrangements for superannuation**

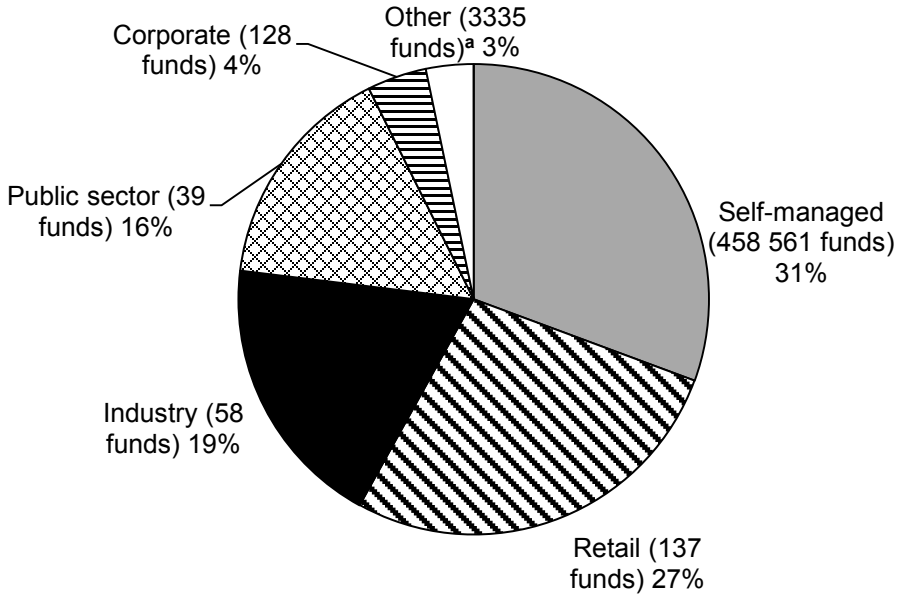
The Australian Prudential Regulation Authority enforces the prudential standards it administers. However, there are several agencies that have responsibilities for superannuation regulation.

- The Superannuation Complaints Tribunal hears complaints relating to the conduct of trustees of superannuation funds.
- Fair Work Australia regulates the industrial relations system and the listing of default funds in awards.
- Failure to make compulsory superannuation contributions results in the employer being liable for a superannuation guarantee charge. This is enforced by the Australian Taxation Office (ATO). The ATO also regulates self-managed superannuation funds.
- Although the Fair Work Ombudsman is responsible for the enforcement of industrial relations laws, it does not enforce payment of superannuation. Complaints received by the Fair Work Ombudsman about non-payment of superannuation are referred to the ATO.
- The Australian Securities and Investments Commission licenses financial advisers and has a general consumer protection role in the financial services industry, including superannuation and insurance.
- The Australian Competition and Consumer Commission has a general role in ensuring competition in a market. It regulates anti-competitive conduct such as price-fixing, cartels, anti-competitive agreements and misuse of market power. It is also responsible for reviewing mergers that could substantially lessen competition.

Sources: ACCC (2008, 2012); ASIC (2012a); ATO (2011a, 2011b); FWO (2011a); SCT (2009).

Other than EPSSSs, self-managed superannuation funds (SMSFs) are the main type of superannuation fund not regulated by APRA. SMSFs have fewer than five members, and are the largest and fastest-growing superannuation sector. From 2000 to 2009, the number of SMSFs almost doubled (about 30 000 new SMSFs were established each year between 2007 to 2011, and during this period, SMSF assets grew at twice the rate of total superannuation assets). As at September 2010, there were about 435 000 SMSFs with over $400 billion in assets, which is about 30 per cent of assets in the entire industry (figure 2.2) (ATO 2011c, 2012c; Australian Government 2009).

Figure 2.2 **Superannuation industry profile**
(Number of funds, per cent share of assets), December 2011



a Other funds, which are not APRA-regulated, comprise pooled superannuation trusts and balance of life office statutory funds. Retirement savings providers have not been included in this figure, as they accounted for 0.1 per cent of assets at December 2011.

Sources: APRA (2012d) performance results based on quarterly data for superannuation funds including APRA-reporting exempt public sector superannuation schemes, pooled superannuation trusts, and retirement savings accounts.

By contrast, between 1996 and 2011, the number of APRA-regulated superannuation funds decreased from 4747 to 386 and this consolidation is expected to continue in coming years, although the rate at which this will take place is uncertain. Estimates for the Cooper Review indicate that, if the number of corporate funds declines at 20 per cent per annum, the number of industry and retail funds declines at 7 per cent per annum, and the number of public sector funds declines at 2 per cent per annum, there will be around 74 APRA-regulated funds by 2035 (Australian Government 2010a).

Mergers of superannuation funds can be influenced by a favourable capital gains tax outcome (TowersWatson 2010) and economies of scale in their operating and investment costs (Higgs and Worthington 2010; Sy and Liu 2010). However, the impact of the Stronger Super reforms (discussed later) on the economies of scale of superannuation funds and their rates of consolidation is uncertain (Deloitte 2010; Rice Warner 2010).

Although the superannuation industry has consolidated rapidly, total assets have generally continued to grow, increasing from $245 billion to $1.3 trillion between 1996 and 2011 (APRA 2007, 2012d).

Despite the overall size of the industry, total assets per member are relatively low, and since each individual holds an average of three accounts in APRA-regulated funds, average individual account balances are even smaller (table 2.1).

Table 2.1 **Average member superannuation assets in APRA-regulated funds**

By fund type, 2009

Type of fund	*Average account balance*	*Average member balance*
	$	$
Corporate	98 493	133 492
Industry	21 895	32 895
Public sector	62 456	100 302
Retail	24 526	46 710

Source: Estimates for the Cooper Review (Australian Government 2010b).

Employers' role in superannuation

In June 2011, there were 826 389 employers in Australia, and almost 90 per cent of these were small businesses (ABS 2012a). Excluding working proprietors[1], employees of small businesses (employing less than 20 employees) accounted for just under 30 per cent of private sector employment (ABS 2011a, 2012a; Farmarkis-Gamboni and Rozenbes 2012). Small employers are more likely to rely on awards or individual arrangements, while larger employers are more likely to use collective agreements (ABS 2011b).

Employer compliance with the superannuation guarantee is difficult to determine as the available data are limited and unreliable. In 2000, about 5 per cent of employees did not receive any of their superannuation guarantee entitlement (that is, their employers did not make the superannuation contributions they were required to make by law). Employees of small businesses, casual employees, and employees aged between 18 and 25 years were at higher risk of receiving no or insufficient superannuation contributions. This was particularly the case for employees in certain industries (arts and recreation; accommodation and food; agriculture, forestry, and fishing; and transport, postal and warehousing) (IGT 2010).

Superannuation compliance, particularly the complexity of the legislation, the costs of administering employee choice of fund, timing requirements for superannuation

[1] Employers are required to pay superannuation for most of their employees. This includes directors of a business, and family members employed by a family company or trust. However, sole traders and partners in a partnership do not have to make contributions to a superannuation fund for themselves (ATO 2011a).

payments, and the cost of paying small amounts for casual employees, is of concern to employers (Australian Government 2006). Small employers in particular might experience higher compliance costs than larger employers.

> … the involvement of small business people in the superannuation system … is also an unreasonable task to impose on small business people who are not only not skilled in superannuation and are the only people in the superannuation system who are not paid for their contribution which is the choice, collection and distribution of funds. (COSBOA, sub. 7, p. 4)

The availability of clearing houses can help reduce compliance costs for employers. The Medicare Clearing House was introduced on 1 July 2010 for small businesses with less than 20 employees. It aims to reduce costs by allowing superannuation contributions to be paid to a single location and then distributed electronically (Treasury 2008). At the end of November 2011, over 14 000 small employers (less than 2 per cent) had signed up to the clearing house, and over $100 million in contributions had been made for just over 79 000 employees (Department of Human Services 2011). There are also private clearing houses which are used by large employers.

> Clearing houses themselves are a critical component of efficient superannuation administration across larger employers. With large numbers of employees and many of these entitled to exercise choice of fund, the number of default funds which are required can be significant. Without the use of clearing houses, larger employers would be overwhelmed. (REST Industry Super, sub. 47, p. 10)

The listing of one or more default funds, which currently occurs in many industrial instruments, relieves employers of the burden of having to research and choose an appropriate default fund (Fear and Pace 2008).

2.2 Australia's industrial relations system

Awards, agreements and individual arrangements

Currently, default superannuation fund arrangements in Australia are part of industrial awards and hence part of Australia's industrial relations system. Understanding the nature and scope of industrial awards is therefore critical to understanding the close interaction between superannuation and the industrial relations system. Modern awards apply to those employees who are employed under the national industrial relations system and for whom the award, and not some other industrial instrument, determines the terms and conditions of their employment (Preston et al. 2012).

Australia's industrial relations system has both a federal and a state jurisdiction, though it moved to a predominantly national system when the *Fair Work Act 2009* (Cwlth) reforms were introduced. In May 2010, 87 per cent of all employees (7.8 million) were in the federal system (ABS 2012c).

Coverage of the federal industrial relations system differs between states. Victoria, the Northern Territory and the ACT are entirely covered by that system — Victoria referred its industrial relations powers to the Commonwealth in 1996 (Business Victoria 2011). Although businesses in Queensland, New South Wales and South Australia are covered by the federal system, state and local government sector employers in these states are covered by state industrial relations legislation (FWO 2011b). In Tasmania, only local government sector employers are covered by the state industrial relations system. In Western Australia, only employees of constitutional corporations (foreign, trading or financial corporations) are covered by the Fair Work Act. All other employees in Western Australia — including state and local governments, sole traders, partnerships and trusts — are covered by the state legislation (Department of Commerce 2012). For employees not covered by the federal system and subject to state industrial instruments, default funds might be listed in these state industrial instruments.

Industrial instruments can be broadly grouped into three categories: awards, individual arrangements and collective agreements.

- Awards set minimum pay and conditions for employees in a particular industry or occupation. The 122 new federal awards — called 'modern awards' — are part of the national industrial relations system and commenced on 1 January 2010. Some entitlements from state awards are still being transitioned into the national system, and a number of federal awards made prior to 1 January 2010 covering individual enterprises and public sector employees are yet to be modernised. About 15 per cent of employees are solely reliant on awards for their pay and conditions.
- The individual arrangements allowed by the new national industrial relations system are common law contracts, above-award payments and individual flexibility arrangements. These arrangements are all unregistered, but still subject to regulation under the Fair Work Act. Some individual agreements implemented under the previous industrial relations system (such as Australian workplace agreements) are still in force but are being gradually phased out. About 37 per cent of employees were covered by different types of individual arrangements in May 2010 (ABS 2011b), and almost all of these were unregistered (ABS 2012c).
- Collective agreements under the new national industrial relations system are known as enterprise agreements. However, collective agreements from the

previous industrial relations system (such as certified agreements) are still in force until they are replaced by a new agreement made under the Fair Work Act. There were an estimated 115 000 collective agreements in force in May 2010, covering about 43 per cent of employees (ABS 2011b; DEEWR 2012a).

Of all the industrial instruments in force, only enterprise agreements and individual flexibility arrangements (which were introduced by the new national industrial relations system) are subject to the 'better off overall' test under the Fair Work Act. This test requires that each of the employees that were covered by the award are better off overall under the new agreement than they would be under the relevant award (FWA 2012a).

Employees to whom the superannuation provisions in the award apply

The Fair Work Act makes a distinction between employees who are covered by an award, and employees who are award reliant. An employee is covered by the award if they are in a group of employees expressed to be within the scope of the award. By contrast, an employee will only be award reliant if their pay and conditions are solely determined by the award, and not some other industrial instrument (Preston et al. 2012).

However, in this inquiry, the Commission is primarily concerned with employees who are subject to the default funds listed in the modern award, and refers to them as being 'employees to whom the superannuation provisions in a modern award apply'. This encompasses three categories of employees.

- Award-reliant employees, who have all the terms and conditions of their employment, including their default superannuation fund, determined by the award.
- Employees who receive some above-award wages or conditions through an individual arrangement, but have the other terms and conditions of their employment, including their default superannuation fund, determined by the award. Although around 37 per cent of employees were employed under individual arrangements in May 2010, it is uncertain how many of these were above-award arrangements (ABS 2011b).
- Employees covered by enterprise agreements that incorporate the terms of the award by reference or are silent on a default fund, but not employees covered by enterprise agreements that specify a default fund.

Profiling award-reliant employees

In May 2010, 15 per cent of employees had their pay solely determined by an award (table 2.2). This category is broader than the Fair Work Australia (FWA) definition of award-reliant employees, since it includes instruments other than modern awards, such as award-based transitional instruments. However, the data for award-only employees is the best available proxy for award-reliant employees. These employees received, on average, 7.8 per cent of wages paid in that year (ABS 2011b).

Table 2.2 **Methods of setting pay**
May 2010

	Number of employees	*Percentage*
	'000	%
Award only	1 361	15.2
Collective agreement[a]	3 892	43.4
Individual arrangement[b]	3 346	37.3
Owner manager of incorporated enterprise	368	4.1
All methods of setting pay	**8 968**	**100**

[a] Includes registered and unregistered agreements. [b] Includes registered and unregistered arrangements.
Source: ABS (2011b).

Award reliance varies by industry, and tends to be lower in more highly skilled industries (Rozenbes 2010).

> … the distribution of award reliance for setting pay is quite focussed. Over 70% of employees who are award-reliant for pay are employed in five of the 18 ANZSIC industry divisions. In descending order of importance these are accommodation and food services, retail trade, health care and social assistance, administrative and support services and manufacturing, which in May 2010 employed over 970,000 of the 1.36 million award-reliant employees identified in the survey. (ACCI, sub. 37, p. 15)

Industries that have a high proportion of award-reliant employees also tend to have a high proportion of part-time and casual employees.

> The hospitality industry workforce is characterised by a higher proportion of younger employees and people working on either a casual or part time basis (such as parents with young children, people earning a second income, etc.) (Australian Hotels Association, sub. 10, p. 8)

The coverage of modern awards does not correspond to the industry classifications in table 2.3 (since modern awards can cover more than one industry, or cover one or more occupations rather than a single industry). Accordingly, the data on award-only employees by industry can only provide some indication of award-reliant employees by industry (Preston et al. 2012). Additionally, some

awards (such as the Social, Community, Home Care and Disability Services Industry Award 2010) cover a large and diverse range of industries and occupations, while others (such as the Poultry Processing Award 2010) cover a smaller, more defined group.

Table 2.3 **Percentage of award-only employees, by industry**
May 2010

	Number of employees	*Percentage*
	'000	%
Accommodation and food services	291.6	21.4
Retail trade	204.9	15.0
Health care and social assistance	193.6	14.2
Administrative and support services	161.0	11.8
Manufacturing	120.8	8.9
Other services	88.2	6.5
Construction	53.2	3.9
Wholesale trade	45.9	3.4
Education and training	43.1	3.2
Rental, hiring and real estate services	40.3	3.0
Transport, postal and warehousing	32.9	2.4
Professional, scientific and technical services	26.2	1.9
Arts and recreation services	24.1	1.8
Public administration and safety	12.8	0.9
Information media and telecommunications	9.2	0.7
Financial and insurance services	7.9	0.6
Electricity, gas, water and waste services	3.0	0.2
Mining	2.6	0.2

Source: ABS (2011b).

In 2008, a casual employee was four times as likely to be award reliant compared to a permanent or fixed-term employee (Rozenbes 2010). Casual employees often work simultaneously for several employers and experience high job turnover (this might also pose a constraint to superannuation account consolidation) (Rice Warner 2007). Further, women are more likely to be award-reliant than men, and typically have lower superannuation balances (Clare 2008).

2.3 Superannuation in awards

History

Employer superannuation began in 1862 with the establishment of a defined benefit pension fund for the employees of the Bank of New South Wales. Superannuation

followed this model for the next 100 years: defined benefit pension funds were established for a minority of employees, who were generally higher-paid white-collar employees in the private sector or civil servants in the public sector (APRA 2007; Sy 2008).

Although superannuation started to become more widely available from the 1970s as a result of claims brought under industrial relations laws, two related developments in the mid-1980s resulted in superannuation clauses being included in awards.

- The first was the 1985 Prices and Incomes Accord, where an agreement was reached between the Australian Government and the Australian Council of Trade Unions (ACTU) that a 3 per cent wage increase deemed due on productivity grounds would instead be paid as superannuation.
- Second was the June 1986 National Wage Case. The ACTU gained approval from the Australian Conciliation and Arbitration Commission (ACAC) (a predecessor of FWA) for an agreement to contribute wage increases of up to 3 per cent into superannuation funds. The ability of the ACAC to make this ruling was challenged by the Australian Chamber of Manufactures and the Victorian Employers Federation. However, the High Court (1986) held that the ACAC had jurisdiction to hear this case (and cases relating to superannuation more generally) because superannuation benefits for employees was an 'industrial matter' as defined in the *Conciliation and Arbitration Act 1904* (Cwlth).

As a result of these developments, superannuation clauses were gradually incorporated into industrial awards as they were renegotiated. This saw superannuation coverage expand from about 40 per cent of employees in 1986 to 79 per cent in 1990 (APRA 2007). Under this system, superannuation payments could only be enforced by bringing a case before the ACAC (APRA 2007).

In 1992, compulsory superannuation was introduced in the form of the superannuation guarantee legislation. The superannuation guarantee required employers to make superannuation contributions of 3 per cent of wages, which was gradually increased to 9 per cent by 2002.

Although superannuation clauses in awards have been negotiated by industrial parties since the mid-1980s, it was not until the *Workplace Relations Act 1996* (Cwlth) was introduced that legislation expressly included superannuation as an allowable matter in awards. However, superannuation in awards has been affected by changes in the industrial relations regime, as noted by MLC Ltd−NAB Wealth:

> … the Howard Coalition Government committed to the removal of superannuation as an 'allowable matter' in industrial award provisions from 2008. This would have enabled employers to choose 'any complying fund' with minimum insurance coverage. However, the excision of superannuation as an 'allowable matter' was overturned when the Rudd Labor Government came to power in 2007 instituting the Fair Work Act which expressly included superannuation as an 'allowable matter'. (sub. 44, p. 4)

Award modernisation and superannuation

The 122 modern awards were developed by the Australian Industrial Relations Commission (AIRC) (a predecessor of FWA) in the course of the most recent industrial relations reforms which resulted in the Fair Work Act. In the course of this reform process, more than 1500 pre-modern federal and state awards were combined and 'modernised' to create 122 modern awards. This award modernisation process involved around six months of consultation for each of the four tranches of pre-modern federal awards in order to develop draft modern awards (AIRC 2009c).

Modern awards commenced on 1 January 2010. The process by which default funds were, and continue to be chosen for listing in modern awards is discussed in detail in chapter 7. Briefly, a variation application will be granted to list an additional default fund in a modern award if:

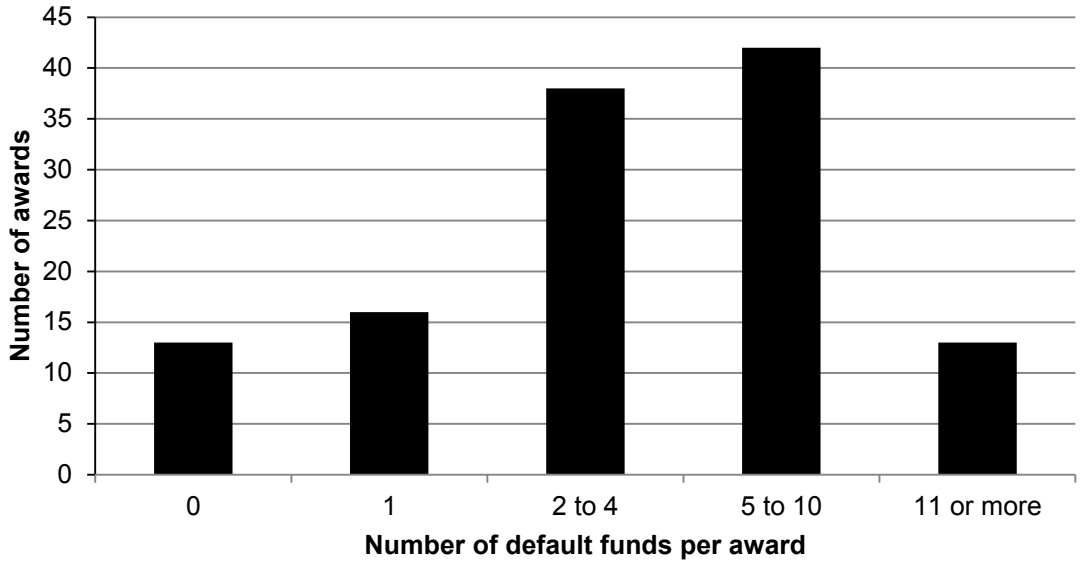
- the fund was nominated as a default fund in an award-based transitional instrument relevant to the coverage of the modern award
- the representatives of the main parties covered by the award consented to the inclusion of the fund, or
- employers were making contributions to the fund before 12 September 2008 on behalf of employees who are now covered by the modern award.

FWA is conducting a review of modern awards in 2012. Some submissions to that review have requested variations to the default superannuation provisions in modern awards (FWA 2012d).

Default funds in modern awards

Of the 122 modern awards, 109 list a default superannuation fund or funds. The remaining 13 awards do not list a default superannuation fund — these awards cover a wide range of industries, including fire fighting, shipping, labour market services and mining (figure 2.3). In eight of the awards that do not list a default fund, there is no reference to superannuation.

Figure 2.3 **Number of default superannuation funds named in each modern award**



Source: Modern awards published by FWA (2012c).

In total, there are 103 superannuation funds named as default funds in at least one modern award. Of the 103 funds listed in at least one award, 42 are named in only one award, 47 are named in between two and nine awards, and 14 are named in ten or more awards. The fund listed most often is AustralianSuper (which appears in 69 awards).

Although there are 103 funds named in awards, there are now only 85 distinct funds, as several have merged, changed their name, or closed since they were first listed. This is about one quarter of the total funds regulated by APRA. Of these 85 distinct funds, 18 are not included on APRA's list of current funds — some are EPSSSs, and others remain unable to be identified (APRA 2012d). Of the remaining 67 default funds that are on APRA's list of current funds and able to be identified:

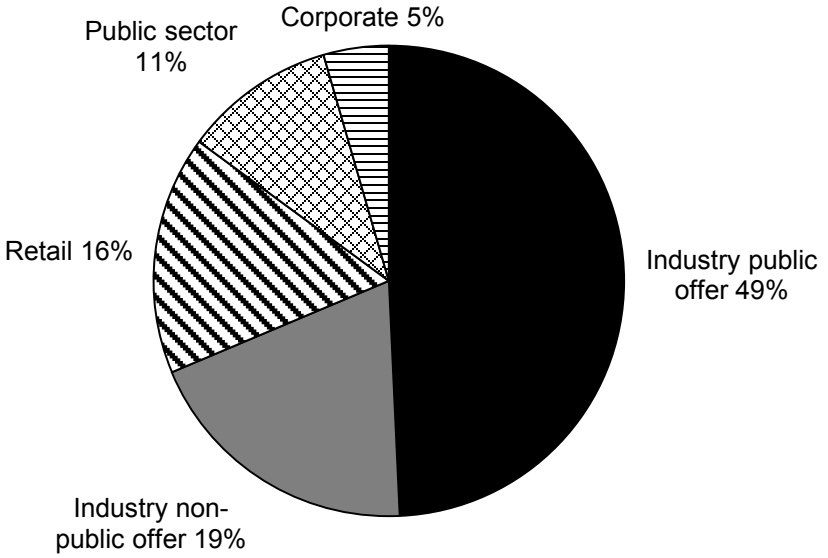
- 46 are industry funds (of which 13 are non-public offer funds)
- 11 are retail funds
- 7 are public sector funds
- 3 are corporate funds.

Most of the funds listed in awards have been classified by APRA as industry funds (figure 2.4). However some funds can have characteristics of two fund types, and the emergence of new superannuation products and industry consolidation makes classification of funds into their appropriate fund types more difficult. In these

circumstances, APRA classifies the fund into the category it considers most appropriate (APRA 2005).

Figure 2.4 **Indicative types of funds listed as default funds in modern awards**

67 identifiable funds[a], by APRA classification



[a] Based on APRA-regulated superannuation funds for which data are available in 2011.

Sources: Productivity Commission estimates based on APRA fund-level profiles and financial performance data (APRA 2012g); Modern awards published by FWA (2012c).

Despite the lesser presence of retail funds in awards, they can still have a significant default business. For instance, AMP noted that it:

> … is responsible for the management of over $60 billion in retirement and superannuation assets on behalf of nearly 4 million customers. Of these funds, approximately $20 billion in superannuation assets are directly attributable to approximately 500,000 members of a number of employer default superannuation plans. (sub. 53, p. 3)

The greater prevalence of industry funds as default funds in awards could explain why they have a higher proportion of assets in their default investment strategy, since employees who do not actively choose a superannuation fund could be expected to be less likely to actively choose an investment strategy (table 2.4).

Table 2.4 **Indicative profiles of the funds listed as default funds in modern awards**

67 identifiable funds[a], by APRA classification

	Members (default and non-default) (average)	*Proportion of assets in the default investment strategy (average)*	*Assets in the default investment strategy*
	no.	%	$m
Corporate	13 177	43	605
Industry	244 370	70	3 586
Public sector	245 826	52	6 840
Retail	392 977	47	1 612

[a] Based on APRA-regulated superannuation funds for which data are available in 2011.

Sources: Productivity Commission estimates based on APRA fund-level profiles and financial performance data and performance results based on annual data for superannuation funds (APRA 2012a, 2012g); Modern awards published by FWA (2012c).

However, not all superannuation contributions made under awards are made to default funds listed in awards, because of the 'grandfathering' provisions in all modern awards that contain superannuation provisions. These allow contributions that were being made to funds before 12 September 2008 to continue to be made, even though the funds in question are not listed as default funds in the modern award. The reach and impact of grandfathering is unclear (chapter 7).

Effect of default funds listed in awards on the flow of employer superannuation contributions

Default superannuation provisions in modern awards directly affect employees to whom the superannuation provisions in a modern award apply. As discussed earlier, this includes award-reliant employees, those who receive some above-award wages or conditions, and those covered by enterprise agreements that incorporate the award by reference or are silent on the default fund, but does not include other employees covered by enterprise agreements that specify a default fund. It is estimated that at least $7 billion, and potentially more than $10.5 billion in superannuation contributions were made to default funds in awards in 2010 for employees to whom the superannuation provisions in a modern award apply, as explained below.

Contributions for employees to whom the superannuation provisions in a modern award apply

There is no precise measure of the number of employees to whom the superannuation provisions in a modern award apply. The Australian Superannuation

Funds Association estimated that 'between 20 per cent and 30 per cent of employees are directly subject to award provisions relating to superannuation' (sub. 31, p. 4), although Tasplan placed this figure as high as 65 per cent (sub. 6, p. 1). REST Industry Super commented that '45 per cent of REST's membership are party to an industrial award' (sub. 47, p. 6).

APRA (2011a) reported that total superannuation contributions by employers totalled $72 billion in 2010, of which an estimated $50 billion was attributable to the 9 per cent superannuation guarantee (Clare 2010). Since the superannuation guarantee is a constant 9 per cent of ordinary time earnings received, and award-reliant employees received 7.8 per cent of total average wages paid in 2010 (ABS 2011b), then, making assumptions about ordinary time earnings of these employees, they received approximately $3.9 billion in superannuation guarantee contributions for 2010. Assuming that award-reliant employees are as likely to make choices about their superannuation fund as are other employees (that is, about 10 per cent) (box 2.1), this would imply 90 per cent are in the default fund (Australian Government 2010a) and about $3.5 billion in superannuation contributions were made to default funds on their behalf.

A number of employees receive above-award wages through an unregistered individual arrangement, but rely on the award for the other terms and conditions of their employment. Existing estimates suggest that roughly 15 to 30 per cent of employees are employed under above-award arrangements (Australian Fair Pay Commission 2006; Buchanan and Considine 2008). Though there are insufficient data on wages received by above-award employees to conclude how much superannuation was paid on their behalf, a lower bound can be estimated by assuming that above-award employees received at least award wages. This implies at least $3.5 billion, and possibly up to $7 billion, was paid into default superannuation funds on their behalf.

Influence of award default funds on enterprise agreements

Employees covered by enterprise agreements are only considered to be employees to whom the superannuation provisions in a modern award apply where the employees and employer who are party to the agreements incorporate the award by reference or are silent on the default fund. However, employees covered by enterprise agreements that specify a default fund are not considered to be employees to whom the superannuation provisions in a modern award apply, although funds listed in awards might influence the funds chosen for inclusion in enterprise agreements.

There are no data on how funds listed in awards influence funds listed in agreements, but several inquiry participants suggested that awards are used as a referential framework for negotiating collective agreements.

> We consider that employers and employees would use their experience of award conditions as a basis when negotiating an enterprise agreement ... Some agreements reproduce provisions from awards, either by including relevant clauses or by cross-reference to award provisions. Single purpose agreements dealing only with superannuation are no longer allowed, but it is possible to include existing award provisions in agreements. (Asset Super, sub. 32, pp. 1−2)

> While there are no records available to the AHA, within the hotel industry it is believed the majority of enterprise agreements in the hospitality industry list Hostplus [one of the default funds listed in the relevant award]. (Australian Hotels Association, sub. 10, p. 6)

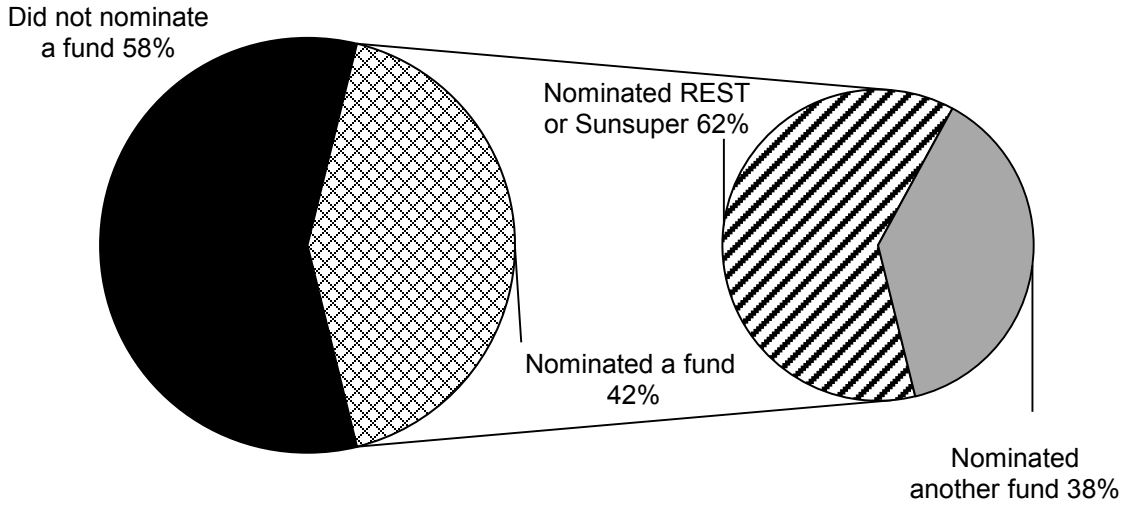
The extent to which this occurs is likely to vary across industries.

> Internal research undertaken by industry super funds indicates that over 43% of enterprise agreements leave the selection of default superannuation fund to the employer. This data was collected across Australia from a range of industries. The treatment of superannuation within industrial agreements is inconsistent across industries … The limited available evidence indicates that where funds are named, at least three quarters are industry funds and the superannuation clauses found in enterprise agreements, more or less, reflect the arrangements within the underpinning award or awards. (ISN, sub. 27, p. 37)

Given the limited data available, the Commission reviewed enterprise and collective agreements in the fast food industry in order to obtain a broad indication of the influence of default funds listed in awards on the superannuation provisions contained in enterprise agreements in one sample industry. The fast food industry was chosen because the modern award covers one industry, rather than one occupation across several industries.

Of the 42 per cent of agreements that listed a default fund, more than 60 per cent listed REST Industry Super or Sunsuper — the default funds that are listed in the relevant award for the sector. This example suggests that default funds listed in awards are quite influential in relation to the listing of funds in enterprise agreements, at least in this sector. However, at least for this sector, most agreements do not specify any default fund at all (figure 2.5).

Figure 2.5 **Superannuation funds listed in enterprise agreements in the fast food industry**



Source: Productivity Commission analysis based on enterprise agreements published by FWA (2012b).

The Stronger Super reforms

While the Australian superannuation industry is undergoing a significant period of fund mergers and consolidation, which is expected to continue, the regulatory environment is also rapidly changing. This inquiry is occurring in the context of the staged introduction of a significant number of reforms to the superannuation system. From July 2013, there will be a new default superannuation product, MySuper, together with disclosure, governance and administrative reforms which are intended to make default superannuation more transparent and comparable.

MySuper

Following the Cooper Review (Australian Government 2010b), the Australian Government (2011a) is introducing a number of reforms to the superannuation system through the Stronger Super reforms and related initiatives. These reforms will, amongst other things:

- introduce MySuper, a new superannuation product authorised by APRA. Only funds that offer MySuper products (or EPSSSs) will be eligible to be listed as default funds in modern awards
- require trustees to develop a single diversified investment strategy for their MySuper product which specifies the investment return target over a rolling 10-year period and the level of risk deemed appropriate

- introduce rules governing the fees which can be charged for MySuper products
- require equal treatment of members by giving all MySuper members:
  - protection against fee subsidisation (since one employee should not be favoured over another where they have the same employer)
  - the assurance that, unless they have otherwise consented, MySuper members can only be transferred to another MySuper product within the fund
- require all MySuper products to offer at least a minimum default level of life and total and permanent disability insurance on an opt-out basis. However, superannuation funds are able to vary insurance terms and conditions between groups of members within the same default product, depending on their circumstances.

SuperStream

The SuperStream reforms will introduce new data and e-commerce standards for superannuation transactions (Australian Government 2010c). This will include electronic transmission of linked financial and member data using standardised formats, and the use of tax file numbers as the primary member identifier. These reforms will be phased in between July 2011 and July 2015. The Cooper Review estimated that SuperStream will save the superannuation industry about $1 billion annually (Australian Government 2010b).

Governance

A range of governance reforms are also being introduced as a result of the Cooper Review's recommendations. These include a requirement that the trustee of a MySuper product:

- promotes the financial interests of the fund members
- determines annually whether or not MySuper members are disadvantaged by the scale of the fund.

Further, a dashboard (for both MySuper, and other superannuation products) will be developed to disclose fee ranking, expense ratios, targeted risk and return, liquidity, and range of possible investment outcomes.

APRA (2012e) is being given the power to draft binding prudential standards for the superannuation industry for the first time. The standards will cover governance, fit and proper persons, risk management, business continuity management, outsourcing, auditing, conflicts of interest, investment governance, insurance,

solvency and capital requirements. These standards will commence on 1 July 2013 to coincide with the introduction of MySuper.

Additionally, improved governance frameworks are being developed by bodies representing various types of superannuation funds, including retail and not-for-profit funds (chapter 5).

3 Conceptual framework

Key points

- In an ideal and well-functioning market for superannuation, individuals would be well informed and have the expertise and motivation to choose a fund which meets their best interests.
- In reality, many do not have either the interest or ability to make decisions that are in their best interests and do not actively choose a superannuation fund. While the proportion of individuals who do actively make a choice is expected to increase over time, a default superannuation system will be required for the foreseeable future.
- A default system can improve outcomes for individuals. However, there are some potential impediments to maximising outcomes that need to be addressed. These include:
  - where a third party is making decisions for an individual (a principal–agent relationship), the interests of these parties will not necessarily be totally aligned and the decisions of the third party might not always be in the best interests of the individual
  - a lack of demand-side competition, which reduces the incentives for funds to compete on price and performance to deliver good outcomes for members
  - potential regulatory barriers to contestability between funds.
- With a focus on default funds listed in modern awards, this inquiry examines the impediments to meeting the best interests of members, the extent to which the Stronger Super reforms are expected to address these impediments, and whether there is an overall net benefit to introducing criteria beyond those required of funds to be authorised to offer a MySuper product.
- Good outcomes, particularly for individuals, depend not only on the criteria by which default funds are selected, but also on the process by which those criteria are implemented. The net benefits of reforming the process for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards will therefore also be examined.

In 1992 the Australian Government made superannuation compulsory. The Government's decision largely stemmed from:

- the fiscal imperative to reduce reliance on the aged pension
- the desire to increase national savings and economic growth, and achieve better retirement outcomes for the community (Kingston 2004).

In a well-functioning superannuation market, individuals would be well informed and have the expertise and motivation to choose a fund which meets their best interests. However, as explained in a wide body of literature, many individuals lack either the interest or ability to make investment decisions that are in their best interests (box 3.1).

Box 3.1 Difficulties individuals face making investment decisions

Individuals might encounter difficulty making investment decisions in their own best interests for a number of reasons.

- Lack of financial literacy, which limits people's ability to make informed financial choices (Australian Government 2010a).
- Complexity of investment decisions and difficulty matching risk preferences with the right products (Brown, Farrell and Weisbenner 2011; Ingels and Fear 2009).
- High search costs, in terms of time taken to research and understand what is often a large number of products (Impavido, Lasagabaster and García-Huitrón 2010).
- The 'endowment effect', where people value money that is lost more highly than money gained, causing them to be unduly conservative in their investment decisions (Ingels and Fear 2009; ISN 2010).
- Lack of price awareness, as compulsory contributions, fees and other costs do not come directly out of members' pockets (Australian Government 2010a).
- Information asymmetries between superannuation providers and individuals (Brown, Farrell and Weisbenner 2011).
- A long lag between the purchasing decision and the time when the benefits can be accessed, making consumers less likely to make decisions in their own best interests (Fear and Pace 2008).
- An associated tendency toward procrastination and inertia in making retirement savings decisions (Gallery, Gallery and Brown 2004).
- Mental rules or short cuts (heuristics) that people use when they have no clear preference for one option over another, or where the cost of acquiring information is too high, which can lead to persistent biases in decision making (Fear and Pace 2008).
- Framing effects, where people make a choice based on how the available options relate to one another, how they are explained and what other information is provided at the same time, rather than which option is in their best interests (Fear and Pace 2008).

One policy option for addressing the tendency for individuals to make sub-optimal retirement savings decisions is to provide information and implement financial

literacy programs to assist them (Bernartzi and Thaler 2007; Brown, Farrell and Weisbenner 2011).

Another option is to introduce a default superannuation system, whereby a third party effectively makes a choice of superannuation fund on behalf of the individual. Under a default superannuation system, an individual can be given the option of choosing for themselves, as is the case in Australia since Choice of Fund legislation was passed in 2005 (chapter 2), or individual choice can be restricted.

While there is much evidence that a default system improves outcomes (for example, Thaler and Sunstein 2009; Bashears et al. 2006), its success in doing so is contingent on the appropriate design and application of the system. Otherwise, unintended and sub-optimal outcomes can readily materialise (Gallery, Gallery and Brown 2004).

3.1 Potential impediments to meeting the best interests of members

There are several potential impediments to meeting the best interests of members under a default superannuation system, some of which are unique to the Australian system. A well-designed default superannuation system needs to take these impediments into account and minimise the effects that they have on outcomes.

Principal–agent relationships and information gaps

Principal–agent relationships are inherent in any default superannuation system. A principal–agent relationship in the case of superannuation is one where an individual engages (or relies on) a third party to make decisions and take action on their behalf (Drew and Stanford 2003). Having an agent might be optimal if that agent acts in the best interests of an individual lacking the expertise to make their own best decisions. However, issues can arise when the agent does not face adequate incentives to act in the best interests of the individual, and that individual does not have the information or means to monitor the actions of their agent.

In Australia's default superannuation system, there are several principal–agent relationships that can potentially be cause for concern, and any negative effects from these need to be addressed in the design of the system.

Employees and employers

In the Australian default superannuation system, employers choose a default fund (either from a list contained in the relevant award, in negotiation with employees or unilaterally) for employees who do not choose themselves.[1] Where an employer is free to choose any default fund for employees (that is, where an award does not require them to make a contribution to one of several listed funds), or where an award lists many funds, there are reasons why employers might not have the incentive to make a decision that is in the best interests of their employees.

Employers:

- receive none of the direct benefits of a fund's high performance, and therefore might have little incentive to invest time and effort into making effective choices for employees
- could choose a fund solely on the basis that it has the least onerous administrative requirements
- might face high search costs when trying to make an optimal choice, especially when choosing from a large pool of potential funds, and especially when they themselves lack information and expertise
- could choose a fund that has additional benefits specific to them, such as cheaper financial products for their organisation that get bundled with superannuation
- might be driven by concerns about any legal repercussions of choices they make, rather than the best interests of their employees.

Employees and industrial parties

In Australia, industrial parties have played a central role in determining which superannuation funds are listed in awards. In choosing default funds, they might bring their own incentives and biases to that task. For example, there is potential for a conflict of interest given that the industrial parties are shareholders of the relevant industry fund (Drew and Stanford 2003). There might also be asymmetric interests at the workplace level where trade unions might have an interest in allocating contributions to industry funds, whereas employers might be more equivocal about the choice of funds.

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1 In some countries, this is not the case. For example, in Sweden, the Government operates and manages a single national default fund. In New Zealand, the Government selects a number of default funds, amongst which employers may then choose (appendix B).

Fund members and fund trustees

Trustees of funds manage and invest the contributions of members. In doing so, trustees might not always act in the best interests of their members unless explicitly required to do so (chapter 5). According to the Australian Government (2010b, p. 5), 'trustees are not always focussed on acting for the benefit of members and maximising members' retirement incomes in an efficient and cost-effective way'.

If funds are not disclosing information in an open, transparent and easy to understand manner, members may find it difficult to assess how well funds are performing on their behalf. Members may also have difficulty making this assessment if they do not have the expertise to do so.

Financial advisers and their clients

In the default system, employers or employees might use a financial adviser to help them choose the right fund. Due to the way that some advisers have been remunerated (based on commissions rather than fee-for-advice), they might be conflicted in the advice they give to their clients (Vidley 2004). These potential conflicts are being dealt with in the Future of Financial Advice legislation (chapters 5 and 6). Where independent firms focus on running corporate tenders, conflicts are much less likely to exist.

The Australian Government and the private superannuation sector

Principal–agent relationships also exist at the aggregate level. The Australian Government has made superannuation savings mandatory, with a view to reducing reliance on the aged pension and improving retirement outcomes, and it uses the private (not-for-profit and for profit) sector as its agent to manage those savings. This means that the superannuation sector overall is not necessarily driven by the same objectives as the Government.

Lack of demand-side competitive pressure

While default superannuation systems can improve outcomes, they do not alter the underlying attitude of indifference by individuals towards making investment decisions (ISN 2010). In fact, by providing a default system, indifference can grow, as some of those who may otherwise have chosen to engage might feel that a default chosen by a third party is a signal or endorsement of the best choice (Brown, Farrell and Weisbenner 2011).

The tendency for individuals not to make active choices means that once placed in a fund, they tend to stay there. According to the Cooper Review (Australian Government 2010a), since the introduction of Choice of Super legislation in Australia, switching rates between funds have declined from an initial rate of around 5 per cent in 2005 to 2 per cent in 2009.

Given the growth in the self-managed super fund sector (chapter 2), it might also be the case that active participants are increasingly choosing to manage their own retirement savings rather than have someone do it on their behalf or choose amongst existing funds.

A lack of active participation means that members will tend not to react to price signals (that is, demand is inelastic) and little demand-side pressure will be placed on funds both within and outside of the default system to compete on price and performance (Fear and Pace 2008). According to the Australian Government (2010a):

> In superannuation, competition in the market for super at the consumer level (ie between funds competing for the business of a new member) has so far been relatively weak. This is because superannuation is different. … the model of member-driven competition through 'choice of fund' (in the form of SG Act choice and consequent portability) has struggled to deliver a competitive market that reduces costs for members. (Australian Government 2010a, pp. 7–8)

Alternatively, demand-side competition could be driven by those making decisions on behalf of members, such as employers, financial advisers and industrial parties. However, for this mechanism to operate, these third parties need to have the incentive to actively participate on behalf of members and not be subject to inertia themselves. And, as discussed above, such incentives might not always be present, given the inherent nature of principal–agent relationships.

A lack of demand-side pressure can lead to:

- administrative inefficiencies within funds, including difficulties for employers dealing with funds
- price distortions
- non-price competition around marketing, distribution and product differentiation, which is costly and of little benefit to those in default funds not making active decisions (Impavido, Lasagabaster and García-Huitrón 2010).[2]

[2] This is what occurred in Chile in the 1980s and 1990s (Appendix B).

Heterogeneity of member preferences

Any one default product is a homogeneous product. However, people have heterogeneous attributes, such as risk preferences and demographic characteristics, which means that the optimal choice will differ between individuals (Carroll et al. 2009). This problem is compounded if the product is not adjusted to suit the changing nature of an individual's preferences over time (Brown, Farrell and Weisbenner 2011). The more closely aligned the preferences of members within a default fund, the better the potential outcomes.

Regulatory impediments

Regulatory impediments can create barriers to entry for funds wishing to participate in the default system. For example, the process by which funds are listed in modern awards could be acting as a regulatory barrier to entry (chapter 7).

Barriers to entry impede contestability and provide scope for incumbent funds to underperform and/or drive up costs (Impavido, Lasagabaster and García-Huitrón 2010). This can exacerbate the problems caused by a lack of demand-side competition.

3.2 The Stronger Super reforms

The Cooper Review and the Government's response through the Stronger Super reform package were aimed at addressing some of the above-mentioned impediments to meeting the best interests of members. According to the Cooper Review:

> The current superannuation system assumes that all members want to make choices about their superannuation and are interested in receiving a variety of superannuation-related services. 'Default' members are not adequately protected and can find themselves paying for services that they do not need or request and, on some occasions that they do not receive. (Australian Government 2010b, p. 5)

The focus of the Cooper recommendations is on member outcomes. They are based on the idea that, as superannuation contributions are mandatory, members should not have to be '… interested, financially literate, or investment experts to get the most out of their super … If members are not interested, then the system should still work to provide optimal outcomes for them' (Australian Government 2010a, p. 1).

More specifically, MySuper is aimed at enabling:

> … members, employers and market analysts to compare funds more easily based on a few key differences. It will also ensure members do not pay for any unnecessary 'bells and whistles' they do not need or use. (Shorten 2011, p. 3).

MySuper will provide information in a manner that will allow easier comparison between products. In this sense, the MySuper regime is primarily about increased disclosure and equips individuals, to a degree, with information to make choices for themselves. Other factors might also contribute to an increasing trend in self-choice (box 3.2).

However, there is still a question of whether individuals will have the interest or ability to use the information from MySuper to make quality decisions about their retirement savings. There is likely to be a long way to go before the vast majority of Australians are actively choosing a superannuation fund, and thus a robust default system is likely to be necessary for the foreseeable future.

There is also a question of whether employers will have the expertise to use the information from MySuper to make quality decisions on behalf of their employees without incurring excessive search costs.

Box 3.2 **Reasons why self-choice might increase over time**

- MySuper will provide a filter for consumers, reducing the number of options from which a choice needs to be made (though the option of choosing from outside MySuper would remain). Consolidation will also reduce the number of funds to choose from (chapter 2).
- The information available to make a choice will be more comparable because of the MySuper reforms.
- The informal sources of information about superannuation have grown as the compulsory system matures.
- Access to information about savings choices is easier and cheaper as the internet becomes increasingly easy to use and access.
- There is a greater focus on financial literacy in schools and the community (ASIC 2011), meaning that savers are likely to be more sophisticated in their knowledge than in the past.
- There may be a greater understanding by upcoming generations that the capacity of government to provide for retirement incomes may be reduced, resulting in greater appreciation that individual savings choices matter.

3.3 Framework for assessing the case for further reform

This inquiry is assessing the range of criteria that can be used for the selection and ongoing assessment of superannuation funds to be listed as default funds in modern awards.

In doing so, the Commission will focus on whether the Stronger Super reforms are expected to do enough to address any impediments to meeting the best interests of default fund members, or whether there is scope to improve outcomes for employees to whom the superannuation provisions in modern awards apply by using criteria.

Chapters 4 to 6 will assess the net benefits of introducing criteria over and above those that will apply under Stronger Super. These chapters will cover:

- the current requirements for superannuation funds
- what additional requirements are contained in the Stronger Super reform package and what impediments to meeting the best interests of members they are seeking to address
- whether the Stronger Super reforms go far enough, or whether there are any remaining impediments to meeting the best interests of members
- whether there is a case for additional eligibility criteria, by weighing up the benefits (such as increasing retirement savings) and costs (such as administrative, transaction, compliance and monitoring costs) of introducing the additional criteria
- where a case for additional criteria is established, what those criteria should be.

The overarching objective of the Commission's analysis will be to achieve whatever is in the best interests of employees to whom the superannuation provisions in a modern award apply. However, the effects on other employees, employers, industrial parties, superannuation funds and the Government will also be taken into account.

While the focus of this inquiry is on default funds listed in awards, the Commission will also consider whether its findings and recommendations have any implications for awards that do not currently contain a list of funds, and for default members employed under other industrial instruments for whom the superannuation provisions in modern awards do not apply.

Minimising the impediments to achieving the best interests of members under the default system, such as the potential principal–agent and contestability issues, might depend not only on the criteria that the default fund must meet, but also the process by which those criteria are implemented and funds are selected. Therefore, in addition to looking at designing a set of criteria, the Commission will examine in chapter 7 whether there is scope to enhance the best interests of members by reforming the process for listing funds in awards. A principles-based approach will be used to assess the appropriateness of the current process and the potential reform options.

Chapter 8 will assess the options for implementing any additional criteria and reforming the process, while chapter 9 will look at transition issues that arise from that analysis.

4 Investment performance

Key points

- Retirement outcomes for superannuation fund members depend in large part on the long-term net investment performance of superannuation funds. Small improvements in annual performance can lead to significant increases in returns upon retirement.
- The Stronger Super reforms prescribe new disclosure requirements for investment strategy, risk, performance, fees and scale for all MySuper products.
- No minimum performance criteria will be required of funds or MySuper products, but each MySuper product will be required to have a single, diversified investment strategy (which may be a lifecycle approach). Each MySuper product will need to clearly articulate an investment return target and level of risk. This will enhance comparability between products and is expected to improve the consumer demand response.
- A particular type of investment strategy should not be prescribed for default funds. Instead, the appropriateness of the MySuper product's investment return objective and risk profile for employees to whom the superannuation provisions in that modern award apply, should be considered as a primary factor.
- Though there are no minimum performance criteria, the selection and ongoing assessment of superannuation funds for listing in modern awards should include consideration of the fund's expected ability to deliver on the MySuper product's investment objectives, as a primary factor.
- The Stronger Super reforms will introduce a standard set of fees for all MySuper products. Some categories of fees will be limited to cost recovery, though investment and administration fees will not be capped.
- The selection and ongoing assessment of superannuation funds for listing in modern awards should consider fees, but only as one of a suite of factors, including investment performance, and consider their 'fit' with the investment return objective and risk profile.
- Trustees of funds that offer a MySuper product will be required to consider whether the scale of the fund negatively affects their ability to promote the best interests of MySuper members. This requirement is appropriate, and no greater prescription with regard to scale is required.

This chapter discusses the scope for additional criteria relating to investment performance (beyond those required to receive authorisation to offer a MySuper

product) to be used to list default superannuation funds in modern awards. Specifically, the chapter analyses the following interrelated factors: investment strategies; past net investment performance (in particular, past ability to deliver on investment objectives); fees and economies of scale.

4.1 Investment strategy

An investment strategy guides the allocation of assets among various investment options to meet the investment objective (such as the investment return target), or objectives of the fund, taking into account its risk tolerance. A defensive investment strategy allocates assets to minimise the risk of losing value, while an aggressive investment strategy allocates assets to achieve maximum return, usually taking on additional risk. A balanced investment strategy portfolio falls between these two extremes.

When formulating, documenting and giving effect to an investment strategy, trustees are required to consider the likely return and risk, diversification, and liquidity of investments. Trustees must consider the risk tolerance of members when setting the risk profile for the fund (Jones 2011).

Stronger Super reforms

Though MySuper trustees will be required to formulate and give effect to a *single*, diversified investment strategy, MySuper products will not be required to employ any particular investment strategy, pursue any particular investment objective/s, adopt any particular risk profile, or include any particular asset class. This reflects the view that trustees are best placed to make these decisions, and that if trustees were required to make particular investments this would limit their capacity to pursue investment opportunities that reflect the best interests of members (Treasury nda).

As a result, investment strategies are likely to vary among MySuper products, though this will be tempered by the features of MySuper products — 'low cost and simple' (Australian Government 2010d).

Trustees will be required to regularly review the investment strategy (for the MySuper product as well as for other investment options), and clearly articulate and justify the investment return target (over a rolling 10 year period) and level of risk they have adopted for the MySuper product. Trustees will also be required to have regard to additional factors when developing an investment strategy including: the availability of valuation information; the expected taxation consequences; the

expected costs of the strategy (such as brokerage); and appropriate due diligence in the selection and monitoring of investment options made available to members (Shorten 2012c).

Lifecycle investment approach

Under Stronger Super, trustees will be able to choose a lifecycle investment strategy as the single investment strategy for the MySuper product (Australian Government 2011a). A lifecycle investment strategy is a tool designed to reduce risk as members get closer to retirement age. Where a lifecycle investment strategy is adopted, trustees would automatically move members into a different investment mix, based on their age.

Scope for additional criteria relating to investment strategies and objectives

Participants' views

A small number of participants considered that the *appropriateness* of a fund's investment strategy or objective/s should be a consideration when listing superannuation funds in awards (for example, CPA Australia, sub. 39). In their view, decision makers should consider the characteristics of employees to whom the superannuation provisions in that modern award apply, and assure themselves that the investment objective/s or strategies of the listed superannuation funds meet their particular needs.

On the other hand, many inquiry participants did not support 'investment strategy' as a criterion, generally suggesting that the MySuper criteria did enough to address this matter. One participant pointed out that, regardless, decision makers need investment strategy information that is clear and complete to allow them to make informed decisions (Centre for the Study of Choice UTS, sub. 22).

Though inquiry participants did not suggest that a specific type of investment strategy, or specific investment objectives, should be criteria for funds that seek to be listed in modern awards, there were a range of views on the appropriateness of offering a lifecycle investment option in default funds. For example, AIST (sub. 20) considered that the presence or not of a lifecycle option should have no bearing on default listing. DFA Australia (sub. 21) considered that a lifecycle strategy should not be prescribed for default funds and that it can limit investor outcomes, though it supported the 'lifecycle exception' option under Stronger Super. The diversity of views on this matter is illustrated in box 4.1.

Box 4.1 **Investment strategy and objectives as criteria for choosing default funds — some perspectives**

The appropriateness of the investment strategy and/or objectives should be considered

On a broad scale, Fair Work Australia should assess the appropriateness of the default investment option of the fund in terms of risk and expected return. This would include an analysis of medium and long term asset allocation, the manager selection and review process, the overall investment philosophy … (NGS Super, sub. 18, p. 2)

Investment strategy and/or objectives criteria not supported

[The investment strategy of a MySuper product should not be factored into the selection of default superannuation funds for inclusion in awards because] … if the fund … secured authorisation through MySuper criteria then these points are covered off. (Tasplan, sub. 6, p. 3)

[The investment strategy of a MySuper product should not be factored into the selection of default superannuation funds for inclusion in awards, because] … these factors will be covered in the fund's successful completion of the MySuper licensing process with APRA. (REI Super, sub. 26, p. 3)

… investment strategy is important but it is the long term outcome that matters most … There is sufficient new regulation of investment strategy requirements for superannuation funds generally and for MySuper [products] … [under Stronger Super]. (AustralianSuper, sub. 36, p. 9)

The ultimate determinant of the success of an investment strategy is the fund's long term net returns, and return targets/risk profile will be a factor contributing to this. [The investment strategy] … should not be separately assessed during the selection of funds in modern award. (AIST, sub. 20, p. 10)

Lifecycle investment strategy

The inclusion or non-inclusion of a lifecycle strategy should … not be separately assessed during the selection of funds in modern award. (AIST, sub. 20, p. 11)

We see existing lifecycle funds as limiting the prospect of successful investor outcomes. This is because they focus on the volatility of returns, which is not a good measure of shortfall risk … The simple age based lifecycle approach will aggregate their investment exposure in age cohorts, and not take into account their differences in salary, their current superannuation savings, their expected retirement age, their total assets or their future income. (DFA Australia, sub. 21, pp. 3–4)

The Commission's view

The Commission does not believe that a specific type of investment strategy, or specific investment objectives, should be prescribed for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. On the contrary, the Commission considers that the likely variability of MySuper investment strategies is desirable, as it will provide a diversity of products that can meet the potentially diverse needs of employees to whom the superannuation

provisions in a modern award apply. Instead, consideration should be directed to the appropriateness of a MySuper product's investment return objective and risk profile for employees to whom the superannuation provisions in that modern award apply. Due to their importance, they should be given primary consideration among a range of factors.

The Commission notes that the Stronger Super reforms give default funds the option of offering members a lifecycle investment product. The Commission does not believe the inclusion or non-inclusion of a lifecycle strategy in a MySuper product should be considered when looking to list default funds in awards. However, it should be considered in evaluating the appropriateness of the investment return objective and risk profile.

DRAFT RECOMMENDATION 4.1

The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should include consideration of the appropriateness of the MySuper product's investment return objective and risk profile for employees to whom the superannuation provisions in that modern award apply (as a primary factor).

4.2 Net investment performance

The importance of net investment performance

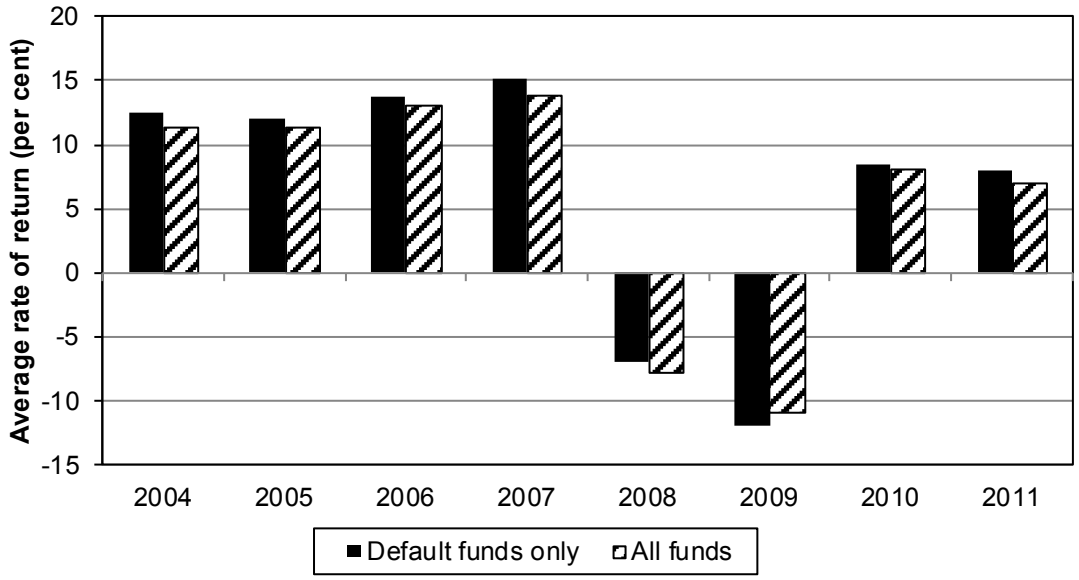
The success of a superannuation fund's investment strategy is determined by its investment performance. The long-term net investment performance of a superannuation fund, and investment options within that fund, can be highly uncertain and variable over time, and is influenced by factors such as asset allocation and the level of fees charged. Small improvements in the annual performance of a superannuation fund can lead to a significant increase in returns for members, given the long time frames over which superannuation assets are typically accumulated.

While the industry itself often chooses to focus on the relative performance of different types of funds, for the purposes of this inquiry, it is useful to look at the relative performance of default and non-default funds.

Investment returns of default funds listed in modern awards have been relatively strong, when compared to returns of non-default funds. Over the eight years to 2011, default funds averaged an annual (after tax) investment rate of return of 6.4 per cent, compared with 5.8 per cent for all funds, and default funds

outperformed non-default funds in each year over that period except in 2009 (figure 4.1).[1] This would suggest that the current default system has, overall, delivered above-average returns for members.

Figure 4.1 **Superannuation fund performance[a, b, c]**
Default funds versus all funds



[a] Based on APRA-regulated superannuation funds for which return data are available in all years 2004–2011. [b] Excludes pooled superannuation trusts, exempt public sector superannuation schemes, small APRA funds and single-member approved deposit funds. Self-managed superannuation funds are regulated by the Australian Taxation Office and are, therefore, excluded. [c] Default fund data based on superannuation funds listed in modern awards, for which return data are available in all years 2004–2011.

Data source: Productivity Commission estimates based on APRA fund-level profiles and financial performance data 2011 (APRA 2012g); FWA (2012c).

Stronger Super reforms

Current regulatory arrangements do not prescribe gross or net performance targets for superannuation funds. Though the Stronger Super reforms will not change this, the reforms will enhance comparability between MySuper products (and choice investment options), and make performance more transparent.

1 The rate of return is the ratio of money gained or lost on an investment, relative to the amount of money invested. This analysis compares the performance of default funds to all funds, including default funds. It is based on average performance of groups of funds and gives no indication of dispersion around the average.

APRA-regulated funds will be required to calculate (gross and net) investment returns in a standardised way for MySuper products and choice investment options. Under legislation currently before Parliament, APRA will be required to publish this information for MySuper products (Shorten 2012a), and trustees will be required to disclose the information regarding choice products (Australian Government 2010d). APRA will consult on proposed requirements for standardised reporting of information by APRA-regulated funds and the publication of that information in the second half of 2012.

Further, all APRA-regulated funds will be required to disclose the net investment return target (and the number of times the target has been achieved), together with other information — such as the average fees charged in relation to the product on a per member basis — for their MySuper and choice investment options, on a product 'dashboard' (Australian Government 2010d; Shorten 2012a).

Scope for additional criteria relating to past performance

One key question is whether past investment performance should be taken into account when selecting default funds for inclusion in modern awards, including whether a particular level of performance should be set before a fund could be considered for inclusion.

Participants' views

Some inquiry participants suggested that overall past net performance should be used to list superannuation funds in awards. Of those, some proposed that past performance should be the prime criterion:

> Recognising that the principal objective of superannuation is improvement in retirement outcomes, long term net returns must, therefore, be the prime criteria on which the suitability of superannuation funds to be named as defaults is judged. (ISN, sub. 27, p. vi)

AustralianSuper considered:

> … the medium to long term net-of-costs investment performance of the default investment option to be the single most important criterion to include. This more than any other aspect has the largest impact on a member's retirement outcome. (sub. 36, p. 5)

Cbus was of the view that funds with default status should have 'a history of strong investment returns in its default product' (sub. 15, p. 4). However, the Actuaries Institute argued that past performance should be only one of many criteria:

> Past performance (net of investment fees, costs and investment taxes) is one of the many factors that should be considered when assessing the investment capabilities of a fund. (sub. 45, p. 3)

Some participants considered that default funds should be selected from a list of the highest performing funds, with selection, therefore, based on performance relative to industry peers. For example, the ACTU recommended that:

> … only those MySuper compliant products that APRA report as being among the top 100 best performing in terms of net returns to members over an extended period (such as 10 years) can be eligible for inclusion as a default in an award. (sub. 29, p. 11)

However, other participants indicated concerns with such an approach. The Law Council of Australia noted that the resulting list may require frequent updating as a 'position in a "league table" in terms of … performance … may vary widely over even relatively short periods' (sub. 23, p. 3).

Another approach is to use a minimum return target. ISN contended that an appropriate minimum performance benchmark should be set to ensure:

> … that only those funds which have demonstrated a capacity to deliver superior returns to members over the long-term should be considered for inclusion as default funds within modern awards. (sub. 27, p. 6).

Others were concerned that a minimum return target may have unintended consequences. The Actuaries Institute noted:

> … the imposition of a target level of investment performance would likely constrain the level of risk that a fund would then be prepared to accept, which would potentially lead to lower investment returns over the long term. (sub. 45, p. 3)

Some participants took the view that past performance should be taken into account, but in the context of a fund's stated investment objectives, so that an assessment of the ability of fund trustees to meet their objectives, albeit in the past, could be made.

AIST considered that:

> [Funds with default status should be selected based on] past performance on 10 year rolling net returns, assessed against each fund's investment objectives and target returns. (sub. 20, p. 3)

Similar views were put by REST Industry Super, which contended that:

> The primary focus should be on the long-term performance of funds against their stated investment objectives. Relative performance can also be a useful tool for assessing historical performance but should only be a secondary consideration. (sub. 47, p. 36)

NGS Super had a similar view:

> Both the appropriateness of the investment strategy and the net return to members should be scrutinised before inclusion [in modern awards]. (sub. 18, p. 2)

Other participants did not support the use of past performance as a criterion (CSSA, sub. 35; Tasplan, sub. 6). For example, CSSA stated that:

> Past investment performance is no guarantee of future performance, and history shows us that a fund which outperforms in one year may not do so in the next … (sub. 35, appendix C, p. 5)

The Commission's view

The Commission recognises that using a past performance criterion to list default funds in awards is intuitively appealing, but has concerns about using past performance as a basis for fund selection.

The recent performance of some top five ranking default funds in 2004 suggest that past performance cannot be relied upon to predict future performance (table 4.1).

Table 4.1 **Recent performance of formerly top ranking default[a] superannuation funds**
2004, 2011

Superannuation fund	*Rank 2004*[b]	*Rank 2011*[b]
MTAA Superannuation fund	1	59
Maritime Super	2	7
Uni Super	3	14
Health Employees Superannuation Trust Australia	4	9
Building Unions Superannuation Scheme (Queensland)	5	33

a Fund data based on superannuation funds listed in modern awards, for which return data are available in all years 2004–2011. **b** Rank based on rate of return.

Sources: Productivity Commission estimates based on APRA fund-level profiles and financial performance data 2011 (APRA 2012g); FWA (2012c).

The nature of past performance as an unreliable predictor of future performance over the medium to long term is reflected in the ASIC requirement that a declaration to this effect is included in promotional material for financial products and services (ASIC 2003). This is supported by an extensive body of research

literature on performance persistence (for example, ASIC 2003), though some literature finds otherwise (Sy and Liu 2009).

Several factors would also hinder the practical application of a performance measure.

- Minimum return targets or 'league table' approaches would require frequent updating, which could prove very disruptive to funds (and their members) that are around the cut-off point.
- There is a likelihood that funds may be more conservative and less responsive to changing market conditions where a performance criterion was applied, to ensure that they did not stray 'too far from the pack'. This could be detrimental to system-wide performance.
- Deciding on how performance should be measured would be highly contentious, given the significance of the decision for stakeholders. It would be difficult to find a measure that would be seen by all as accurate, consistent and that allowed for full comparability between funds. Issues include:
  - how to value, and how often to value, unlisted assets that are not traded on an open exchange
  - how to measure 'performance'. For example, SuperRatings rate superannuation funds by taking into account over 300 'aspects'. Performance is included under the investment module, and that module accounts for little more than one-fifth of the total assessment (Super Ratings nd). Canstar Cannex apply ratings to superannuation funds by taking into account 80 'features' including available investment options, account access, insurance options and premiums, availability of advice, fund performance and investment strategy (Canstar Cannex 2011).

Notwithstanding these limitations, past performance may provide a useful guide of the ability of trustees to deliver on their stated investment objectives. Though the Stronger Super reforms that require funds to clearly articulate a target rate of return and level of risk will not guarantee that specified return objectives are met, it — along with past performance data — presents an opportunity for decision makers to assess a fund's expected ability to deliver on its investment objectives.

The Commission's view, therefore, is that a fund's past performance should not be used in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards per se. Instead, a fund's expected ability to deliver on its objectives, which will relate in part to its performance record, is a valid factor to consider, and should be given primary consideration among a range of factors.

The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should include consideration of the fund's expected ability to deliver on the MySuper product's investment objectives (as a primary factor).

4.3 Fees

Superannuation funds charge a range of fees that arise from their operating and investment expenses. Investment expenses relate to the asset allocation and approach to risk taken by the fund, whether the assets are managed actively or passively, and the liquidity of the fund's asset holdings. Operating expenses relate to expenses not directly linked to the investment portfolio, such as administration and audit costs. The level of the fees can make a significant difference to the ultimate retirement benefit received by fund members.

Fees charged by superannuation funds

Comprehensive data on fees charged to members are not currently available, though this will change under Stronger Super (discussed below). One of the most common measures of how returns to members are reduced by expenses is the management expense ratio (MER). The MER gives the investment and operating expenses of a fund expressed as a percentage of a fund's net asset value. The MER may not allow a uniform comparison across all funds (Finch 2005), and it will underestimate operating and investment expenses where embedded fees are incurred.[2]

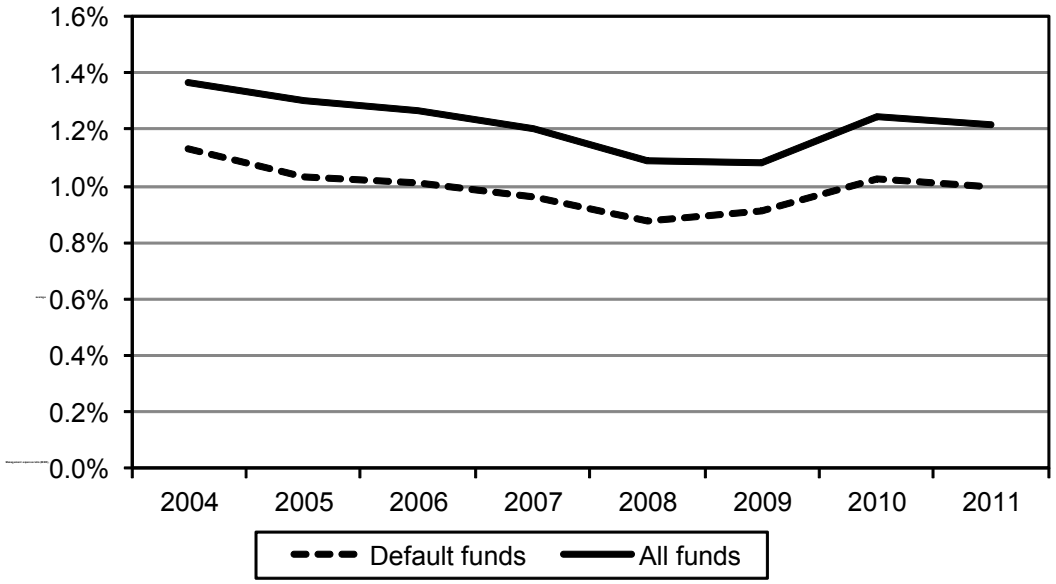
The average MER of default superannuation funds has consistently trended below that of all superannuation funds (figure 4.2). Among default funds, the average MER for all superannuation funds in 2011 (1.0 per cent) is also lower than in 2004.

[2] Embedded fees are fees that are already captured in gross returns and undisclosed to members. For example, embedded fees arise when a superannuation fund invests through a pooled superannuation trust (PST) structure. Fees and charges are paid by the PST on behalf of the fund, and the PST reports net performance back to the superannuation fund without disclosing the associated fees.

Stronger Super reforms

The purpose of the Stronger Super fee reforms is to ensure that fees charged to MySuper members are representative of the costs associated with their account, as well as to aid comparison between MySuper products.

Figure 4.2 **Superannuation fund expenses** [a, b, c]



[a] Based on APRA-regulated superannuation funds for which return data are available in all years 2004–2011. [b] Excludes pooled superannuation trusts, exempt public sector superannuation schemes, small APRA funds and single-member approved deposit funds. Self-managed superannuation funds are regulated by the Australian Taxation Office and are, therefore, excluded. [c] Default fund data based on superannuation funds listed in modern awards, for which return data are available in all years 2004–2011.

Data sources: Productivity Commission estimates based on APRA fund-level profiles and financial performance data 2011 (APRA 2012g); FWA (2012c).

Under the Stronger Super reforms, trustees of MySuper products must disclose all fees to members and may only charge the following fees:

- administration fee — relating to the administration or operation of the fund (including intra-fund advice)
- investment fee (including performance-based fees, subject to limitations)
- a buy–sell spread (limited to cost recovery) — relating to transaction costs incurred in relation to the sale and purchase of assets
- a switching fee (limited to cost recovery) — relating to costs of switching in and out of MySuper and from one choice product to another choice product.
- an exit fee (limited to cost recovery)
- an activity fee (fees for member-specific costs).

The charging of entry fees for MySuper products is prohibited, as is the deduction of commissions from member accounts.

There must be fair allocation of costs between MySuper products and other products, and there must be equal treatment of members by giving all members of a MySuper product:

- the same fees (except where a discounted administration fee is offered to employees of particular employers)
- protection against fee subsidisation (since one employee should not be favoured over another where they have the same employer).

All APRA-regulated funds will be required to calculate fees in a standardised way. APRA will be required to publish information on returns, fees and costs of all MySuper products on a quarterly basis and trustees will disclose information regarding choice products. APRA will have additional powers to collect information on a 'look-through' basis. This will enable APRA to obtain more complete and comparable data, in particular in relation to costs (Australian Government 2010d; Shorten 2012a).

Further, a range of Stronger Super reforms are expected to reduce fees charged to members. For example, Super Stream is intended to reduce administration costs for funds, and as a result, fees charged to members may be reduced in the long term. Further, trustee duties to manage MySuper costs in a manner aimed at 'optimising fund members' financial best interests, as reflected in the net investment return over the longer term' (Australian Government 2010d, p. 16), may drive down fees.

Scope for additional criteria relating to fees

The Stronger Super reforms will limit some fee categories to cost recovery and, therefore, protect the interests of MySuper members by restricting, in part, how much their member contributions and returns can be eroded by fees. The Stronger Super reforms will not place limits on investment and administration fees.

Participants' views

Only a small number of inquiry participants argued that a fee limit should apply for funds to be listed as default funds in modern awards, though the benefits of low cost options are recognised (for example, Employment Law Committee of the Law Society of NSW, sub. 11). In contrast, other participants believe that maximum fee

limits should not apply and that the fee rules prescribed for MySuper products are sufficient (box 4.2).

REI Super stated that imposing an investment fee limit ignores that '… there may be a case … for higher investment fees if active investment management produces higher net performance to members' (sub. 26, p. 3). In addition, imposing a fee cap may have the unintended consequence of '… providers pricing their products at the maximum amount' (FSC, sub. 30, p. 21).

The Commission considers that though imposing a fee cap would limit the extent to which member contributions can be eroded by fees, such a cap would impede optimal performance outcomes.

Box 4.2 Fees as a criterion for choosing default funds — some perspectives

Fees should be a criterion

Fees should only be a consideration when a fund is demonstrably charging an unreasonably high fee for administration, or where investment fees are unreasonably high on a like-for-like basis. (AIST, sub. 20, p.12)

CPA Australia believes … [the] level of fees … should be considered when determining the suitability of a default fund … Importantly, the focus should be on the overall value or benefit provided to members … Costs should not be a driver. (CPA Australia, sub. 39, p. 2)

A maximum fee limit should apply to all superannuation products listed in awards. The decision about whether the member would benefit from a higher-fee fund should be made by each individual member, not by anyone else on his/her behalf. (Australian Hotels Association, sub. 10. p. 8)

Fees should not be a criterion

No [maximum fees should not be set for funds that are selected for inclusion as default funds in awards], the process for authorisation of a MySuper product factors in fees. (Tasplan, sub. 6, p. 4)

Fees should not be a factor beyond the standards set by MySuper. It is the net return to members and services provided which are important. (Unions NSW, sub. 13, p. 5)

Fees and costs are not a proxy for member value. There are no maximum fees set in the MySuper regulatory framework reflecting that fee caps have, in other jurisdictions, led to providers pricing their products at the maximum amount. (FSC, sub. 30, p. 21)

The imposition of an investment fee cap ignores that some fund members might prefer a higher investment fee or higher return product, albeit with a potentially higher risk profile. Further, imposing an investment fee cap may focus trustee attention on fees to the detriment of performance. As trustees become reluctant to

increase their costs, including management expenses, this could lead to a 'race to the bottom' in terms of performance.

Though the Commission does not recommend the capping of fees, it considers that fees should be taken into account among a suite of factors when determining the suitability of a MySuper product, including the appropriateness of the level of fees, given its stated investment return objective and risk profile.

DRAFT RECOMMENDATION 4.3

The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should include consideration of the appropriateness of the fees charged by the MySuper product, given its stated investment return objective and risk profile.

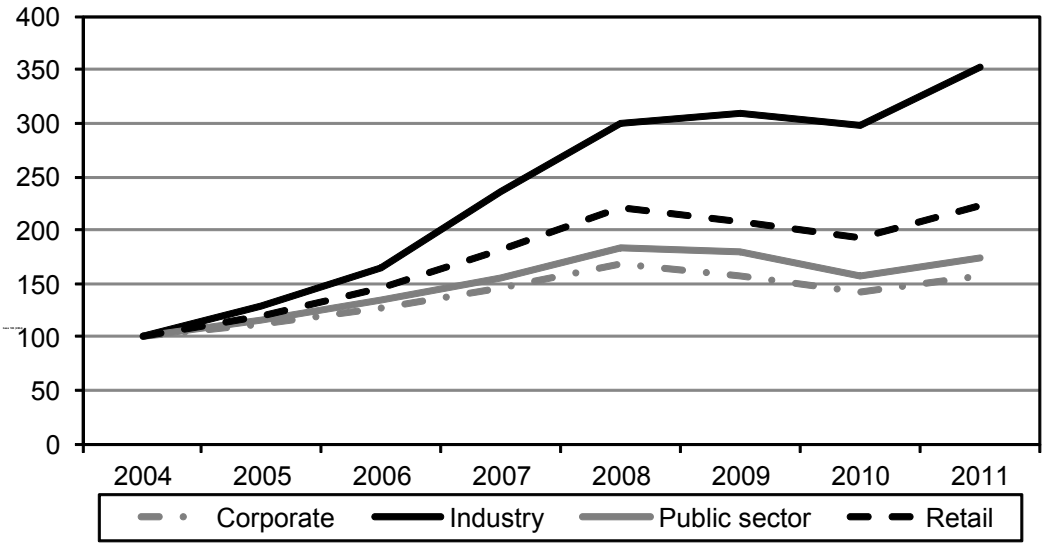
4.4 Scale

Scale refers to both the number of members and amount of assets in a superannuation fund. Economies of scale will result if there are fixed costs that are distributed across a greater number of members/value of assets and these reduced (per dollar of assets or per member) costs may be passed on to members in the form of lower fees and improved fund performance. In the case of superannuation funds, economies relating to size of membership can be achieved in such areas as the collection of contributions, record keeping and marketing (Impavido, Lasagabaster, and García-Huitrón 2010). Economies relating to the size of the assets can be achieved through lower investment-related transaction costs. Economies associated with size of membership and assets are interrelated to the extent that additional members will add to the asset base.

The scale of superannuation funds

The scale of superannuation funds by asset size increased over the period 2004 to 2007 for all fund types, before the effects of the global financial crisis took their toll, and increased again between 2010 and 2011 (figure 4.3). That the scale of superannuation funds has increased over the same period that expenses have trended downward (section 4.3) indicates that falling expenses may be linked to scale economies (see for example, Deloitte 2010).

Figure 4.3 **Scale of superannuation funds by asset size**[a, b, c, d]
By fund type, indexed



[a] Based on APRA-regulated superannuation funds for which return data are available in all years 2004–2011. [b] Excludes pooled superannuation trusts, exempt public sector superannuation schemes, small APRA funds and single-member approved deposit funds. Self-managed superannuation funds are regulated by the Australian Taxation Office and are, therefore, excluded. [c] Retail funds include Eligible Rollover Funds. [d] Based on cash-flow adjusted net assets.

Data source: Productivity Commission estimates based on APRA fund-level profiles and financial performance data 2011 (APRA 2012g).

Overall, default funds have lower average MERs than non-default funds at the same time that they have higher average assets (table 4.2).

Table 4.2 **Fund size and expenses of superannuation funds**[a, b]
By fund type, 2011

	Fund assets (average)[c]	*Management expense ratio (MER) (average)*
	$m	%
All funds	3 232	1.22
All default funds	5 519	1.00

[a] Based on APRA-regulated superannuation funds for which return data are available in all years 2004–2011. [b] Excludes pooled superannuation trusts, exempt public sector superannuation schemes, small APRA funds and single-member approved deposit funds. Self-managed superannuation funds are regulated by the Australian Taxation Office and are, therefore, excluded. [c] Net assets, cash adjusted.

Sources: Productivity Commission estimates based on APRA fund-level profiles and financial performance data 2011 (APRA 2012g); FWA (2012c).

Stronger Super reforms

Current regulatory arrangements do not include a scale test for superannuation funds. Though Stronger Super reforms will not prescribe scale requirements for funds that offer MySuper products, trustees will be required to consider scale.

In the process of seeking MySuper authorisation, a trustee will have to demonstrate to APRA that the product had sufficient scale (or, for a new entrant, that they have a credible path to achieving sufficient scale). MySuper trustees must also implement the 'scale test' on an annual basis by determining whether their members are disadvantaged because of the scale of the fund. Where trustees determine that assets or members are insufficient to meet the scale test, they must take appropriate action to meet their obligations (Commonwealth of Australia 2012). APRA will provide prudential guidance on relevant considerations for trustees in rectifying insufficient scale (Shorten 2012c).

Further, other Stronger Super reforms are expected to increase the scale of superannuation funds. New operational risk financial requirements will require APRA-regulated funds to hold a minimum level of operational risk reserve (APRA 2012b). These higher capital standards may accelerate merger activity that is part of the major long-term restructuring of the industry. This will complement the ongoing restructure of the superannuation industry that has already seen a significant number of fund consolidations in recent years (AMP, sub. 52) (chapter 2). Ongoing consolidation will be supported by the recently announced capital gains tax relief provisions for superannuation funds (Shorten 2012e), regarded as a prerequisite for ongoing merger activity (Asset Super, sub. 32).

Scope for additional criteria relating to scale

Participants' views

Few inquiry participants believe that scale should be a criterion for superannuation funds to be listed in awards, but some recognised scale benefits. For example, REST Industry Super contended that scale facilitates the development of business capabilities, and may result in a broader range of investments and improved overall rates of return (sub. 47). Further, where scale exists, it may benefit members.

> Scale allows a trustee to negotiate better rates with service providers such as investment managers, administrators and custodians. (AMP, sub. 52, p. 6)

Most participants believe that the MySuper scale requirements are sufficient, and that no additional scale requirements should apply (box 4.3).

Box 4.3 **Scale as a criterion for choosing default funds — some perspectives**

Scale should be a criterion

> Entry to awards after 2013 [should] be conditional on funds being able to prove to APRA that they have operated an equivalent of a scale … that would make it appropriate for award inclusion. (ACTU, sub. 29, pp. 11–12)

Scale should not be a criterion

> A prescriptive scale requirement ignores that '… it is not the case that … returns [always] increase in sync with fund size …' (Tasplan, sub. 6, p. 5).
>
> We believe [scale] is adequately addressed in the MySuper licensing process and ongoing 'scale test'. (REI Super, sub. 26, p. 5)
>
> There is no ideal fund size in assessing member value. Regardless, the MySuper framework contains a requirement that a MySuper trustee annually makes an assessment of scale. (FSC, sub. 30, p. 24)
>
> We do not believe that scale should be a deciding factor as smaller or specialised funds may provide the necessary value to employees in a particular industry or achieve scale through pooling administration or investment resources. (CPA Australia, sub. 39, p. 2)
>
> Funds will be required to make their own assessment of scale to ensure that they are able to offer a MySuper product that is in their members' best financial interest. As this process is a threshold MySuper criteria, it should not be a criteria that is duplicated in the selection of funds in awards. (AIST, sub. 20, p. 15)

The Commission's view

Imposing a scale criterion that prescribes a minimum fund size ignores the fact that superannuation funds can access 'scale advantages' in a number of ways other than through merger activity. For example by outsourcing administrative or investment components (such as by using organisations that offer a 'one-stop-shop' investment capability) (Deloitte 2010).

Further, it is possible for smaller funds to outperform larger ones, and imposing a scale criterion that prescribes a minimum fund size could penalise small well-performing funds. A scale criterion might also have the unintended consequence of shutting out new and smaller players, preventing competition from driving down prices.

Further, a prescriptive scale requirement would ignore that scale is just *one* factor among many that influence fund performance. Such a requirement may risk introducing 'false security' for industrial parties and trustees, and divert their focus from fund performance and other risks.

The MySuper 'scale test' is a flexible approach without the disadvantages outlined above, though its success will depend on the thoroughness with which APRA reviews each MySuper application, and the extent to which it polices the annual 'scale test' review.

The Commission considers that the MySuper requirement that trustees consider scale is appropriate, and that no greater prescription of scale is required.

DRAFT RECOMMENDATION 4.4

The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should not include scale as a specific criterion over and above the MySuper 'scale test'.

5 Governance and transparency

Key points

- This chapter looks at whether, and to what extent, issues of governance and transparency should be taken into account in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.
- Default superannuation arrangements are subject to significant principal–agent relationships. Good governance arrangements are therefore critical to ensure the security of monies held in the form of superannuation, and to ensure superannuation funds operate in the best interests of members.
- The Cooper Review found no significant evidence of systemic trustee governance failure, but found a number of areas in which governance arrangements needed to be improved. Conflicts of interest, and conflicts of duty, were seen as commonplace.
- In response, as part of Stronger Super, the Australian Government has announced a number of reforms including new duties for trustees, stronger requirements with regard to conflicts of interest, increases in the standard of care, skill and diligence required of trustees, and expansion of the covenants for which trustees must have regard.
- Submissions to this inquiry support the need for good governance considerations in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards, though there were different views about how this should be achieved in practice. One significant issue is whether superannuation boards with equal representation work best, or whether a greater number of independent directors would be preferable.
- Considering that many of the Stronger Super reforms relating to governance have only recently been announced, and given the broad nature of these reforms, the Commission is not persuaded that additional strict criteria are warranted.
- Nonetheless, the Commission recommends the Australian Government consider setting up a panel of corporate governance experts and regulators to assess the appropriateness of the board structures of default superannuation funds.
- The Commission also considers that a variety of factors should be taken into account in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards, including governance structures, mechanisms put in place by fund trustees to deal with conflicts of interest, and practices relating to the treatment of a member's superannuation when they cease employment ('flipping').

This chapter discusses the scope for additional criteria relating to governance and transparency to be considered in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. It begins with a discussion of the importance of having good governance arrangements in place. It also analyses, in the context of the Stronger Super reforms, the case for additional criteria relating to the key governance and transparency issues identified by inquiry participants.

5.1 The importance of good governance

In a system of compulsory superannuation — where people are unable to opt out of investing — it is especially important to ensure the security of monies held, and that the interests of fund members are paramount. Good governance arrangements are critical in this regard. The Cooper Review highlighted the importance of good governance in the context of compulsory superannuation:

> It is sometimes overlooked that the superannuation industry is quite different from other businesses. It owes its existence to government policy and is underpinned by a social purpose that runs alongside many other economic and stakeholder considerations. Recognising this special purpose, the Panel believes that all those involved in the system need to have — and be seen to have — high standards of governance. In superannuation, just as in other areas of corporate activity, good governance plays a major role in promoting better decisions, greater accountability and in reducing unintended operational and investment risks. (Australian Government 2010b, p. 44)

Participants have also noted the importance of good governance. The Australian Institute of Superannuation Trustees (AIST) said:

> The links between improved governance and higher performance is well documented and we expect that with the improved level of governance come improved returns. (sub. 20, p. 15)

The Industry Super Network (ISN) stated:

> Analysis of superfund performance suggests that governance affects performance, but that the loyalties and perceived role of directors are the crucial factors. (sub. 27, p. 25)

Default superannuation arrangements are subject to significant principal–agent relationships (chapter 3). The role of governance arrangements is to limit the ability of agents to act in a manner contrary to the interests of the principals, to ensure the interests of principals override other interests, and to promote overall transparency and confidence in the compulsory superannuation system. Studies have suggested good governance arrangements can increase annual returns by between one and two percentage points (Ambachtsheer, Capelle and Lum 2006).

Regulatory arrangements for the superannuation industry are contained in the *Superannuation Industry (Supervision) Act 1993* (Cwlth) (SIS Act), regulations under the SIS Act, the *Corporations Act 2001* (Cwlth) and are also based on other licensing requirements for superannuation entities. There are also a number of non-binding guidelines produced by the Australian Prudential Regulation Authority (APRA). The Cooper Review found a lack of coordination between these regimes led to a range of governance problems.

5.2 The Government's response to the Cooper Review's governance recommendations

In response to the Cooper Review, the Australian Government has proceeded with a number of reforms in the area of governance, including:

- introducing a duty for trustees and directors to give priority to the interests of fund members when that duty conflicts with other duties
- strengthening the requirements on individual directors in relation to managing conflicts of interest
- increasing the standard of care, skill and diligence required of trustees and directors of corporate trustees to that of a 'prudent superannuation trustee'
- clarifying the duties applying to individual directors of corporate trustees to act honestly and to exercise independent judgement
- introducing a requirement for trustees to devise and implement an insurance strategy and imposing a statutory duty on trustees to manage insurance with the sole aim of benefiting members
- expanding the covenants to which APRA-regulated fund trustees must have regard to include expected costs, expected taxation consequences, and the availability of valuation information (Australian Government 2011a).

The Government has also drafted legislation which will require superannuation funds to publish on their websites information including:

- details of asset holdings every six months
- a product dashboard as proposed by the Cooper Review, with information on target returns, past performance, investment risk, liquidity and fees (Shorten 2012c, 2012d).

Further, the Government has foreshadowed that regulations will require other documents to be published on fund websites. These documents include:

- details of director and executive remuneration
- performance information for the past ten years
- trust deeds
- annual reports, and other financial and actuarial reports
- names of outsourced providers
- names and biographies of directors, trustees and people involved in the trusteeship of funds
- details of board meeting attendance by directors
- the proxy voting policies and procedures of funds, and their voting behaviour (Shorten 2012c).

APRA is being given the power to draft binding prudential standards for the superannuation industry for the first time, and is currently developing these standards. Where possible, APRA will seek to align these standards with those applying to other financial institutions subject to APRA oversight (in line with APRA's objective for greater regulatory convergence).

The Government has also, through the Australian Securities and Investments Commission (ASIC), set up a centralised superannuation website, www.moneysmart.gov.au.

Not all of the governance-related recommendations of the Cooper Review were adopted by the Government. For example, the Government rejected the recommendation to remove the mandatory requirements for trustee boards of employer-sponsored funds to have equal representation between employer and employee representatives. Recommendations that boards be required to have a 'critical mass' of independent (or 'non-associated') trustee directors were also rejected (Australian Government 2010d). These issues are discussed further in section 5.3.

Future of Financial Advice reforms

The Government is also proceeding with new Future of Financial Advice (or FOFA) laws which are designed to improve governance arrangements and transparency in all fields of financial advice. Proposed reforms include:

- a prospective ban on conflicted remuneration structures, including commissions and volume payments, in relation to the distribution and advice of retail investment products including managed investments, superannuation and margin loans
- a prospective ban on up-front and trailing commissions and like payments for both individual and group risk insurance within superannuation
- a ban on soft-dollar benefits (monetary and non-monetary benefits) received by financial planning firms, representatives and associates in relation to both retail investment products and insurance within superannuation, where a benefit is $300 or more
- a prospective requirement for advisers to request retail clients to opt-in (or renew) their advice agreement every two years, with ASIC being given the power to exempt advisers from the opt-in obligation where they are satisfied that the adviser is signed up to a professional code which obviates the need for opt-in
- the introduction of a best interests duty so that advisers must act in the best interests of their clients, subject to a 'reasonable steps' qualification, and to place the best interests of their clients ahead of their own when providing personal advice to retail clients.

Industry initiatives

In addition to these government initiatives, other bodies have also moved to improve disclosure. For example, AIST has announced new disclosure guidelines for its not-for-profit member funds. Under the guidelines, information that funds will be expected to disclose includes:

- remuneration for trustees and senior executives
- trustee attendance at board and committee meetings
- a listing of 'material' service providers
- proxy voting policies
- a list of fund assets with a three month lag (Patten 2012c).

The Financial Services Council (FSC) (an industry association representing retail funds) has also adopted a new governance policy titled 'Raising the Bar', which is binding on members from 1 July 2013. Key elements include:

- requirements for the Chair and the majority of directors to be independent
- disclosure of director and senior management remuneration
- preclusions on directors holding multiple and conflicting board positions
- development of environmental and social risk policies
- requirements for trustees to develop and publish voting policies, and to publish voting records (FSC 2012).

AIST has questioned the effectiveness of the FSC guidelines as they only require remuneration payments made directly from funds to be declared (Patten 2012c). Where a parent company pays an executive to sit on its commercial superannuation board, the payment from the parent company would not need to be declared under the FSC guidelines. The Commission also questions the effectiveness of these disclosure arrangements, particularly given payments from parent companies are more likely to raise concerns about conflicts of interest. That said, if the Government proceeds with regulations requiring remuneration details to be disclosed, the FSC (and AIST) guidelines are likely to be 'overridden' in any case.

Scope for additional criteria relating to governance and transparency

The Commission is supportive of the direction of the governance reforms contained in the Stronger Super package, and is also conscious the reforms have only recently been announced. Therefore the Commission does not see it as appropriate to place additional governance and transparency criteria on funds beyond those envisaged under Stronger Super. There are, however, some areas where the Commission considers further consideration is justified in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.

5.3 Superannuation board representation

Equal representation and independent directors

The Cooper Review challenged the prevailing equal representation model for employer-sponsored funds (that is, industry and corporate funds), which is required by the SIS Act (where, in the SIS Act, there is allowance for one additional independent trustee or director who is unable to exercise a casting vote). The

Cooper Review listed a number of reasons why consideration should be given to moving away from the equal representation model.

- The introduction of fund choice, and a move away from defined benefit funds, reduces the close relationship between employers and super funds.
- Many employer and employee representatives on boards are appointed by third parties rather than being elected by employers and members. As a consequence, the democratic principle that equal representation was meant to reflect is not always observed in reality.
- The potential for perceptions that individual trustee-directors are dictated to by the organisations that appointed them.
- The large number of employers, employer organisations and employee organisations related to a fund can sometimes lead to larger boards than would be ideal.
- Equal representation left some groups 'unrepresented', such as members who are pensioners and members who have joined the fund because they exercised fund choice.

In summary, the equal representation model was seen to impose rigidity on fund governance practices and reduce accountability, without ensuring the representation objective on which it was predicated.

Further, the Cooper Review saw best practice in corporate governance as involving the presence of independent directors. The Cooper Review therefore recommended that a minimum number of independent trustee-directors should be on the boards of all funds, representing a 'critical mass' to ensure board decisions could be genuinely influenced.

Scope for additional criteria related to superannuation board representation

Participants' views

The Commission, in its 2001 Review of the SIS Act (and other legislation), supported equal representation on boards:

> The equal representation rules for trustee boards of standard employer-sponsored funds provide balanced representation of employer and employee interests. They are conducive to active member interest in the prudent management of these funds. This benefit exceeds the cost of finding and appointing members who are capable of undertaking trustee duties. (PC 2001, p. 113)

The Industry Funds Forum highlighted the advantages of the equal representation model:

> Industry funds developed the current governance structure, which applies to regulated superannuation funds. Industry funds have from virtually the beginning had equal representation and a two-thirds majority for decision-making. This representative governance structure helps ensure that member interests come first, at the same time allowing key stakeholders have a say in how the fund is run, with no one stakeholder or group of stakeholders having a controlling interest. (sub. 51, p. 9)

Some participants, including industry funds that have independent representation on their boards, highlighted that independent representation can work well. Unions NSW said:

> In our view a fund should have an equal representation of employer and employee representatives with an agreed independent chair. (sub. 13, p. 6)

HOSTPLUS took this further, stating:

> HOSTPLUS … is now overseen by a Board made up of three representatives from the AHA, three from United Voice and three independent Directors. The structure ensures the interests of employers and workers are met and provides the fund with a strong understanding of the intricacies and employment nuances of our sectors. (sub. 8, p. 2)

BT Financial Group noted that, outside of superannuation, there were requirements for financial services entities to have independent board members:

> With the exception of superannuation, APRA currently requires that regulated entities have both an independent Chair and that the majority of directors are also independent. The Australian Stock Exchange also believes that independence of the majority of directors and the Chair is best practice. (sub. 46, p. 3)

BT Financial Group also suggested this should be mandatory in the area of superannuation:

> We believe all members deserve superannuation funds which adhere to best practice governance standards. As such, the Government should allow APRA to introduce prudential standards requiring superannuation fund boards to have an independent Chair and the independence of the majority of directors. (sub. 46, pp. 3–4)

However, the Australian Council of Trade Unions (ACTU) questioned whether the case for independent directors was particularly strong:

> We noted [the Cooper Review's recommendation for independent board members] flowed from the review panel's assertion that such a reform reflected 'contemporary best practice in corporate governance.' It did not arise on the basis of actual evidence that the equal representation model in Australia was failing and therefore required this particular reform. Nor did the panel's report consider any of the evidence and debate generated by researchers in corporate governance which questions the extent to which non-associated or independent directors actually deliver better performance and

> governance in practice. In short, the panel opted for speculative assertion rather than evidence-based policy analysis. We therefore welcomed the government's rejection of the Cooper panel's recommendation and its view that the equal representation model worked well and should continue. (sub. 29, p. 7)

The Commission's view

The Commission agrees that the equal representation model has generally operated well to date. However, as increasing numbers of industry funds actively broaden their membership beyond their traditional base through becoming 'public offer' funds, the arguments for equal representation become less compelling. Once a fund takes members from outside the industry in which it originated, for these 'outside' members, the board is likely to be 'non-representative'.

Further, in view of recent controversies surrounding the governance of some industry funds, it has been suggested the case for independent directors is strengthened. For example, Jeremy Cooper has recently suggested that giving boards the power to dismiss directors could be quite problematic[1] and 'the solution [to removing unworthy board members] is having more independents' (Patten 2012b, p. 6). That said, directors would not necessarily need to be independent to exert pressure on poorly performing directors, and the most recent controversies have been resolved without the presence of independent directors.

Some arguments for increasing the number of independent directors apply to both retail and industry funds, albeit for different reasons. As highlighted by the Cooper Review, it is important for retail funds to have directors that are independent from management, while there are likely to be benefits from having independent directors of industry funds to introduce an 'outsider's perspective', and to ensure the interests of those members who have exercised fund choice are taken into account.

For both retail and industry funds, there is the potential for independent directors to bring increased knowledge and expertise to superannuation boards. The Commission has previously noted the benefits of non-aligned expert members in other reports (such as the Commission's 2005 Health Workforce research report).

The Deputy Chairman of APRA, Ross Jones, recently expressed support for independent directors in media interviews, citing the additional expertise they can

[1] As it stands under Australian corporate law, it is up to shareholders to determine the composition of boards, and boards have no legal authority to remove individual directors even where there is a strong case for doing so. A concern with giving boards such authority is that it could lead to individual directors feeling they were unable to freely express their views at board meetings without fear of retribution in the form of dismissal.

bring, and stating that their presence has added value in those financial industries where having independent directors is compulsory. Media reports have also suggested APRA is likely to recommend that funds have independent directors, seeing this as representing good governance, but that it will not require funds to have independent directors by law (possibly addressing the issue through the guidance notes to its prudential standards for superannuation) (Patten 2012a, Korporaal 2012).

The Commission considers it is timely to assess the appropriateness of board structures of default superannuation funds. This includes examining any limitations on board composition contained in the SIS Act for 'employer-sponsored' (that is, industry and corporate) funds — particularly if the reforms in this report result in increased competition between retail and employer-sponsored funds — and to ascertain whether current board structures adequately promote increased board expertise and transparency. This could be done by setting up a panel of corporate governance experts to review the issue, with the composition of the panel to include the relevant regulators (APRA and ASIC).

APRA has published new guidelines regarding what constitutes an independent director. Under the APRA guidelines, an independent director would be one who is not, and in recent years has not been:

- in an executive role with an employer–sponsor
- an official or representative of a body that has the right under the governing rules to nominate or appoint directors (or individual trustees) to represent either member or employer interests
- a director, employee or shareholder of a company related to either a standard employer-sponsor or to the fund licensee (other than in the case of a wholly-owned subsidiary of the licensee)
- a director, employee or shareholder of a material service provider, whether related or not (APRA 2011).

The Commission considers that funds which intend to appoint independent directors should use this guidance as a starting point. The Commission further considers that, in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards, decision makers should take into account whether the governance structures of individual default funds are consistent with meeting the best interests of members. However, until the panel described above has reported on the issue of appropriate board structures, decision makers should ensure the legislative constraints relating to the composition of some boards do not represent a barrier to the selection of the funds governed by those boards.

DRAFT RECOMMENDATION 5.1

The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should include consideration of whether governance structures are, as far as legislative requirements allow, consistent with meeting the best interests of members.

DRAFT RECOMMENDATION 5.2

The Australian Government should consider assembling a panel of corporate governance experts and relevant regulators to assess the appropriateness of board structures of default superannuation funds, including any limitations contained in the Superannuation Industry (Supervision) Act 1993.

5.4 Managing conflicts of interest

The management of conflicts of interest is particularly important within the default superannuation system given the inescapable reliance on principal–agent relationships. This is not only to ensure agents' interests can be aligned with those of members, but also to promote overall transparency and confidence in the system.

Stronger Super reforms relating to managing conflicts of interest

As detailed above, the Stronger Super reforms seek to deal with conflicts of interest and make it clear that members are owed the highest duty by fund directors and trustees. APRA has proposed a new prudential standard SPS 521 to deal with this issue.

APRA notes that conflicts of interest can be actual, perceived or potential in nature. The new APRA standard does not seek to eliminate conflicts, but rather to ensure that funds are aware of them, and have measures in place to deal with them. This includes proposed requirements to have two registers: one that outlines all duties of the licensee and duties of each individual director, and the other that lists all material interests of individual directors and senior management (where interests include matters such as gifts, emoluments and benefits). APRA's expectation is that conflict management frameworks should be appropriate to the size, business mix and complexity of a licensee's operations (APRA 2011).

Scope for additional criteria relating to managing conflicts of interests

Participants' views

NGS Super highlighted the importance of ensuring members' interests were paramount:

> The introduction of MySuper brings with it increased fiduciary responsibilities for fund trustees … they will have to give priority to the interests of members in the case of a conflict or potential conflict of interest … it is clear that strong corporate governance focussing on the promotion of members' best interests … is a priority. (sub. 18, p. 5)

Several submissions expressed particular concern about conflicts of interest among retail funds (for example, ACTU (sub. 29), AMWU (sub. 49)). The ACTU stated:

> To many financial institutions our superannuation system is primarily an opportunity to accumulate private profit. The existence of a large number of customers who are compelled to participate in a market they often do not understand and are unable to influence has provided financial institutions with many opportunities to apply a raft of fees, charges and commissions at the expense of member benefits. This is evidenced by the fact that while retail funds have on average underperformed relative to most not-for-profit funds in terms of net returns to members, they continue to charge significantly higher fees. This indicates that a major inefficiency in the Australian superannuation system … is the retail super sector. (sub. 29, p. 3)

The ISN pointed to past performance to suggest the governance structure of industry funds showed they are better placed to deal with conflict of interest concerns:

> Eliminating the pernicious effects of conflicts of interest — namely, the effects of conflicts of interest that undermine performance and otherwise undercut the ability of the fund to maximise retirement outcomes — is a critical part of [producing superior returns to members]. Accordingly, any consideration of governance in connection with naming default funds in modern awards should be tied to the available research, which demonstrates that the representative trustee model employed by not-for-profit funds has best served the public interest and member interests. (sub. 27, p. 26)

The Commission's view

Many potential conflicts of interest are inherent in the superannuation industry, but it is important that funds and trustees seek to minimise their impact. When selecting and assessing superannuation funds for listing as default funds on an ongoing basis, conflicts of interest associated with superannuation and the mechanisms put in place by fund trustees in dealing with these conflicts should be considered. These decisions should be made on a 'fund by fund' basis rather than being based on any

inherent assumption that particular governance structures deal best with conflict of interest issues.

DRAFT RECOMMENDATION 5.3

The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should include consideration of the mechanisms put in place by fund trustees to deal with conflicts of interest, and the transparency in disclosing those conflicts.

5.5 Flipping of members

A large number of participants raised the issue of 'flipping'. Flipping was defined in the Cooper Review as the practice of fund members 'being automatically moved from one division of a fund to another … on cessation by the member of the particular employment to which the original fund division related' (Australian Government 2010b, p. 24). Concerns about flipping emerge when members are transferred to a higher cost division of a fund, often without their knowledge or understanding of the consequences for their superannuation balance. This highlights potential principal–agent problems when the interests of members and fund managers do not align.

'Flipping' measures under Stronger Super

Under Stronger Super, one core criterion for MySuper products is that a member's interest cannot be transferred without the member's consent *except* to another MySuper product within the fund (Shorten 2011). Given the Government's intention that MySuper products are 'low cost and simple' (Australian Government 2010d), this requirement makes it much less likely members will be moved to a significantly higher cost product (but does not entirely eliminate the possibility).

Scope for additional criteria related to flipping of members

Participants' views

A number of participants considered that the practice of flipping should be addressed when considering the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. For example, HOSTPLUS stated that only funds that demonstrate no (past) evidence of flipping should be eligible for nomination (sub. 8). The ISN considered that 'funds that

actively flip their members into a higher priced MySuper product should not be eligible to be named as a default fund' (sub. 27, p. vi), and AustralianSuper suggested that eligible MySuper products should be 'prohibited from engaging in fund flipping' (sub. 36, p. 5).

Some participants expressed concern that the legislation before parliament leaves room for flipping to occur. Some employers (subject to having more than 500 employees) with award employees may negotiate a tailored MySuper product with the fund nominated in the relevant award. In these circumstances, an individual MySuper member, when they cease employment with the employer that negotiated the tailored product, could be moved to the 'mainstream' MySuper product within the same fund (permitted under the Stronger Super reforms). The concern relates to the (potential) practice of a fund providing artificially low prices in its tailored products, with a view to recouping its losses and making additional profits when employees leave their employer (and are 'flipped' to the fund's non-tailored MySuper product).

The key concern here is that some funds could adopt a business model that targets high-turnover industries for tailored products with discounted fees (potentially below cost). As the ACTU put it:

> Retail funds will be able to offer 'loss leading' versions of their MySuper products to particular large employers on the basis that employee turnover will mean such losses are recouped over time. (sub. 29, p. 10)

Cbus stated:

> Regrettably the incentives to create opportunities to engage in 'sharp practice' of flipping are high. High labour mobility and short job tenure in the construction industry expose workers to being unknowingly moved into funds with a high cost structure. (sub. 15, p. 6)

This approach could be profitable if the fund's 'mainstream' MySuper product was a higher fee product than its tailored product.

The Commission's view

The Commission considers that the best safeguard against flipping of members is to include the likelihood of flipping as one of the factors to be considered in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. Funds with a reputation for flipping would therefore be at a competitive disadvantage when seeking future inclusion as default funds.

However, in seeking to prevent flipping it is important not to prevent funds from offering members attractive discounted tailored MySuper products where an employer can negotiate a good outcome for their employees. Where discounts that are available to an employee while at one employer are removed when the employee changes employers, as long as the employee's fees become no higher than the standard rate for the relevant product, then consideration should be limited to whether the fees or other features remain comparable with other, similar MySuper products.

DRAFT RECOMMENDATION 5.4

The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should include consideration of the likelihood of members being switched to higher cost divisions of the fund, or facing significantly higher fees for features of their policies (such as insurance), upon exiting their current employment.

5.6 Board tenure and renewal policy

A further issue brought to the Commission's attention is an area of contention under the Stronger Super reforms: the requirement for funds to develop a board tenure and renewal policy. The logic behind this requirement is a perceived need to ensure boards continue to remain open to new ideas and independent thinking.

APRA has not proposed specific tenure limits for directors or individual trustees, but rather that each fund have a renewal policy incorporating an explicit statement as to the maximum term the fund licensee considers appropriate for its directors. APRA states that funds can choose to develop policies that allow for flexibility for term extensions of individual directors 'where appropriate and justifiable' (APRA 2012e, p. 13).

Participants' views

REST Industry Super considered tenure to be an inappropriate criterion for judging directors:

> REST … holds the view that it is important to strongly advocate the benefits of long-standing directors and what this brings to a fund's board and its members. REST's view is that tenure, by itself, is a poor measure to assess the appropriateness of a director. It is the contributions made to the Board through their collective skills, education, experience and participation that are more relevant. The REST Board is made up of individuals who have a wealth of retail industry and commercial experience in a corporate environment. Their long standing in-depth knowledge of the fund which

> can only be gained over a long tenure, together with their understanding of the industry adds huge value not only to the operation of the fund but also to the members and employers. (sub. 47, p. 24)

APRA's current position is that directors should only be reappointed in relatively rare circumstances:

> APRA considers that … licensees should have a clear approach for assessing, prior to the cessation of the term of an individual director, what would make it appropriate, at that time, to step outside their tenure policy. The presumption would continue to be that a director would leave office at the end of their term unless the RSE licensee could appropriately form a view on why that director should remain. (APRA 2012e, p. 13)

The Commission's view

The Commission considers there are important trade-offs between the benefits of renewal and the benefits of having experienced board members. On balance, it supports APRA's policy, in that the policy allows for sufficient flexibility, while recognising that the status quo has seen some very long board appointments that might not have always been in the best interests of members. Accordingly, it would not be necessary to consider this issue in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.

6 Other potential criteria

Key points

- No strict criteria can usefully be applied to insurance as a requirement for eligibility for selection in modern awards because:
  - the Stronger Super reforms remove many existing concerns relating to insurance
  - the Commission found no systemic issues that are likely to remain that would require further prescriptive criteria after the implementation of the Stronger Super reforms
  - there is potential for any additional regulation to have unforseen and adverse consequences, due to the complex nature of insurance.
- However, as part of the selection process, consideration should be given to the compatibility of a fund's insurance offerings with the characteristics of those employees to whom the superannuation provisions in the modern award apply. The extent to which a fund designs a range of insurance offerings under its default product, and the way these offerings are allocated to members, should be taken into account.
- Intra-fund advice improves the ability of members to make informed decisions about their superannuation. In the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards, the adequacy of member- and fund-specific intra-fund advice should be considered.
- However, further prescriptive criteria cannot usefully be applied in this area because the Stronger Super and Future of Financial Advice reforms adequately address concerns about financial advice in superannuation.
- Where funds are 'connected' to a particular industry, there might be components of their products that are highly suited to employees in that industry. However, it is the suitability of those components, rather than industry connectedness per se, that should form part of the consideration for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.
- Some employers and members face significant costs in dealing with certain superannuation funds. The superannuation system does not currently meet the needs of these stakeholders.
- The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should include consideration of the administrative efficiency of the fund according to a set of benchmarks determined by the Australian Prudential Regulation Authority (or another appropriate body) in consultation with the industry.

This chapter looks at potential criteria relating to insurance, financial advice, industry connectedness and administrative efficiency in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. The Stronger Super and Future of Financial Advice (FOFA) reforms are taken into account in this assessment.

6.1 Insurance

Superannuation is an important distribution channel for insurance in Australia. Types of insurance currently offered with superannuation products include life, total and permanent disability (TPD), income protection and trauma insurance (box 6.1). Research suggests that more than 80 per cent of life and TPD insurance policies in Australia are held through individual superannuation accounts (AIST and IFF 2008).[1]

There is currently a requirement under section 32C of the *Superannuation Guarantee (Administration) Act 1992* (Cwlth) for default funds to offer, as a minimum, a level of life insurance that is defined in terms of a premium of $0.50 per week, or a level of cover that is dependent on the member's age.

Funds generally set a higher level of life insurance than the legislated minimum in their default products. In addition to life insurance, members are typically allocated a default level of TPD insurance on joining a superannuation fund. They can usually opt out or vary the level of insurance if they wish. Underwriting procedures for members wishing to increase their cover vary by fund.

Box 6.1 **Types of insurance offered with superannuation**

Life insurance provides a benefit to beneficiaries of the policy holder in the event of the policy holder's death.

Total and permanent disability (TPD) insurance provides a benefit to the policy holder in the event they suffer mental or physical injury and are permanently unable to return to their normal occupation as a result.

Income protection insurance provides a benefit to the policy holder when they are temporarily unable to earn income due to illness or injury.

Trauma insurance provides a lump sum benefit to the policy holder if they are diagnosed with an injury or illness covered by the policy. Under the Stronger Super reforms, trauma insurance can no longer be offered with superannuation products.

[1] Pension systems in other countries, such as New Zealand, do not include insurance (appendix B).

There are two arguments commonly made for bundling insurance with superannuation products. First, as provided for under section 62 of the *Superannuation Industry (Supervision) Act 1993* (Cwlth) (SIS Act), the sole purpose of a superannuation fund is to provide financial benefits when members retire, become disabled and are unable to work, or die. Second, obtaining insurance through superannuation can provide members with a range of benefits, including:

- lower premiums than those in the retail insurance market as a result of wholesale insurance contracts
- premiums being paid from pre-tax contributions
- automatic acceptance.

Insurance differs across several dimensions, including:

- the types of insurance on offer (such as life, TPD and income protection)
- premiums
- default levels of cover
- maximum levels of cover
- ability to opt in or out
- automatic acceptance levels
- waiting periods
- continuity of insurance between jobs
- other terms and conditions.

The complexity of insurance makes it difficult for members to compare and contrast offerings across products, to address their needs. Consequently, some members might have the wrong type or level of insurance for their circumstances, such as their age, occupation or other personal circumstances.

Superannuation funds may vary insurance terms and conditions between groups of members within the same default product, depending on their circumstances. For example, a fund may differentiate offerings based on occupation, with a higher level of cover for members in a white collar industry, and a lower level of cover for members in a blue collar industry at the same premium, reflecting different occupational risks (box 6.2). Funds may also differentiate offerings between workplaces, or based on age and other demographic factors. However, the terms of the group insurance contract, as negotiated between the fund and the insurer, may restrict the fund's ability to vary the terms between groups of members.

Box 6.2 **Variation in insurance across superannuation funds**

All default superannuation products are currently required to offer life insurance under section 32C of the *Superannuation Guarantee (Administration) Act 1992* (Cwlth). Some offer income protection cover as well. A small number of funds offer trauma insurance, although this will be prohibited by the Stronger Super reforms.

Most funds allocate a default level of life and total and permanent disability insurance, which typically varies with age. The level of cover usually rises until members reach their 30s, then declines to a small amount of cover at retirement age.

Some funds offer one insurance schedule for 'blue collar' employees, and another for 'white collar' employees with the latter having higher levels of cover for the same premium. This recognises the increased risks of injury faced by employees in blue collar industries. Members are usually allocated to the blue collar schedule initially, but may change to the white collar schedule on application if they are eligible.

Some funds also differentiate premiums and levels of cover based on other factors such as the member's gender and whether or not they smoke.

Members are usually allowed to cancel or increase their insurance on joining without having to provide health information or undergo medical examination, within automatic acceptance limits. These limits vary between funds.

In many policies, members can also increase their cover when significant life events occur, such as getting married or having a child. The life events which allow a change in cover vary between policies.

If a member wishes to increase their cover at other times, they will usually be required to provide evidence about their health. Exactly what is required is usually determined by the fund's insurance provider. Industry funds generally acquire insurance through large insurers, although retail funds might be able to acquire insurance through a related party.

Other policy conditions, such as exclusions for certain events, also vary between funds.

Stronger Super reforms

The Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System (Cooper Review) argued that the provision of life and TPD cover aligns with the purpose of superannuation (that is, to provide members with benefits when they no longer work) and recommended that, in addition to life insurance, funds should be required to offer a default level of TPD insurance. Income protection was considered to be less clearly linked to the purpose of superannuation. The link between other types of insurance and the purpose of

superannuation was found to be insufficient. As a result, the Stronger Super reforms require that:

- life and TPD cover must be included with MySuper products on an opt-out basis
- income protection insurance may be included on an opt-out or opt-in basis, or not at all in MySuper products
- no types of insurance other than life, TPD and income protection should be permitted to be paid for by members through their superannuation in MySuper products.

Aside from the requirement for all members to receive life and TPD cover on an opt-out basis, the ability of funds to differentiate insurance offerings in MySuper products between different groups of members is not diminished under the Stronger Super reforms.

The Cooper Review also recommended that trustees should exercise the same level of care in making decisions about insurance as they should in making investment decisions. As a result, the Stronger Super reforms require trustees of MySuper products to:

- manage insurance with the aim of benefiting members
- devise and implement an insurance strategy specifying types, default levels and maximum levels of cover to be offered.

The Review considered that the current level of information disclosure for insurance in superannuation products is poor and, as a result, members face considerable difficulty in comparing and contrasting options. To address this issue, the Review recommended that trustees of large funds regulated by the Australian Prudential Regulation Authority (APRA) should be required to publish on their websites the terms and conditions applicable to each type of insurance offered, a plain-English explanation of the terms and conditions, and detailed premium tables. This recommendation is expected to be implemented in an upcoming tranche of legislation.

The Review also recommended that success rates for TPD claims be made publicly available. However, this is not expected to be implemented, as the Government's consultation process identified concerns that this might lead to adverse selection issues (Australian Government 2011b).

In examining the issue of funds providing 'in-house' insurance, the Review found that the savings associated with this practice were not large enough to justify the additional risk which would ultimately be borne by members. The Stronger Super reforms address this issue by mandating that self-insurance of any fund benefits

should not be permitted in APRA-regulated funds except in the case of defined benefit funds that are currently allowed to self-insure.

Another issue investigated by the Cooper Review was the inconsistency between benefits paid under insurance policies in superannuation, and the conditions for release of benefits to members under the SIS Act. These inconsistencies have resulted in some members being unable to access a benefit paid from an insurance policy (particularly TPD) until another condition of release (such as reaching the retirement age) was reached. This has been addressed through Stronger Super by aligning the insurance definitions with the conditions of release.

Scope for additional criteria

Participants' views

The main concerns regarding insurance raised by inquiry participants relate to the appropriateness of insurance offerings for the demographic profile of employees associated with a particular modern award.

Most inquiry participants agreed that a fund's insurance offering should be appropriate for members' needs. Many also considered that insurance offerings should be tailored to the employees to whom the superannuation provision in a modern award applies — rather than just the members of a fund — in order for a fund to be listed as a default fund in that award (ACTU, sub. 29; Australian Hotels Association, sub. 10; AIST, sub. 20; AiGroup, sub. 25; Corporate Super Association, sub. 14; CPA Australia, sub. 39; CSSA, sub. 35; legalsuper, sub. 19; NGS Super, sub. 18). For example, the Industry Super Network argued that:

> MySuper will require trustees to develop and maintain an insurance strategy. Consistent with the wider duty upon the trustees to act in the financial interests of the fund beneficiaries, this strategy should be appropriate for the fund demographic. However, it may not be appropriate for the demographic of the relevant award. This duty should be extended and tested to ensure the product's associated default insurance offering is appropriate. (sub. 27, p. 5)

However, the Financial Services Council noted that the Stronger Super reforms allow funds the flexibility to meet the insurance needs of diverse groups of members, submitting that:

> Under the MySuper framework, a default fund provider will be allowed to tailor the insurance arrangements of any workplace. [In this way, the Stronger Super reforms] recognise the need for default funds to tailor the insurance arrangements according to the demographics of members of that fund, including occupation, age etc. Therefore, the [Financial Services Council] submits that if a default fund meets the legal

requirements to hold a MySuper license then no additional requirements should be necessary to be able to qualify for inclusion as a default fund in an award. (sub. 30, pp. 20–2)

The Commission's view

The Commission recognises that insurance is currently an important feature of superannuation, and considers that funds which are seeking to be listed in modern awards should be assessed on their ability to offer appropriate insurance.

Employees in different occupations face different risks, and thus require different types of insurance. The more that insurance can be tailored to a member's circumstances, the better will be the outcome for that member. Given that employees within some industries are likely to face similar insurance needs that relate to the level of risk inherent in their occupation, there is likely to be merit in considering insurance on an award basis.

Superannuation funds are able to vary their insurance offerings in order to meet the potentially diverse needs of industries, workplaces and employees to whom the superannuation provisions in a modern award apply. The range of insurance offerings within a default product, and the extent to which that range is able to meet the needs of members allocated to that product, should form part of the evaluation when selecting funds to be listed in modern awards.

Another important consideration is the way that individuals are allocated to a fund's default insurance offering. Where funds vary their insurance offerings within a product, with more advantageous schedules available to members who represent a lower risk, members are usually allocated to the least advantageous schedule. Some members will be able to opt into a more advantageous schedule by providing evidence that they represent a lower risk, but disengaged members are unlikely to take this action and will receive insurance that is of a lower standard than that for which they may otherwise qualify. Therefore, the default settings of a fund's default product should also form part of the evaluation when selecting funds to be listed in modern awards.

Although the Commission believes that the assessment of funds to be listed in modern awards should consider the appropriateness of insurance, the Commission contends that no additional prescriptive criteria can appropriately be applied to insurance in default superannuation funds for three reasons.

First, the Stronger Super reforms impose a duty to manage insurance solely for the benefit of members which, in conjunction with insurance strategies that funds are required to implement, implies that each fund will optimise insurance offerings for

its membership base. As a result, it is expected that insurance offerings in default funds will be appropriate for fund members without the need for additional regulation.

Second, insurance is a very complex product. If additional regulation is introduced regarding insurance, it could adversely affect other components in unforseen ways. For example, setting an upper limit on premiums might cause funds to reduce some of the costlier components from their offerings, such as automatic acceptance levels. This might increase underwriting expenses and ultimately increase costs to members.

Third, inquiry participants identified no systemic issues that are likely to remain after the implementation of the Stronger Super reforms that require further intervention.

DRAFT RECOMMENDATION 6.1

The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should include consideration of the compatibility of the fund's insurance offerings with the characteristics of employees to whom the superannuation provisions in that modern award apply.

6.2 Financial advice and member education

Financial advice is commonly made available to superannuation fund members. The advice can relate to the member's existing interest in the fund and products offered by the fund — intra-fund advice — or to their financial situation more broadly. The advice is typically provided by an employee of the fund or by a wholly owned subsidiary of the fund.

Some superannuation funds also offer member education services consisting of information that is of a general nature, such as financial education seminars delivered in member workplaces. Although some see this as a form of intra-fund advice, the Commission has considered it separately from intra-fund advice, as it might not provide information specific to the member or the fund.

In 2011, the Australian Securities and Investments Commission (ASIC) conducted a study of retirement income advice. It found that of 64 advice examples, only 2 were rated as good, with the remainder considered either adequate (37) or poor (24). Examples graded as poor (accounting for more than one third of the total) represented a breach of the *Corporations Act 2001* (Cwlth). A significant

determinant of this result was the conflicted remuneration structure of advisers (ASIC 2012b).

The Independent Financial Advisers Association of Australia found that, of more than 18 000 financial advisers in Australia, only 9 met the definition of independence contained in the Corporations Act (SuperGuide 2012). The incentives faced by advisers in the form of commissions and other conflicted remuneration structures, combined with a lack of independence in the industry, can affect the current quality of financial advice. These issues formed the focus of the FOFA reforms (below).

Stronger Super and Future of Financial Advice reforms

The Cooper Review considered that intra-fund advice is an important tool to assist members in making decisions about their superannuation, and should be proactively provided as part of superannuation products. However, it raised concerns about broader financial advice being bundled with superannuation products.

> By bundling the cost of advice into the price of the product, and by having that cost incurred on an ongoing basis, members do not appreciate the true cost of the advice and may pay much more for the advice than it is worth. Also, members' choices in this regard are limited; they generally cannot opt-out. (Australian Government 2010b, p. 18)

To address these concerns, the Stronger Super legislation requires that:

- trustees do not charge across the membership of the fund for providing personal financial advice (other than intra-fund advice[2]), or for any financial advice on an ongoing basis
- the cost of advice or services provided to employers may not be recovered through a fee charged to any member of the fund.[3]

However, the Cooper Review considered that the provision of financial advice to members through superannuation products helps to ensure that advice remains accessible to those who cannot afford to pay for it from other sources. As a result, the ability to opt into financial advice broader than intra-fund advice on a user-pays basis was supported, and an accompanying recommendation was made that such arrangements should lapse unless expressly renewed by the member.

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2 A legislative definition of intra-fund advice has not yet been determined.

3 In the Government's consultation process, however, it was noted that this restriction should not extend to services that assist employers to interact efficiently with the superannuation fund (such as clearing house services) or to services that are designed to educate or benefit members or potential members. These exemptions are yet to be reflected in legislation.

Additional concerns were raised about commissions for financial advice, and the Review recommended that MySuper products be banned from:

- paying or funding any product-based up-front or trailing commission or other similar payment
- making or funding any payment that relates to volume
- paying premiums for insured member benefits that include or fund an up-front or trailing commission or like payment.

These recommendations are expected to be addressed through the FOFA reforms (chapter 5) which are focused on improving the quality of advice and enhancing retail investor protection. The key measures of the reforms include:

- a prospective ban on conflicted remuneration structures such as commissions and volume-based payments
- a duty requiring advisers to act in the best interests of clients when giving personal financial advice
- a requirement for advisers to obtain client agreement to any ongoing advice fees.

Scope for additional criteria

Participants' views

Inquiry participants acknowledged the importance of financial advice to superannuation fund members. For example, REST Industry Super noted that financial advice can help members 'get on the right path at an early stage in life' (sub. 47, p. 18), and Corporate Superannuation Specialist Alliance (CSSA) submitted that:

> … the provision of services, general advice and ultimately financial planning advice in the workplace is critical to achieving the Government's goals of improving access to financial advice and maximising retirement incomes for members. (sub. 35, p. 5)

Other participants considered financial advice as a component of member services, and put forward comments relating to member services in general. When assessing the scope for additional criteria related to member services, there is a range of views. These range from the Industry Super Network's view that 'member services are matters that should be open to trustees to determine, provided they do so in the financial interests of beneficiaries' (sub. 27, p. 45), to that of AIST, which contended that Fair Work Australia should be satisfied that funds should have 'cost effective … member services suitable for employees covered in the award' (sub. 20, p. 4) and CSSA, which proposed that 'workplace education should be provided

proactively to assist people to be engaged with their super' (sub. 35, attachment C, p. 7).

The Commission's view

Intra-fund advice and broader advice

The Cooper Review identified several shortcomings relating to financial advice in the current superannuation system. The Stronger Super and FOFA reforms aim to address these shortcomings and many other long-running issues relating to financial advice, and should encourage greater independence of such advice in future. In turn, this is expected to improve the value of advice to superannuation members.

In considering whether the imposition of additional criteria relating to financial advice would be appropriate, the Commission considered intra-fund advice and broader financial advice separately. The Commission could not identify, nor was it made aware of, any systemic issues relating to intra-fund or broader financial advice for members that are likely to remain after the implementation of the Stronger Super and FOFA reforms. Therefore further strict criteria cannot be usefully applied to either form of advice.

Nevertheless, the Commission considers that the quality of intra-fund advice should be a factor taken into account when choosing default funds. Such advice can help members to make decisions that improve their financial wellbeing. Also, as the information required to deliver such advice is held by the fund, the fund is best placed to deliver the advice.

DRAFT RECOMMENDATION 6.2

The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should include consideration of the quality of member- and fund-specific intra-fund advice.

Advice relating to a member's broader financial circumstances will usually incorporate a more comprehensive set of information that may include superannuation interests as one of many components. The advantages of having a superannuation fund provide this advice is therefore diminished in comparison with intra-fund advice. Also, there is an established market for such advice, and individuals do not usually face any significant barriers to accessing the advice. Therefore, it is the Commission's view that the availability and quality of advice other than intra-fund advice should not be a mandatory consideration for selecting and assessing funds for listing as default funds in modern awards.

Member education

The Cooper Review and Stronger Super reforms aim to optimise outcomes for both members of MySuper products (including disengaged members) and members of choice products. They do not attempt to shift members between these two groups, or otherwise encourage engagement. Since much of the regulation relating to superannuation has been made necessary as a result of member disengagement, the Commission considered whether any selection criteria could be implemented which would encourage member engagement.

Equipping individuals to make well-informed decisions about their superannuation, and subsequently increasing member engagement, might improve outcomes for members and for the superannuation system as a whole (chapter 3). The provision of sound financial advice can improve the ability of members to make such decisions.

However, providing this service through superannuation funds incurs costs that would ultimately be borne by fund members in the form of higher fees. Also, funds might have a disincentive to provide education to its members that could result in the member transferring to a different fund. Further, academic research questions whether the provision of financial education actually leads to greater levels of member engagement (Brown, Gallery and Gallery 2002; Gallery, Gallery and Brown 2004).

Therefore, like financial advice that is broader than intra-fund advice, the Commission considers that the provision of member education programs should not be taken into account when selecting default funds.

6.3 Industry connectedness

There are currently some funds that tailor their superannuation products to employees in particular industries (for example, Cbus, HOSTPLUS, legalsuper and REST Industry Super). Some inquiry participants contended that where funds are 'connected' to a particular industry, the fund is better equipped to meet the needs of employees in that industry than other funds. The Commission therefore considered whether any additional criteria around industry connectedness would be appropriate in the selection and ongoing assessment of funds for listing as default funds in modern awards.

Scope for additional criteria

Participants' views

Many inquiry participants considered that the default fund selection process should require applicant funds to demonstrate an understanding of, and relevance to, a particular industry. Cbus submitted that:

> … the application of criteria which value industry knowledge and experience … is important because it will assist funds to develop a service approach and product development which will increase the net benefit to members. (sub. 15, p. 10)

legalsuper noted that:

> Members of specific occupational industries have common superannuation needs that are very different to members of other occupational industry groups. This enables specialised funds to provide products and services specifically designed for them, and to provide tailored products and services not available through funds with a more diverse membership profile. (sub. 19, p. 2)

The Accommodation Association of Australia (sub. 28), HOSTPLUS (sub. 8), the State Public Services Federation Group of the CPSU (sub. 16) and Unions NSW (sub. 13) made similar comments, while the Master Plumbers and Mechanical Services Association of Australia emphasised that its members should be able to 'identify [a default fund] as being relevant to their business and industry' (sub. 33, p. 1).

Other participants considered that awards were too broad in their coverage to be a good guide to members' interests. For instance, CSSA suggested that:

> Different workplaces require different superannuation arrangements to reflect their demographic profile. We believe this is very important. MySuper is proposed to provide some flexibility to tailor a plan to a workplace's requirements. The main requirement for tailoring is insurance design and investment selection. Awards can cover millions of employees, so it is not in any way logical to try to tailor investments at an award level, it is better to do so at a workplace level. (sub. 35, appendix C, p. 4)

The Commission's view

With the introduction of MySuper, default funds will have a heightened obligation to consider the interests of their members (chapter 5). Funds are also explicitly required to have regard to the demographic characteristics of members when considering their interests. Therefore, it is expected that funds will seek and maintain an understanding of their members — including of their particular industries — to the extent that this assists funds to act in the best interests of their members.

Superannuation funds that have intimate knowledge of a particular industry might be able to provide superannuation products that are highly suited to members in that industry (particularly in terms of insurance offerings). However, it is ultimately the overall appropriateness of individual components of the product that is beneficial, and not the fund's industry knowledge. This has been recognised in the listing of some default funds in modern awards, many of which are public offer funds that draw their membership from a variety of industries. For example, Australian Super is listed as a default fund in 69 modern awards in a diverse range of industries from alpine resorts to corrections and detention.

Therefore, it is the Commission's view that although a fund can have a close understanding of a particular industry through direct association, explicit consideration of this association is unnecessary in the selection and ongoing assessment of funds for listing as default funds in modern awards.

6.4 Administrative efficiency

Employers and members face costs in interacting with superannuation funds. Employers administer employee contributions, and failure to do so can lead to fines. Employers incur costs in the form of time and resources spent selecting default funds, administering contributions and otherwise acting on behalf of their employees. Members and beneficiaries incur time and transaction costs when obtaining advice or account information, selecting product options, making claims on insurance policies or arranging to receive benefits on retirement.

Funds can take actions to reduce these costs for its stakeholders. Administrative efficiency is important to improve outcomes for stakeholders, and to minimise total costs in the superannuation system.

The limited choice of default funds in some awards (chapter 2) can restrict employers' abilities to choose administratively efficient funds that minimise the costs they face. This in turn can reduce the incentives that funds face to provide good service to employers (chapter 3).

Small and medium employers might be more adversely affected by administrative inefficiencies than large employers for two reasons.

- Clearing houses are available to larger employers, but smaller employers are unlikely to want to incur the cost of, and might be too small to be able to secure, the services of a clearing house. Although small employers have access to the Medicare Clearing House, which may simplify their superannuation guarantee

obligations, the take up of this service has been low and it excludes medium-size employers with 20 or more employees (chapter 2).

- Without the resources to choose a default superannuation fund through an enterprise bargaining agreement, smaller employers are more likely to rely on provisions contained in awards (ABS 2011b).

Stronger Super reforms

The Cooper Review outlined many recommendations that together establish the SuperStream administrative reforms. In general, the recommendations promote the use of electronic commerce, standardised forms and member tax file numbers to:

- improve the quality and speed at which transactions are processed
- standardise the interactions between employers and funds
- consolidate lost accounts.

Legislation has been drafted which would give powers to the Commissioner of Taxation and APRA to roll out and enforce these new standards (Shorten 2012b).

Scope for additional criteria

Participants' views

The Council of Small Business Organisations of Australia noted that:

> Due to the placement of a fund in an industrial award or instrument there is no motivation for a fund to be efficient in dealings with employers. … employers cannot change to a different, more employer friendly fund, as the choice of fund (other than those mandated in the award) is not one that we can make. We also have no room for complaint as these organisations are outside the public service and there is no capacity for APRA or ASIC to demand they become more efficient. (sub. 7, p. 5)

Other participants also noted the burden that superannuation can impose on employers (Electrical Contractors Association, sub. 17; FSC, sub. 30; ISN, sub. 27; MLC Ltd–NAB Wealth, sub. 44; REST Industry Super, sub. 47).

The Commission's view

The SuperStream reforms are expected to improve the general administrative efficiency of the superannuation industry in the long run. However, the reforms do not improve the incentives for funds to efficiently interact with members and employers, particularly small- and medium-sized employers.

The administrative efficiency of a fund will directly flow through to the costs incurred by employers, potentially impacting on the level of compliance with their superannuation guarantee obligations, as well as on the profitability of the business. The effect on businesses can, in turn, impact on employees. The administrative efficiency of a fund will also flow through directly to employees, in terms of the ease with which they can access details of their account, switch between products and options, make voluntary contributions and receive benefits.

Given the importance of these factors to the interests of members and employers, the Commission considers that there is a case for funds applying to be listed in modern awards to be assessed on their administrative efficiency in meeting the needs of members and employers, against a set of relevant benchmarks. As the primary regulator of superannuation funds, APRA might be best placed to determine the benchmarks, in consultation with the industry. Funds applying to be listed in modern awards (or indeed any fund offering a MySuper product) could elect to publish this information with the product dashboard required under MySuper (chapter 4).

DRAFT RECOMMENDATION 6.3

The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should include consideration of the administrative efficiency of the fund, according to a set of benchmarks determined by the Australian Prudential Regulation Authority (or another appropriate body) in consultation with the industry.

7 Performance of the default superannuation fund selection system

Key points

- In preceding chapters, the Commission recommends nine factors that should be taken into consideration in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. A system is needed within which this consideration can take place.
- This chapter assesses the performance of the current system, as evaluated against a set of principles for a well-designed system.
- As a first principle, the system should give primacy to the best interests of members.
  - It should also be contestable, transparent, consistent with other relevant policies and procedurally fair.
  - It should not impose an undue burden on any party, or destabilise the broader superannuation system.
  - There should be an ongoing assessment of listed funds.
- While the current default system has delivered stability, partial transparency and has led to the listing of default funds which have provided better than average investment returns to members, it falls short of meeting other principles of a well-designed default system.
  - It is based primarily on precedent and the consent of industrial parties. As such, it is not fully contestable and therefore may not include a fund or funds which better serve the best interests of default fund members.
  - It does not provide for full procedural fairness, with some funds unable to have their case for listing as a default fund heard by an unbiased decision maker.
  - There is no requirement for an ongoing assessment of the list of funds in awards, and no established process for removing a listed default fund, even where there are serious concerns about governance or underperformance.
- Most stakeholders acknowledge that changes to the selection system are required.
- The absence of a more open and transparent selection system has reduced the competitive pressures on incumbent default funds. In some cases this has resulted in inefficiencies (including unnecessary burdens on employers who, in some cases, have no choice but to use a listed default fund for some or all of their employees).
- Around 10 per cent of awards do not list a default fund. There is little evidence to indicate whether employees or employers operating in these industries have been affected by the absence of a default fund, or the direction of any effect.

In chapters 4 to 6, the Commission evaluated a number of potential criteria that could be used in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. It did not identify any criteria beyond those required to be met for an Australian Prudential Regulation Authority (APRA) authorisation of a fund's MySuper product.

DRAFT FINDING 7.1

There is no case for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards to involve any prescriptive criteria over and above those used by the Australian Prudential Regulation Authority in authorising MySuper products.

That said, while the Commission does not consider there is a need for additional prescriptive criteria, there are nine factors that should be considered when a third party is selecting funds to be listed in modern awards. This is for two main reasons.

- The Stronger Super and related reforms provide an effective foundation to promote disclosure and comparability of default superannuation products and funds, but there needs to be a 'quality filter' to distinguish among them.
- There is an administrative burden for employers in being required to choose from a potentially wide range of funds that offer MySuper products (chapter 6).

For the most part (with the notable exception of the factor relating to a fund's administrative efficiency), the factors apply filters to the underlying MySuper criteria used by APRA. Therefore, to ensure the interests of members are the primary objective in selecting default funds and to minimise the administrative burden placed on employers, the Commission considers the following factors should, as a minimum, be taken into consideration when assessing whether a superannuation fund that offers a MySuper product (or an exempt public sector superannuation scheme) should be listed as a default fund in a modern award.

1. The appropriateness of the MySuper product's investment return objectives and risk profile for employees to whom the superannuation provisions of that modern award apply (as a primary factor).
2. The fund's expected ability to deliver on the investment objectives of its MySuper product (as a primary factor).
3. The appropriateness of the fees charged on the fund's MySuper product, given its stated risk and return profile.
4. Whether governance structures are, as far as legislative requirements allow, consistent with meeting the best interests of members.

5. The mechanisms put in place by fund trustees to deal with conflicts of interest and the transparency in disclosing those conflicts.
6. The likelihood of default members being switched to higher cost divisions of the fund, or facing significantly higher fees for features of their policies (such as insurance), upon exiting their current employment ('flipping').
7. The compatibility of the fund's insurance offerings with the characteristics of employees to whom the superannuation provisions of that modern award apply.
8. The quality of member- and fund-specific intra-fund advice.
9. The administrative efficiency of the fund, according to a set of benchmarks determined by APRA (or another appropriate body) in consultation with the industry.

Given that the overriding objective should be the best interests of members, the Commission considers that its proposed factors for consideration represent the most relevant factors that apply across all default funds, while also taking into account the interests of employers (chapter 3). In some specific cases, there may be other factors that are also relevant.

The process by which these factors are taken into consideration will be the ultimate determinant of whether the best interests of members are met if their superannuation contributions are allocated to a default fund under a modern award.

Irrespective of who makes the decisions about which funds should be listed, the factors are subjective rather than strict or prescriptive. To properly consider them will require a decision maker to analyse a wide range of complex information and exercise considerable judgement, including on such matters as:

- how to weight the importance of each factor
- whether to limit the assessment to those factors identified by the Commission, or whether there are circumstances that require consideration of other factors
- how to best assess and respond to the characteristics and needs of the employees covered by each award. This may be particularly important in awards that cover a large and diverse group of employees (chapter 2).

The importance of exercising judgement in the selection of default funds was highlighted by the Actuaries Institute.

> Importantly, many of these issues require qualitative judgements and, as a result, we do not believe that the selection process can therefore be reduced to a mechanical sequence of decisions … it would therefore be preferable to simply codify the factors that should be considered.

> Of course, a key objective of the selection process should be to ensure that the default fund selected for an Award or agreement is appropriate for the needs of the employees under that Award or agreement. It should also be incumbent on those who determine the default fund to demonstrate that a suitable process has been followed. (sub. 45, p. 2)

The MySuper reforms will assist in this regard, by providing for improved information disclosure and clearer comparisons between the default products offered by different funds. Nevertheless, a decision maker (agent) still needs to make the same kinds of trade-offs and judgements that an informed individual (principal) would — by 'standing in the shoes' of that individual or group of individuals.

Judgements required of a decision maker include consideration of the factors identified by the Commission, their relative importance and the appropriate fit for employees to whom the superannuation provisions of the modern award apply. Given this need for decision makers, the Commission has also considered the extent to which the current system, and its decision makers, conforms with relevant principles of good process.

Given the primary objective of the process is to meet the best interests of members, the Commission considers that the following principles should guide the assessment of the current process used to select default funds. These same principles are used to assess the merits of reforms to the process (chapter 8).

DRAFT RECOMMENDATION 7.1

The process used in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should adhere to the following principles.

- ***Best interests of members — there is an explicit focus on members' interests.***
- ***Contestability — all funds have an equal chance to put forward their case for consideration.***
- ***Transparency — relevant information is made publicly available and potential conflicts of interest are declared.***
- ***Procedural fairness — all parties have the right to put forward their case for consideration by an unbiased umpire.***
- ***Minimum regulatory burden — each party involved incurs the minimum cost and inconvenience compatible with achieving the aims of the process.***
- ***Avoidance of instability — the broader superannuation system is not destabilised.***

- ***Consistency with other policies — alignment with other relevant policy directions, including the Stronger Super and Future of Financial Advice reforms.***
- ***Regular assessment — all default funds must earn their listing in an award on a regular basis.***

Following a description of the current process (section 7.1), these principles will be used to assess its performance (sections 7.2 to 7.9). The Commission's conclusions about the current process are set out in section 7.10.

7.1 The current fund selection process

Selecting default funds in modern awards

Modern awards were developed in 2008 and 2009, and came into effect on 1 January 2010 (see chapter 2 for more detail on award modernisation). Though most of the currently listed default funds obtained their listing during the award modernisation process, additional default funds have subsequently been added to many modern awards.

During award modernisation

The superannuation funds that were selected for listing in the initial drafts of modern awards were largely those that were already listed in award-based transitional instruments relevant to the coverage of the modern award. As discussed in chapter 2, due to the historical development of award superannuation, most funds that were listed in award-based transitional instruments were industry funds established and chosen by industrial parties.

In deciding which default funds to list in modern awards, the Australian Industrial Relations Commission (AIRC) considered that:

> … the nomination of default funds should be made on some readily ascertainable basis and one which does not lead to any disruption. For that reason it was decided to provide for named default funds as the primary basis. (2009a, p. 22)

Many, but not all, of the funds that were listed in previous instruments were listed as default funds in the corresponding modern award.

The financial outcomes for members were not explicitly assessed by the AIRC.

> We do not think it is appropriate that the [AIRC] conduct an independent appraisal of the investment performance of particular funds. Performance will vary from time to

> time and even long term historical averages may not be a reliable indicator of future performance. We are prepared to accept a fund or funds agreed by the parties, provided of course that the fund meets the relevant legislative requirements. (2008, p. 6)

Following the publication of the draft modern awards, superannuation funds and industrial parties made 74 applications to list additional funds as default funds on the basis that:

- the fund was nominated as a default fund in an award-based transitional instrument relevant to the coverage of the modern award, or
- the representatives of the main parties covered by the award consented to the inclusion of the fund.

The AIRC approved 67 of these applications and considered that 'either basis would constitute a good reason for the fund being specified as a default fund in a modern award' (AIRC 2009a, pp. 22–3).

In accepting a fund or funds recommended by the parties, the AIRC was not required by the *Fair Work Act 2009* (Cwlth) to ensure that the parties had considered the relative merits of competing funds or that they had necessarily proposed funds that would more likely best meet the interests of default fund members.

Since the commencement of modern awards

Once modern awards commenced on 1 January 2010, the process by which an additional default superannuation fund is listed in a modern award is for a person or organisation to make an application to Fair Work Australia (FWA) under the Fair Work Act to vary the award, and for that application to be granted.

When a variation application is made, all subscribers to the electronic mailing list about the relevant award are notified of the application. The application is posted on the FWA website and submissions are invited. Anyone may make a submission, though FWA may decide how much weight to place on each submission. FWA can hold a hearing before deciding whether the application will be granted, but is under no obligation to do so, particularly where the application is not controversial.

Between January 2010 and April 2012, 23 applications were made to vary the superannuation provisions of a modern award. A hearing was held for 17 of these applications. Over 80 per cent of the applications made during this period were successful.

Standing

An applicant is generally required to have standing to make a variation application, though FWA has the power to consider an application and vary the award on its own initiative in some circumstances. An applicant will have standing if they are:

- an employee, employer or 'organisation' covered by the award, or
- an 'organisation' entitled to represent the industrial interests of an employer or employee covered by the award. An 'organisation' is an employer or employee representative body registered under the *Fair Work (Registered Organisations) Act 2009* (Cwlth).

Parties without standing (such as superannuation funds) must find a party with standing who is willing to bring the application, or rely on FWA exercising its discretion to vary the award on its own initiative. To date, there has only been one case brought under the Fair Work Act in which standing was explicitly considered (box 7.1), and this case did not definitively establish the principles by which standing will be granted or by which FWA will exercise its own initiative power.

Box 7.1 AMP application for inclusion as a default fund

In March 2010, AMP applied to Fair Work Australia (FWA) to vary the Professional Employees Award 2010. AMP's application was supported by the Australian Information Industry Association (which is not a registered organisation and did not take part in industrial negotiations). However, the application was opposed by the Australian Industry Group and the Association of Professional Engineers, Scientists and Managers Australia (both registered organisations that were parties to the relevant pre-modern awards, and were involved in the negotiations that led to the development of the Professional Employees Award 2010). AMP was not listed as a default fund in any relevant pre-modern award or award-based transitional instrument that preceded the Professional Employees Award. (It is separately listed in other modern awards through historical precedent.)

FWA dismissed the application on the grounds that AMP did not have standing. FWA chose not to exercise its power to vary the award on its own initiative, because including AMP as a default fund would have been inconsistent with earlier decisions of the tribunal.

Source: FWA (2010a).

Grounds

In decisions issued to date there have been three grounds on which a variation application may be granted. The first is whether the fund was listed in a pre-modern

instrument, such as a pre-modern federal award or a notional agreement preserving a state award, relevant to the modern award's coverage. A pre-modern instrument will be relevant if it covered employees who are now covered by the modern award (FWA 2010f). The pre-modern instrument will not be relevant if the employees for whom the contributions were being made are now covered by a different modern award (FWA 2010c).

The second ground is whether the representatives of the main parties covered by the award consent to the fund's inclusion. Since the focus is on the main parties to the award, consent does not need to be unanimous (FWA 2010d).

The third ground is whether employers were making contributions to the fund before 12 September 2008 for the benefit of employees who are now covered by the modern award (FWA 2010c, 2010e).

When making a decision, FWA is not limited by the laws of precedent or by the grounds in the application — it is free to make a decision based on other grounds.

In addition to the three grounds, if funds that are listed in the award merge or change names, they can apply to have this change reflected in the award (table 7.1).

Table 7.1 **Grounds used in applications made under the Fair Work Act to vary the superannuation provisions of a modern award**[a]

January 2010−April 2012

	Number
Fund was included in a relevant pre-modern instrument	12
Consent of industrial parties	4
Contributions are already being made to the fund on behalf of employees covered by the award (as at 12 September 2008)	7
Fund merger or name change	5

a Applications may be brought on more than one ground. FWA may base its decision on other grounds.

Source: Productivity Commission estimates.

Review

FWA is currently conducting an interim review of modern awards, and is required to review modern awards every four years. It could potentially include superannuation provisions in those reviews. Outside the four-yearly award reviews, funds remain listed in awards unless industrial parties bring the matter of their ongoing inclusion to the attention of FWA. This means that there is:

- no regular process for assessing whether the default funds listed in modern awards are acting in the best interests of default fund members
- no established procedure for the removal of a default fund from an award. This is the case even when:
  - a listed default fund is delivering verifiably inferior outcomes for members
  - serious concerns about the governance of a listed default fund are raised
  - a listed default fund has merged, been taken over or otherwise ceases to exist (16 of the 103 funds currently listed in modern awards are no longer active)
  - a listed default fund fails to meet legislative and regulatory requirements.

Though rarely used in relation to superannuation, FWA has the power to vary modern awards on its own initiative, meaning that a listed fund could be removed at any time if it became demonstrably unsuitable for listing.

Exceptions to the general award default arrangements

Awards without a default fund

While the processes for selecting default superannuation funds described above apply in most awards, there are exceptions. In particular, 13 of the 122 modern awards do not list any default superannuation funds. These awards cover a wide range of industries, from fire fighting to labour market services to various types of mining and maritime services.

Just as the inclusion of default funds in awards is largely a matter of history and precedent, the absence of a default fund in 13 modern awards is also due to historical factors. The AIRC and/or industrial parties chose not to include default funds in these awards because there were no default funds listed in the relevant pre-modern instruments (see, for example, AIRC 2009b).

Where awards do not list a default superannuation fund, employers are free to choose any complying fund as a default fund. There is little evidence about how these employers approach the task of selecting a default fund, though hypotheses

can be made for several industries. For instance, because the Rail Industry Award 2010 and the Fire Fighting Industry Award 2010 cover industries that are (or have been) largely in the public sector, it is likely that most employers in these industries use the relevant public sector superannuation fund or its successor as their default fund.

Economy-wide studies indicate that employers rarely undertake their own assessment of default funds, but instead tend to rely on precedent, industry norms or advice from those who may be more knowledgeable about superannuation (see below). This could be attributed to the costs and expense of conducting a tender or engaging consultants to select a default fund, which are likely to be prohibitive for most employers given their small size. Indeed, the Association of Superannuation Funds of Australia suggested that 'the use of competitive tenders and/or tender consultants … is more common when there is no default fund listed in an award, particularly in the case of larger employers' (sub. 31, p. 7).

There is little evidence on whether employees covered by awards that do not list a default superannuation fund have been affected by this absence, or if any effect is positive or negative. Some employers are likely to have incurred additional costs in selecting a default fund but may also have gained some benefit for themselves (such as being able to choose a fund that is administratively efficient and responsive to their needs) or for their employees.

Awards that allow contributions to be made to 'grandfathered' funds

The modern awards that list default funds allow employers to continue making default contributions to funds to which they were contributing before 12 September 2008. The AIRC intended that this 'grandfathering' provision would minimise inconvenience to employers (2008b).

Very little information is available on the use of the grandfathering provision. The Association of Superannuation Funds of Australia suggested that 'the funds benefitting from the grandfathering provisions in the main are relatively small funds and/or regionally based although there are exceptions' (sub. 31, p. 7), while Asset Super considered that 'grandfathering clauses are a safety net for small employers who do not have access to professional advice and who do not belong to industrial associations' (sub. 32, p. 2). Grandfathering may also be used for many payments to corporate superannuation funds, as only a small number of corporate funds are listed as default funds in modern awards (for instance, the BHP Billiton Super Fund is listed as a default fund in the Coal Export Terminals Award 2010 while the Rio Tinto Staff Superannuation Fund is not).

Several inquiry participants commented on the absence of information on the use of the grandfathering provision. For instance, the Industry Super Network (ISN) noted:

> It is not known how many grandfathered funds are currently being used by employers as a result of the grandfathering arrangements inserted in superannuation clauses as a result of the 2008 decision. Nor is there any data on the number of employees, size of contributions or the type of fund being utilised. There is some anecdotal evidence that some employers are utilising the grandfathering arrangements to extend the use of a preferred default fund named in one award to other award dependent employees. However, it is suggested that the grandfathering arrangements are primarily used to allow continued contributions to retail or master trust funds. (sub. 27, p. 39)

There is also considerable doubt about the permissibility and application of the grandfathering provision in many circumstances, including in relation to corporate mergers, takeovers and restructures (Mercer, sub. 34).

Employers make the final selection

If an award lists more than one default superannuation fund, or does not list a default fund, employers must choose a fund (or funds) to receive superannuation contributions for employees who do not choose a fund for themselves (chapter 2). In doing so, there is no legal obligation on employers to compare funds in any structured way.

The 'vast majority' of employers have not actively selected their current default superannuation fund — they simply use the fund they have 'inherited' (Colmar Brunton 2010b, p. 27). Those employers who have chosen a default fund tended not to conduct their own research into available funds, instead relying on advice from a range of sources (box 7.2).

Many inquiry participants submitted that employers would prefer to choose from a small number of funds rather than from the hundreds of funds in the market. Many also highlighted that the burden of choosing between a large number of funds can be costly for employers.

> … some employers are troubled by the responsibility of selecting the default superannuation fund for their employees as they see this as an onerous obligation and one they are not necessarily capable of discharging satisfactorily. (Industry Funds Forum, sub. 51, p. 2)

> It is important that the number of funds listed in awards remains limited to prevent overwhelming employers with excessive options for default funds. It is unrealistic to expect employers to spend the time examining the relative merits of potentially dozens of different superannuation funds. (Australian Hotels Association, sub. 10, p. 9)

Box 7.2 How do employers choose a default superannuation fund?

Administrative convenience

[Employers] want to "get on and build" rather than be concerned with intimate and complex issues of superannuation administration. (Master Builders Australia, sub. 41, p. 4)

Generally, the primary concern of employers in this process is the ease of the transaction process with a fund and any employer costs involved. (Australian Hotels Association, sub. 10, p. 7)

Employers naturally evaluate funds based on the ease of contribution and processing … most employers look for ease of processing and online transactions in choosing their default funds. (Colmar Brunton 2010b, p. 27)

Industry norms and experience

[Employers] will most likely choose the fund that most of their employees are members of already. If it is a new business the employer will most likely choose the fund that he/she has some experience with … It is very rare for an employer to research the benefits (i.e. fees, etc) of a fund and base their choice on that data. (Tasplan, sub. 6, p. 1)

Historically, in the previous state based industrial system and currently in the federal modern award system employers have utilised a default fund already listed … this will continue as employers will have already established a system and relationship with the relevant fund and established relevant financial transaction processes to minimise delays and costs … Where more than one fund is nominated, the selection made by an employer is either ad-hoc or based on previous experience with the fund in question, with little to no investigation into the relative features of each fund. (Electrical Contractors Association, sub. 17, pp. 1−2)

Advice from financial advisers

Employers typically receive advice from consultants and/or financial advisers to assist them select an appropriate fund. As part of the selection process a number of criteria are generally considered including pricing (fees), selection of investment options, strength of brand, insurance premiums and coverage, education, member service and access to financial advice etc. (Colonial First State, sub. 42, p. 2)

Relevant employer associations or Business Enterprise Centres may also provide guidance. (Tasplan, sub. 6, p. 1)

A combination of these factors

Businesses will often choose a fund based on prior experience with a fund if they have such experience, or alternatively, based on the fund which suits the majority of their employees. In many cases they will seek guidance from their employer organisations, such as the state Real Estate Institutes, Real Estate Employer's Federation, or Real Estate Institute of Australia. (REI Super, sub. 26, p. 1)

When they eventually understand that they have to choose a super fund (for themselves or a new employee) [small businesses] will seek advice from their accountant (when they finally choose one), a financial adviser, TV/magazine advertisements, business group mentors, their family or Google. (COSBOA, sub. 7, p. 2)

> We … do not wish to see further complex decisions imposed upon tourism businesses who are not necessarily equipped to make such decisions (National Tourism Alliance, sub. 4, p. 1)

To avoid the cost of comparing funds:

> Most employers do not actively seek information about the performance of their default superannuation fund. … [They] consider this to be the employee's responsibility to investigate if it is something they are interested in. This attitude is reinforced by the perceived lack of distinction between different superannuation funds and different superannuation fund types. None of the employers had considered changing their default fund, or changing the default options within their chosen fund. (Colmar Brunton 2010b, pp. 28–9)

However, it is also costly for employers to ensure that they are contributing to the fund specified in the award or awards that cover their employees.

> For some [employers] subject to multiple awards, there is an ongoing need to assess which of their employees are covered by particular awards and subsequently which superannuation funds must be used as defaults. (MLC Ltd–NAB Wealth, sub. 44, p. 5)

Indeed, despite the grandfathering arrangements noted above (which allow many employers to continue with funds to which they were already making contributions), since award modernisation more employers have been required to ensure that they are making default contributions to the funds listed in the award.

> Prior to the commencement of the Modern Award system … most Awards did not restrict employers from going beyond the nominated funds through the inclusion of an open clause stipulating they could choose from any other complying superannuation fund. The introduction of the Modern Awards removed this clause meaning new employers to an Award are completely restricted to those funds nominated in the respective Award … Further, significant difficulty is caused for those employers who may have employees under multiple Awards. For example, a school may have employees consisting of teachers, administration/clerical staff, cleaners, gardeners, etc … all under different employment awards. For these employers, they may be required to choose a different default fund between Awards if there is no consistent fund available. (AMP, sub. 52, pp. 3–4)

The prevalence of clauses in pre-modern awards which allowed employers to choose a fund other than those listed in the award — and the potential for the re-introduction of such clauses — is discussed in more detail in chapter 8.

7.2 Assessing the current process — best interests of members

Participants' views

Inquiry participants generally supported the principle that the selection of default funds should be conducted with members' best interests in mind.

> Default funds should be selected on the basis of advancement of members' interests, and MySuper products may not all achieve this aim – or at least not to the same extent. (eo Financial Services, sub. 12, p. 2)

> … the selection of a default fund … must be demonstrably in the best interests of workers covered by modern awards, as well as their employers. (AIST, sub. 20, p. 6)

However, differing views were expressed about the extent to which the current process takes members' best interests into account. Many participants focused on the above-average returns received by members of default funds chosen under the current process, and considered that these returns demonstrate that members' best interests have been well served (chapter 4). In contrast, BT Financial Group considered that:

> … the current arrangement of nominating specific default superannuation funds in Modern Awards does not serve the best interests of employees, employers or the community at large (sub. 46, p. 1)

Others expressed concern about the conflicts of interest that can arise in the absence of a requirement to make a decision in members' best interests. As noted in chapter 3, various agents acting on behalf of members can have conflicts of interest, including industrial representatives, employers and fund managers.

eo Financial Services suggested that employees' interest can sometimes diverge from those of their industrial representatives.

> At present, nominated default funds or funds seeking nomination as a default fund are not required to address or to reveal actual or potential conflicts of interest or duty (or both) and where applicable, nor are applicants to vary an award to nominate a fund as a default fund required to reveal their connection to or interest in the fund. (sub. 12, p. 3)

Similarly, the Financial Services Council said:

> The few parties registered under [the *Fair Work (Registered Organisations) Act 2009*] are the only stakeholders entitled to appear before Fair Work Australia. As typically each of these parties has pre-existing affiliation with an industry superannuation fund, the only stakeholders entitled to access Fair Work Australia are therefore conflicted. Accordingly the process is not transparent. In other words, the decisions about default funds are not made by Fair Work Australia, they are made elsewhere in a non-transparent manner. (sub. 30, p. 16)

Vincent Mahon noted that:

> Last year FWA permitted the MTAA Superannuation Fund access to retail sector employees. The application was made by the Australian Manufacturing Workers Union (AMWU). The two AMWU officials making the application before FWA … were trustees of MTAA Superannuation Fund. The applicants had a conflict of interest.… The MTAA balanced fund was ranked 49 out of 49 over the three (3) years to June 2010. Yet FWA approved the MTAA Superannuation Fund application. (sub. 1, p. 2)

In relation to the potential for employer conflicts of interest, ISN considered that:

> Where employers have a number of competing default fund options; either a limited number of named funds within an award or an unlimited choice of funds, there is a potential for conflicts to arise. The business environment raises these potential conflicts with large banking corporations which businesses are reliant upon dominating the retail superannuation options. (sub. 27, pp. 31–2)

The Industry Funds Forum was of the view that:

> Where there are multiple default funds listed in modern awards consideration needs to be given to the potential for conflict of interest should the employer be guided by anything other than the best interest of their employees. (sub. 51, p. 10)

In contrast:

> Suncorp believes employers' and employees' interests with regard to superannuation are closely aligned and strongly rejects the notion of principal–agent conflict. (sub. 38, p. 2)

The Commission's view

The Commission notes the relatively strong returns received by members of default funds chosen under the current process (chapter 4). However, it is concerned by the absence of an explicit requirement to give primacy to members' interests, particularly given that principal–agent issues are present. As outlined in chapters 3 and 5, these problems arise because an agent making decisions on behalf of a principal may not always act in the latter's best interests, and the principal does not always have the information, resources or inclination to monitor the actions of the agent. Generally, employees whose superannuation is paid into a default fund do not take an active interest in their superannuation and are unlikely to ensure that their agents faithfully represent their interests.

There are several reasons why principal–agent problems are likely to be present when industrial parties are deciding which superannuation funds to recommend for listing as default funds in awards.

- Many industrial parties are likely to have other potentially conflicting interests in the field of superannuation, either as trustees of an industry superannuation fund or as employees of an organisation that nominates trustees to a fund. In either case, these representatives could have an interest in ensuring that the fund they are associated with is listed as a default fund in the award.
- Industrial parties may represent their members rather than all the workers covered by a particular award. This can mean that the majority of workers may not be represented in the selection of a default fund (only 18 per cent of Australian employees were union members in their main job in August 2011 (ABS 2012b)).

Principal–agent problems are also likely to arise where the employer chooses from a relatively large number of listed funds (there are up to 18 funds in some awards). In such cases employers have little incentive to investigate the relative merits of different default funds and to select a fund that best meets their employees' needs. Indeed, they are likely to have an interest in maintaining existing superannuation arrangements because this minimises their administrative costs. They are also likely to face an incentive to use funds that are easy for them to deal with, or funds that offer benefits to employers in exchange for default fund status. These incentives may lead some employers to choose a default fund that is less suited to their employees than other available funds.

The Commission also notes that similar concerns could apply in relation to employer selection of funds in the instances where the relevant award does not list any fund (chapter 8).

In order to counteract possible conflicts of interest, the Commission considers that where default funds are listed in awards the process for the selection and ongoing assessment of default funds should include explicit requirements for all parties — employee representatives, employers, employer representatives and default fund decision makers — to make decisions in the best interests of default fund members.

7.3 Assessing the current process — contestability

Participants' views

Participants had varying views as to whether the process used to select superannuation funds for inclusion as default funds in modern awards is contestable, and whether contestability is desirable.

Should the process be contestable?

The Shop Distributive and Allied Employees Association considered that:

> A fund that has been purposely developed to service the needs and requirements of a particular workforce or industry must be given the right to be a default fund (sub. 24, p. 7)

Similarly, Unions NSW said:

> Contestability can be deceiving and not necessarily in the interests of fund members although competition from industry funds against retail funds has been healthy to date. (sub. 13, p. 7)

Other participants emphasised the potential benefits of increasing contestability and competition. For instance, BT Financial Group noted that:

> … BT recently competed for the default business of Employer C and was able to outbid the incumbent industry fund. The impact on the average employee with a balance of $50 000 was a reduction in total annual fees of 7%. (sub. 46, p. 2)

ANZ Wealth said:

> The possibility of new markets and new customers is a key driver of price competition and of new investments and innovation. This is true for all superannuation funds (be they retail funds or industry funds) which expend resources to market, compete and distribute their products, as well as to maintain their existing customer base. (sub. 48, p. 2)

Is the current process contestable?

Colonial First State considered that:

> Specifying individual default funds in awards and thereby creating effective oligopolies / monopolies for certain funds has reduced the overall level of competition in the sector. This has led to an upward impact on fees for these funds and resulted in reduced quality of products and services for members … these arrangements are restrictive, anti-competitive and compromise the best interests of employees and members. (sub. 42, p. 2)

The Corporate Super Specialist Alliance said:

> There is currently not contestability or competition with default superannuation funds listed in Modern Awards. Increased competition invariably leads to a lowering of costs and an increase in quality. (sub. 35, appendix C, p. 2)

ISN considered that:

> … the current process is more open and transparent than has been suggested by some … Notwithstanding this, ISN's proposed process provides a level playing field and

> unrestricted access to all those that seek to be named as default funds in awards, provided these funds meet the reasonable and fair criteria proposed. (sub. 27, p. 48)

CPA Australia mentioned 'the "closed shop" nature of the arrangements' (sub. 39, p. 1). In contrast, Unions NSW submitted that:

> If a retail fund has an exceptional product to sell then they do have an ability to convince an employer organisation, an employee organisation or indeed an employer to make application under the [Fair Work] Act for the inclusion of their fund in the award as a default fund. This process in our opinion should not change. (sub. 13, pp. 2–3)

Tasplan (sub. 6) considered that there is a level playing field between industry and retail funds, while AustralianSuper (sub. 36) did not consider the concept of contestability to be relevant. In addition, as discussed in chapter 6, a range of participants also commented on industry connectedness.

The Commission's view

As is evident from the process described in section 7.1, not all superannuation funds can present their case for inclusion as a default fund in an award on an equal basis. Funds that have not previously been included as a default fund are not able to present their case unless they can find an industrial party that has standing before FWA and is willing to make the application. Given that a significant proportion of industrial parties have an interest in (and nominate trustees to) one or more superannuation funds, they could be expected to extend preference to those funds, to the exclusion of potential competitors. Even some funds that had been included in pre-modern awards but have only 'slight' coverage of the national industry now covered by the modern award have had their application for inclusion denied (see, for example, FWA 2010g).

Another limitation on the contestability of the default fund selection process is that employers must generally choose one of the default funds listed in the award (though the grandfathering provisions allow some employers to continue to make payments to the fund to which they were contributing on 12 September 2008). This means that most employers have only a limited ability to switch to a fund that better meets their employees' interests, or to a fund that has better administrative systems (but still meets members' interests).

The current process of fund selection therefore has the effect of reducing the contestability of the default fund market. This reduces competition, and reduces the likelihood that the funds chosen best meet default fund members' interests.

It also reduces dynamic efficiency, reducing the likelihood that, over time, consumers are offered new and better products, and existing products at lower cost. This may lead to less innovation and poorer financial and administrative performance in the default superannuation market.

Allowing all funds to present their case for inclusion as a default fund in awards on an equal basis is likely to lead to improved outcomes for default fund members. Similarly, allowing employers to choose a fund that is not listed in the award, provided employees are at least no worse off than if the employer had chosen a fund listed in the relevant award, would further enhance contestability and spur the benefits of competition. Importantly, it is not necessary that all, or even most, employers make active comparisons and decisions about default superannuation funds in order to drive improved product and services offerings. The threat of competition is sufficient.

7.4 Assessing the current process — transparency

Participants' views

Participants generally agreed that the default fund selection process should be transparent.

> AIST believes it is important to have a robust and transparent process for the selection of default funds in industrial awards. (sub. 20, p. 4)
>
> Transparency is important. (Unions NSW, sub. 13, p. 7)
>
> … it is essential that the listing of any superannuation funds be subject to a robust and transparent process. (Mercer, sub. 34, p. 6)
>
> Suncorp opposes any selection process for default superannuation funds. If, however, a selection process were to remain, this process must be transparent. Transparency can be achieved by requiring Fair Work Australia to provide written decision statements that are publicly reported. (sub. 38, p. 2)

However, there were differing views on the transparency of the current process. Asset Super said:

> The current process for listing default superannuation funds in awards is transparent. (sub. 32, p. 4)

A number of participants held the opposite view.

> CPA Australia's primary concern with the current process for nominating default superannuation funds in modern awards is the lack of transparency. (sub. 39, p. 1)

> The present system is failing consumers and employers — it lacks transparency and is no longer appropriate following the introduction of MySuper. (Financial Services Council, sub. 30, p. 1)
>
> The existing FWA process surrounding the variation of Modern Awards to include a new nominated default fund is opaque. Without this transparency, the cost (through the need to employ expert resources) and effort of interacting with the system can often override any benefits. This leads to inertia in the system where employees are disadvantaged by a lack of competitive tension amongst superannuation providers. (AMP, sub. 52, p. 5)

ISN also indicated that there is scope to improve the transparency of the current process, in suggesting that 'all relationships, including payments and commercial arrangements other than superannuation, between the fund and its related entities, on the one hand, and employers, employer organisations, and employee organisations relevant to the subject modern award, on the other hand' should be disclosed as part of the fund selection process. (sub. 27, p. 5)

The Commission's view

Open and transparent processes are essential for good public policy outcomes. While there is concern about the grounds used by FWA to assess whether additional superannuation funds should be included as default funds in modern awards, the processes used by FWA to list funds in awards meet appropriate standards of transparency. FWA habitually publishes variation applications, allows interested parties to comment on those applications, and generally publishes its decisions. It may hold hearings and publish transcripts of those hearings. Its written decisions include an explanation of the basis on which the decision was made (see, for example, FWA 2010f).

However, while the decisions made by FWA may be transparent, there are shortcomings in the transparency of the bases on which the decisions are made.

- During the award modernisation process, the AIRC accepted the default fund or funds agreed by the industrial parties (AIRC 2008).
- Industrial parties did not always, and are still not required to, disclose to their members or to the public the basis upon which they select and nominate superannuation funds for inclusion as default funds in modern awards.

Taken together, these shortcomings mean that the selection of the overwhelming majority of the current default funds listed in modern awards was not made on a fully transparent basis. A transparent assessment process is required that puts employees' interests first and is based on known and appropriate factors.

7.5 Assessing the current process — procedural fairness

Related to contestability and transparency is the concept of procedural fairness. In order for a decision to meet the requirements of procedural fairness, the decision maker:

- must allow parties the opportunity to put their case and to be heard
- must not be biased or be seen to be biased.

Participants' views

A number of participants made comments relating to the procedural fairness of the current process. The Financial Services Council submitted that:

> As retail funds do not have formal links with unions or employer associations (i.e. retail funds do not share directors who work for a union or employer association) they are effectively locked out of the current system. (sub. 30, p. 4)

eo Financial Services considered that:

> The lack of accountability means that funds cannot be sure why they were excluded when other funds were included — especially when funds that are included might not have better investment performance or lower costs that those that were excluded … there seems to be no basis other than 'who you know' for being successful in the selection process. (sub. 12, pp. 2–3)

The Transport Industry Super Fund said:

> The current system does not provide transparency, fairness or a competitive landscape that ensures the best outcome for members' accumulation of superannuation for retirement. (sub. 40, p. 8)

Suncorp suggested that mechanisms for 'fair and independent review' of decisions should be put in place, to ensure that the selection process operates 'in a competitive, open and transparent manner' (sub. 38, p. 6).

The Law Council of Australia considered that:

> … if FWA were charged with applying additional criteria, consideration would need to be given to how such criteria could be applied consistently with the concepts of natural justice, rights of appeal and other administrative law principles. This is especially the case as the viability of a fund may very well depend on whether it is named as a default fund in a Modern Award. (sub. 23, p. 5)

Participants did not comment directly on whether FWA is, or is seen to be, an impartial decision maker.

The Commission's view

As discussed in section 7.3 with reference to contestability, the current process does not provide all superannuation funds with an equal opportunity to put their case for listing as a default fund in an award. This inequality arises regardless of a fund's ownership — though many retail funds are not on an equal footing with the (mainly industry) incumbent funds in the default market. Non-incumbent industry funds and potential market entrants (including foreign firms) are similarly disadvantaged.

In addition, as is apparent from the discussion of transparency in section 7.4, there is no requirement for industrial parties to disclose the basis upon which they select and nominate superannuation funds for listing as default funds in modern awards. This leaves open the possibility that this aspect of the selection process may involve bias.

Taken together, these shortcomings mean that the current process for selecting default superannuation funds does not provide procedural fairness. Changes to the process are needed so that, before decisions are made, affected parties have a right to be heard by an impartial decision maker.

7.6 Assessing the current process — regular assessment

Participants' views

A wide range of inquiry participants highlighted the importance of having a process for regularly assessing the list of selected default funds. Mercer submitted that:

> … there needs to be a regular review process so that the listed funds are not guaranteed long term recognition within an award. Such a result can lead to less innovation and poorer results for the employees covered by that award. (sub. 34, p. 6)

Master Builders Australia said:

> As funds consolidate, the list of named funds will not meet the requirements of being straightforward and helpful to employers unless regularly updated … This further underlines the need for a regular statutorily vindicated review of modern award provisions that ensures they are meeting employer and employee needs. (sub. 41, p. 6)

The Financial Services Council considered that:

> … there is neither a process nor review mechanism for the selection of default superannuation funds in Modern Awards … Neither APRA nor ASIC has regulatory capacity to remove a default fund selected by Fair Work Australia; accordingly the present system represents a failing of consumer protection. (sub. 30, p. 10)

The ACTU acknowledged that 'there is a case for a more rigorous and consistent approach' to reviewing default funds included in awards, and noted that:

> … there is a risk that a named fund begins to underperform for a period of years. It is open to the relevant industrial parties to identify underperformance and take appropriate action. However, the extent to which fund performance is reviewed and acted upon is uneven, reflecting the fact that in the context of their broader bargaining activities particular employer and employee representatives attribute varying levels of priority to award default fund issues. (sub. 29, p. 11)

REST Industry Super said that it:

> … supports a periodic review and assessment of superannuation funds which best meet the design criteria for nomination as default funds in modern awards in any particular industry. (sub. 47, p. 4)

The Commission's view

The Commission considers that in the absence of an ongoing assessment and a realistic likelihood that less suitable funds will lose default fund status, listed funds are likely to face reduced incentives to act in the best interests of default fund members. The creation of a process for the regular assessment of default funds listed in awards is therefore essential.

7.7 Assessing the current process — minimising regulatory burden

The process used to select default superannuation funds should impose the minimum possible cost and inconvenience on the parties involved, subject to achieving the aim of ensuring that the best interests of members are met.

Two aspects of regulatory burden merit specific consideration:

- the overall administrative burden of the selection process
- the compliance burden imposed on employers.

Participants' views

Overall burden of the selection process

Few participants made specific comments about the regulatory burden imposed by the current selection process. However, some implicitly suggested that the current process imposes appropriate burdens, by emphasising the benefits of the current system of selecting suitable funds for different groups of employees. For instance, legalsuper said:

> By assigning specific funds to each award, employers are guided as to their most appropriate choice of superannuation fund, thereby helping to ensure retirement outcomes are more suitable for employees working under those awards. (sub. 19, p. 1)

In contrast, a number of participants considered that once MySuper is in place, a further selection process would be burdensome.

> Given the strict and appropriate criteria designed by the Government for MySuper and the legislation requiring that only MySuper compliant funds and trustees operate in the default space, it may be considered onerous and burdensome to have a further subset of requirements for selection in Modern Awards. (Colonial First State, sub. 42, p. 4)

> We do not believe the prudential framework, particularly the enhanced MySuper framework, is so lacking in efficacy as to warrant another regime and another regulatory party to be embedded in the framework to identify limited funds to which default contributions can be made. (MLC Ltd–NAB Wealth, sub. 44, p. 5)

ISN suggested that a more burdensome process would be justified.

> Although the proposed framework will place additional requirements upon funds that seek to be named in modern awards, this is appropriate. Australia's superannuation system must continue its transition into a mature, well-regulated, system. Funds that seek to be named in modern awards should meet heightened public expectations. Being subject to reasonable due process that provides public accountability, and that will result in improved public policy, is to be expected. (sub. 27, p. 3)

Burden placed on employers

Participants suggested that selecting and interacting with a default fund can place a particular burden on employers. For example, ACCI considered that:

> Many employers find dealing with the system unduly onerous, and for many there is excessive complexity and a lack of standardisation. (sub. 37, p. 3)

Others suggested that default funds can be difficult for employers to deal with (Adam Johnston, sub. 54). COSBOA said that:

> Due to the placement of a fund in an industrial award or instrument there is not motivation for a fund to be efficient in dealings with employers. (sub. 7, p. 5)

Similarly, the Financial Service Council was of the view that:

> The captive market enjoyed by many large superannuation funds has failed to provide an incentive for the adoption of efficient and user-friendly administration services. Employers, as major users of superannuation administration services have no choice but to utilise the fund regardless of its administrative capacity / functionality. (sub. 30, p. 9)

Many participants also commented on the way in which employers go about selecting a default fund, and on the potentially onerous nature of this choice (box 7.2).

Other participants suggested that the role of the selection process is to produce a small shortlist of funds, in order to make it easier for employers to choose a default fund.

> The value of nominating eligible default funds is to assist employers in their selection process. (Australian Hotels Association, sub. 10, p. 2)
>
> … the purpose of the award nomination is to give confidence to the employer that the nominated fund is a quality offering. (Tasplan, sub. 6, p. 9)
>
> … providing employers with a large range of funds from which to choose undermines the purpose of the award default system, which is to ensure an employee voice in the choice of fund, and to control the risk of a poor choice. (Cbus, sub. 15, p. 8)

The Commission's view

Overall burden of the selection process

The process currently used to select default superannuation funds does not place an undue regulatory burden on any party. However, this is not the direct result of good design but rather a consequence of the current process falling short when measured against sound principles.

- Because there is no requirement to give primacy to members' best interests when selecting default funds, industrial parties do not have to spend time establishing and articulating what those interests may be.
- Because the process is not contestable, funds incur few costs in attempting to obtain or retain listing as a default fund.
- Because transparency is lacking, little effort is devoted to preparing and publishing relevant information.
- Because there is no requirement for regular assessment, the costs of preparing for and conducting ongoing assessments are minimised.

Correcting these shortcomings is likely to involve an increase in the overall regulatory burden imposed by the selection process. However, improving the selection process in ways that increase the regulatory burden (as efficiently as possible), will be worthwhile if it leads to substantially better outcomes for default fund members.

Burden placed on employers

The Commission considers that the selection process should provide employers with a manageable short list of default funds from which to choose. With up to 18 funds currently listed in some awards, choosing between them can present difficulties for employers, particularly small businesses. The Commission therefore considers that to simplify employer choice, there would be benefit in limiting the number of funds that are listed in awards.

At the same time, the Commission shares the concern expressed by inquiry participants that superannuation funds listed as default funds in modern awards, in the absence of contestability or regular assessment, do not have strong incentives to be responsive to employers' needs. This is particularly the case when only a small number of funds are listed in the award. These privileged funds remain listed and have almost guaranteed market share regardless of the costs or burdens they impose on the employers who must make payments to them. Therefore, in order to promote greater efficiency in the default superannuation market, the Commission considers that there would be benefit in listing more funds in awards that currently list only one or two. (In chapter 8, the Commission recommends that modern awards that list default superannuation funds should list no fewer than five and no more than ten funds).

In addition, in another measure to reduce inefficiency, the Commission is recommending that a fund's administrative efficiency should be considered as a relevant factor in the default fund selection process (chapter 6).

7.8 Assessing the current process — avoiding system instability

Concerns about the stability of the superannuation system are generally expressed in a dynamic context, when new processes and policy reforms are being proposed or enacted. Consideration of the stability of an established process is less common. It nevertheless remains important to consider the extent to which the current process has delivered stability before contemplating any changes.

Participants' views

Few participants commented on the effect of the default fund selection process on the stability of the broader superannuation system. Those participants who did mention stability did so with reference to the potential for default fund selection to affect the investment opportunities available to funds, and the returns on those investments.

> If industry funds are less certain about the stability of their members and assets and their future growth, this may reduce the willingness of funds to provide additional capital to finance infrastructure assets. (REST Industry Super, sub. 47, p. 41)
>
> High participation rates and strong cash flows also help funds to provide stability and confidence in the superannuation system (Industry Funds Forum, sub. 51, p. 10)

Similarly, Infrastructure Partnerships Australia said:

> The Productivity Commission must also be mindful of any changes to the regulatory structure that results in greater 'churn' and could work against the stability required to make illiquid and longer dated assets attractive. (sub. 9, p. 1)

The Commission's view

The process currently used to selected default superannuation funds promotes stability. Because some funds do not have an equal chance to present their case to be listed as a default fund, and current default funds are unlikely to lose default status, there is little risk that the current process for the selection of default funds will provoke large movements of members from one fund to another. Were this to occur under future changes, it could have significant consequences for all members of those funds that were losing membership.

However, as discussed above with reference to contestability, the likelihood that funds may be challenged for their default fund status also leads to inefficiencies, which in turn can lead to the members' best interests not being met. There is therefore a need to find a balance between contestability and the stability of the default fund system.

7.9 Assessing the current process — consistency with other policies

As discussed in preceding chapters, this inquiry is occurring at the same time as other significant reforms to the superannuation and financial services industries are being implemented. In particular, the Stronger Super and the Future of Financial

Advice (FOFA) reforms will change the way in which default superannuation products and financial advice are provided. Broadly, these reforms are intended to deliver better outcomes to superannuation members through simpler products, greater transparency and enhanced competition, and to ensure that financial advice is provided by professional advisers acting in the best interests of their clients.

Participants' views

Participants did not make specific comments about the importance of consistency, or the potential for inconsistency, between the default fund selection process and other related policies.

However, many inquiry participants did comment on the way in which the introduction of MySuper will affect the default superannuation market. Some suggested that the additional requirement for funds to gain authorisation to offer a MySuper product should in turn allow any fund that offers a MySuper product to be listed in awards. Similarly, some participants considered that MySuper will make it unnecessary to continue to list funds in awards. Others noted that MySuper is primarily a disclosure rather than a quality regime, and that the most suitable funds for employees covered by different awards still need to be chosen and listed in the award. These differing views are discussed in more detail in chapter 8.

The Commission's view

The Commission considers that the process used to select superannuation funds to be listed as default funds in modern awards should be consistent with the direction of the Stronger Super reforms.

In one respect, this would require the selection process to be based on clear and simple information that was made available in a transparent fashion. And, as discussed above, there is scope to improve the transparency and other features of the current process.

Similarly, the FOFA reforms are designed to tackle conflicts of interest that have compromised the quality of financial advice. To be consistent with this policy, changes to the default fund selection process would need to be made, including:

- requiring decision makers to act in the best interests of default fund members
- improving the disclosure and management of conflicts of interest.

In addition, there are existing requirements for financial advisers to be qualified and licenced — that is, to have expertise. Consistency with these requirements would require that default fund decision makers also had a certain level of expertise.

7.10 Overall assessment of the current process

After considering the current process against the principles outlined in draft recommendation 7.1, it is apparent that it has both strengths and shortcomings.

DRAFT FINDING 7.2

The process currently used in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards has the following strengths. It:

- *has generally led to the listing of funds that have delivered above-average returns for members*
- *has a measure of transparency*
- *imposes few regulatory burdens and fosters stability in the superannuation system.*

The process has the following shortcomings. It:

- *does not explicitly require decision makers to act in the best interests of default fund members, or to consider the regulatory and administrative burden that may result from their decisions*
- *does not give equal access to all superannuation funds, and therefore lacks contestability*
- *is insufficiently transparent*
- *lacks important elements of procedural fairness*
- *has inadequate mechanisms for the ongoing assessment of funds.*

In view of the nature of the shortcomings to the current selection process, the Commission considers that reform to that process is essential. In its view, this is the only way of ensuring that the factors that should be considered in selecting funds, as summarised at the beginning of this chapter, will be systematically taken into account. There are several options that build on the strengths of the current process, while addressing its shortcomings. The assessment of these options is the subject of chapter 8.

8 Options to reform the selection process

Key points

- This chapter outlines options to reform the process for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.
- The Commission has identified four options that it considers are representative of the views of participants and that cover the feasible range of alternatives.
  - Option 1 involves each employer choosing a fund from all of those that offer a MySuper or other approved default product.
  - Option 2 represents a minimal change where industrial parties assess all potential funds and nominate a subset to Fair Work Australia (FWA) for listing in awards.
  - Option 3 represents a more significant change to the industrial process, with decisions made by an expert panel within FWA, and all funds presenting their case for inclusion in awards to FWA.
  - Option 4 is similar to Option 3, but decisions would be made by a new expert body independent of FWA, with FWA administering the decision.
- Irrespective of which decision-making body is chosen:
  - All funds that have MySuper authorisation (and exempt public sector superannuation schemes) should be able to apply to be listed in an award and have their application considered on its merits.
  - The list of funds in awards needs to be restricted to avoid excessive costs for employers when choosing a default fund, while still promoting competition. A range of five to ten funds per award is an appropriate target.
  - Employers who wish to choose a fund not listed in an award should be able to do so provided they can demonstrate that their employees are made no worse off than if a listed fund had been chosen.
  - A wholesale reassessment should occur every eight years at which time the full selection process would be repeated, with a light-handed interim assessment mid-way between those reassessments.
- Option 1, by itself, does not sufficiently protect the best interests of members or address the needs of employers when making a choice of fund. Option 2 does not sufficiently open up the process to greater contestability.
- Options 3 and 4 are most aligned with the best interests of members while also addressing the needs of employers when choosing a default fund. The Commission is seeking feedback from participants on the relative merits of these two options.

This chapter focuses on options to reform the process for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. Chapters 4 to 6 found that there is a range of factors that should be considered when determining which funds are listed in awards, thus requiring a process that selects a subset of funds from the pool of all authorised MySuper products offered by funds. Chapter 7 concluded that the current process by which funds are selected has significant failings. Therefore, reform is required, and options need to focus on:

- which agent should assess the suitability of funds against the factors for consideration
- the process by which the agent will consider these factors
- how many funds should be chosen out of those found suitable.

Section 8.1 summarises the views contained in submissions to this inquiry on the best way forward. Taking these views into account, together with evidence from the Commission's consultation and its own analysis, this chapter canvasses four options for reform.

- Option 1 — allowing all employers to choose from all funds that offer a MySuper or other approved default product.
- Option 2 — a minimal change to the industrial process.
- Option 3 — more significant change to the industrial process.
- Option 4 — the introduction of a new independent body.

Option 1, which allows all employers to choose any fund with a MySuper or other approved default product (which, under the Stronger Super reforms, includes exempt public sector superannuation schemes (EPSSS) and defined benefit funds) without any other process, is outlined and assessed in section 8.2.

Options 2 to 4 each detail a process for selecting a subset of funds for listing in awards. These options sit on a continuum where Option 2 represents the least, and Option 4 the greatest, change to the current process. There are some features which are seen by the Commission as being essential to maximising the best interests of members under any such process and are therefore common across those three options. These features are outlined in section 8.3. Options 2 to 4 are then outlined and assessed in section 8.4. The principles outlined in chapter 7 guide the assessment of all options.

The Commission's conclusion is set out in section 8.5.

8.1 Views of participants

Some participants saw no need (Asset Super, sub. 32 and AustralianSuper, sub. 36) or little need (REI Super, sub. 26; Unions NSW, sub. 13) for change to the way that funds are listed as default funds in modern awards. Others expressed a range of views on how default funds should be chosen for inclusion in modern awards.

Standing

There were differences in opinion among participants about who should be able to apply and be heard by Fair Work Australia (FWA) to be listed in awards. The Australian Council of Trade Unions (ACTU) (sub. 29), AustralianSuper (sub. 36) and the Australian Institute of Superannuation Trustees (AIST) (sub. 20) thought that the range of stakeholders that currently have standing should not be broadened. According to the AIST:

> At the moment, standing to make an application rests with industrial parties … To give other parties standing without good reason is a distraction, and not in accordance with the objects of the act, other than in exceptional circumstances. This is a principle that is relevant to the operation of FWA writ large, and is not just specific to superannuation. To relax this rule in this case would ultimately undermine the operation of FWA in providing a balanced framework for the consideration of issues pertaining to employers and employees. Super funds do not have standing before FWA but it is open for them to directly approach an industrial party to seek to be included as a default fund in an award. (sub. 20, pp. 22–3)

Despite believing that there should be no changes to who has standing, the ACTU recognised that there is a need to deal with the potential conflict of interest of industrial parties.

> … we recommend that when making representations to Fair Work Australia to have particular funds named in awards, all those making representations be required to fully disclose any relevant interest they have in those funds and to declare that in advocating the naming of a particular fund or funds they are acting in the best financial interests of those affected. (sub. 29, p. 12)

Many other participants, however, suggested that any fund offering an authorised MySuper product should be able to apply for default fund status in awards (AHA, sub. 10; IFF, sub. 51; NGS Super, sub. 18). For example, in detailing its proposed approach the Industry Super Network (ISN) said:

> … it will be open to any [registrable superannuation entity] RSE or fund representative to have standing to make application and appear and be heard in support of their application before FWA. (sub. 27, p. 3)

Approaching the issue from a different perspective, the Financial Services Council (FSC) emphasised the need to remedy the current situation where those with standing can block applications made by those without standing and suggested that:

> Should default funds continue to be listed in Modern Awards, conflicted parties (and their associates) which have standing under the *Fair Work (Registered Organisations) Act 2009* should be prohibited from intervening in applications made by other funds seeking to be included in a Modern Award. This addresses the clear conflict that exists as a consequence of the equal representation trustee model whereby conflicted parties (and their associates) with standing are able to block applications made by competitor funds. (sub. 30, p. 5)

Notwithstanding the view of some that applications should be opened up to all funds, several participants emphasised the importance of considerable weight nonetheless being given to the views of the industrial parties, as they represent the opinions of those most affected by the awards (ACTU, sub. 29; Cbus, sub. 15; HOSTPLUS, sub. 8; IFF, sub. 51; NGS Super, sub. 18). For example, ISN stated:

> When considering the merits of a default superannuation fund within an award Fair Work Australia should be required to give considerable weight to the views of the industrial parties who have the role of representing the interests of those who are directly affected by the choice of default fund. Such a requirement should be clearly expressed as a requirement upon FWA. (sub. 27, p. 4)

HOSTPLUS shared a similar view.

> We believe it is appropriate that Fair Work Australia's decisions regarding the naming of default funds within awards should be guided by the informed views of the industry participants. The views of those who use and are directly affected by choice of fund legislation should be given pre-eminence. (sub. 8, p. 3)

Expertise of FWA

Many participants questioned FWA's qualifications for assessing the eligibility of superannuation funds against any additional criteria (ACCI, sub. 37; AFA, sub. 50; Law Council of Australia sub. 23; Master Builders Australia, sub. 41).

To deal with this lack of expertise, some participants suggested that there be a role for an expert panel to sit within FWA to assess which funds should be included in awards (ACTU, sub. 29; ISN, sub. 27). For example, the Australian Hotels Association said:

> Given the nature of superannuation payments and their acceptance by both employers and employees that these are deferred wages, it is appropriate that this process remain within the industrial relations system and adjudicated by an independent arbiter in Fair Work Australia. There may be merit in FWA appointing a committee or panel of superannuation experts to assist in this process. (sub. 10, p. 5)

The ACTU and ISN suggested that this panel could operate like FWA's minimum wage panel.

> … we recommend that the Fair Work Act be amended to require Fair Work Australia to convene a special purpose full-bench (similar to the minimum wages panel) that would assess the effectiveness of award default arrangements and consider representations for their amendment …. Ideally this would occur in conjunction with, or closely follow, the conduct of the four yearly reviews of modern awards. In line with the mechanism for appointment of part-time members of the minimum wage panel, provision could be made for the appointment of subject matter experts to assist Fair Work Australia in its deliberations. Additional provision could also be made to specifically allow or require Fair Work Australia to seek or consider the views of relevant regulatory bodies including APRA. (ACTU, sub. 29, p. 14)

> It is suggested that a panel of superannuation experts be attached to FWA for the period in which FWA considers applications from funds to be named as default funds within awards. This is not an uncommon process for Fair Work Australia and is undertaken during the tribunal's Minimum Wage Case considerations. We suggest it would be appropriate for FWA to use the discretion available to it to determine the number of external experts and from where they call them. During a period of regulatory change it may be appropriate to consider representation from another Commonwealth agency. The panel would assist the normally constituted FWA panel in its deliberations. Such arrangements would add an additional level of informed expertise to FWA's deliberations and could be implemented at minimal cost and without the need for legislative change. (ISN, sub. 27, p. 3)

Instead of a special purpose panel of experts, some participants saw a role for APRA to assist FWA by assessing applicants against an objective set of criteria, before FWA deliberates. AustralianSuper (sub. 36), ACTU (sub. 29), Master Builders Australia (sub. 41) and NGS Super (sub. 18) all suggested that APRA should first use its data on performance, fees and flipping to make an objective assessment of these aspects of the funds, before FWA conducts a more subjective assessment based on other factors.

eo Financial Services took a different approach to dealing with the issue of expertise by suggesting that a special purpose panel separate to FWA be set up to nominate funds for inclusion in awards.

> We suggest that there should be a new mechanism for assessing the applications and a uniform approach to that assessment. Perhaps an expert panel could be assembled for this purpose, composed of people with a range of skills, including superannuation industry experience, investment knowledge and industrial relations experience. The panel would assess the applicants against the criteria and make recommendations to Fair Work Australia as to whether any, some or all of the applicants are appropriate for inclusion in the particular modern award. (sub. 12, p. 2)

Grandfathering

Participants that commented on the current superannuation grandfathering arrangements in modern awards were generally critical of them. According to the AIST:

> AIST is opposed to grandfathering continuing in its present format. We believe that a 'day zero' must be implemented to ensure that the considerations of employees subject to default arrangements are at the very heart of future arrangements. (sub. 20, p. 22)

In addition, the FSC stated:

> While this clause worked in some instances where the superannuation fund was the default fund to which the employer was contributing before 12 September 2008, it:
>
> - excludes default fund arrangements put in place since that date;
> - effectively prohibits employers from changing an existing default fund to seek a better outcome for its employees - for example lower fees, better member services unless this can be done via an industrial agreement which overrides the Award (the costs of this make such an option unlikely for all except very large employers). This means employees may be worse off if the default funds nominated in the award do not offer the best available benefits, competitive fees, member services etc., when compared with other funds in the market. (sub. 30, p. 12)

Mercer (sub. 34) stated that the successor fund and grandfathering provisions in modern awards are inadequate for dealing with corporate mergers and de-mergers.

One exception was the Corporate Super Association (sub. 14), which saw a case to retain grandfathering arrangements to allow employers to continue to use an employer-sponsored fund to which they were making contributions before 12 September 2008 even if it does not meet any eligibility criteria.

Assessment

Many inquiry participants suggested that the funds listed in awards should be reassessed every four years as part of, or in conjunction with, FWA's four-yearly reviews of modern awards (ACTU, sub. 29; Ai Group, sub. 25; AustralianSuper, sub 26; Cbus, sub. 15; HOSTPLUS, sub. 8).

The Australian Industry Group suggested that there also needs to be provisions in place to remove funds between four-yearly reassessments.

> Flexibility should be provided for a fund to be removed from a modern award between 4 Yearly Reviews in exceptional circumstances, e.g. where the fund failed to meet legislative and regulatory requirements. (sub. 25, p. 13)

Some participants thought that a four-yearly reassessment would be too irregular, and suggested more frequent reassessments. Tasplan (sub. 6) and CPA Australia (sub. 39) thought that every two to three years was appropriate, and the Electrical Contractors Association (sub. 17) advocated annual reviews.

According to Mercer, one consequence of having a robust reassessment process could be that funds are delisted from an award and this could lead to instability:

> … as contribution inflow would be significantly reduced and some members are likely to want to transfer their accrued benefits to their new default fund. As new contributions are paid to a different default fund, disengaged members will incur two sets of fees and potential doubling up of insurance cover and associated costs. Due to these potentially severe consequences, a decision to remove a default fund from an award would tend to be made only in extreme circumstances. Therefore the integrity of any proposed monitoring and review process would be limited by these potential consequences. (sub. 34, pp. 6–7)

Any MySuper product

As discussed in chapters 4 to 6, many participants did not see a case for additional criteria to be introduced when selecting default funds in modern awards over and above those used in MySuper authorisation. They believe that existing superannuation regulations, as well as the incoming MySuper regime, will offer standards, the right incentives and protection for all employees and employers in choosing funds. These participants therefore expressed support for a system where employers can choose any authorised MySuper product (ACCI, sub. 37; AMP, sub. 52; ANZ Wealth, sub. 48; Association of Financial Advisors, sub. 50; Colonial First State, sub. 42; CSSA, sub. 35; FSC, sub. 30; Mercer, sub. 34; MLC Ltd–NAB Wealth, sub. 44; Suncorp, sub. 38). For example, the FSC said:

> It is … unnecessary to overlay further regulation on the MySuper product as it already contains every conceivable provision that a default fund could attract under law. Further criteria would also suggest that APRA's licensing process for MySuper is insufficient to be able to accept default superannuation contributions. (sub. 30, p. 20)

In addition, AMP said it:

> … believes that the standards set through the MySuper legislative environment are satisfactory and of a suitably high quality to ensure employees' superannuation assets are maximised and protected. Importantly, MySuper will simplify and standardise the default superannuation products available to Australians. Funds will be limited in the number of MySuper products they will be able to offer and this will make comparison of MySuper products more manageable. In our view, no additional criteria are required to further enhance the MySuper regulatory regime from an Awards perspective. (sub. 52, pp. 5–6)

Colonial First State (sub. 42) warned that additional criteria could undermine public confidence in MySuper, call into question the rationale for MySuper and increase regulatory burdens for funds.

The view that all employers should be able to choose any fund offering a MySuper product was expressed not only by retail funds and their representative bodies, but also by some industry funds. For example, the Transport Industry Superannuation Fund believes it has been 'locked out' of the current process and said that it:

> … supports the allowance of all MySuper Funds as default super options, and believes there is no net benefit to designing criteria over and above this, or requiring extra supervision by Fair Work Australia, when MySuper Fund options meet specific criteria already and provide a simple solution. (sub. 40, p. 3)

In addition, the Law Council of Australia stated:

> The rules which will apply to MySuper products and providers under the *Superannuation Industry (Supervision) Act 1993* (Cth) are already very prescriptive … The rules and standards are the result of significant work by members of the Cooper Review, the Government's Stronger Super Working Groups, Treasury and APRA. They have been designed to ensure that each MySuper product contains features which are most likely to be suitable for the majority of employees. On this basis, it is in the Committee's view, inappropriate for Fair Work Australia (FWA) to impose additional requirements in order for a MySuper product to be nominated as a default fund in a Modern Award. (sub. 23, p. 3)

Many participants noted that a key advantage of giving employers the choice of any MySuper product is that it would drive competition in the default superannuation market (Colonial First State, sub. 42; FSC, sub. 30; Suncorp, sub. 38). According to BT Financial Group:

> We believe allowing employers to select a default superannuation fund most aligned to their employees' needs, will bring an important level of competition into the superannuation market place. Active employer decisions will force default superannuation funds to carefully consider how they price and service members. Competition allows for poor performers to be punished by the market, as employers move towards funds that have established themselves as consistent performers … Where companies are permitted to select a default fund for their employees, market participants can compete to offer the most efficient pricing and services possible to win the business. (sub. 46, p. 2)

Advocates of this approach also believe that allowing employers to choose amongst any fund that offers a MySuper product is what most employers want. Some pointed out that many employers already take an active interest in choosing a superannuation fund that delivers the greatest benefits to employees and do not wish to be restricted to choosing from the list of funds in awards (AMP sub. 52;

MLC Ltd–NAB Wealth, sub. 44). The Corporate Superannuation Specialist Alliance (CSSA) said:

> The vast majority of employers we deal with do not want to have their choices restricted by Modern Awards. It has often been the case that, when an employer discovers that they can only choose from a short list of Industry funds, they will decide to retain their incumbent superannuation provider [which they are able to do through the grandfathering provision]. This may end up providing a sub-optimal result as another provider may be able to offer better benefits, lower fees, and other enhanced features. Incumbent funds are aware of this and hence there is little incentive for them to enhance their existing offering. This often compounds the dissatisfaction that the employer has with the fund. (sub. 35, p. 2)

Research commissioned by the FSC (sub. 30) found that employers feel that the system is over-complicated, and want empowerment and freedom of choice of their own default fund, and do not want additional criteria to MySuper. In addition, ANZ Wealth stated:

> Different employers and employees will have different needs when it comes to superannuation. Large companies may have several divisions and different levels of workers and management each representing specific demographic groups and subgroups. Large and small employers within different industries will have different needs, different administrative capacities and even different investment needs. Providing greater choice will enable these differences to be addressed in the selection of a default fund. (sub. 48, p. 3)

AMP (sub. 52) and MLC Ltd–NAB Wealth (sub. 44) noted that after the introduction of MySuper, employers will be better able to compare funds and base their decision on current information supplied by APRA. AMP (sub. 52) also pointed out that:

- there are currently 13 modern awards that do not list any funds and that this has not had any significant negative effect on employers
- in most pre-modern awards, employers were given the option of using a fund not listed in the award.

However, several other submissions highlighted the difficulty that employers would face in choosing one fund among all MySuper products (Michael Burke, sub. 3; Clubs Victoria, sub. 5; Peter Doyle, sub. 2; HOSTPLUS, sub. 8; Electrical Contractors Association, sub. 17; National Tourism Alliance, sub. 4; SDA, sub. 24). For example, CPA Australia said:

> One or more MySuper products should be nominated as the default arrangement in a modern award but there should be a limit on the number of funds that can be nominated to allow meaningful comparisons. To allow all MySuper products to be listed as default funds for a modern award would result in overwhelming choice making it difficult for

> [employers] to differentiate and make an informed choice in much the same way as if no funds were listed. (sub 39, p. 2)

To deal with this as a potential issue, the FSC suggested that rather than having a list in awards to help employers, a government website could be established to provide guidance for employers encountering difficulty choosing a MySuper product. For example, on the issue of listing funds in awards, the FSC stated:

> Breaking the nexus between named superannuation funds and the industrial system will remove the ongoing administrative complexities and costs of the existing system … Moving to a standardised MySuper default fund framework negates the need for the industrial relations system to contain this process, does not require provisions for consolidation of super funds and grandfathering. (sub. 30, pp. 25–6)

The FSC also stated:

> The Westfield/Wright research reveals that employers want empowerment and freedom of choice of their own default fund — they do not want union or external party involvement or Fair Work Australia. They seek assistance through a government website such as an APRA provided employer-focused MySuper website. (sub. 30, p. 17)

In a similar vein, Mercer (sub. 34) suggested that a process should be established where a list of appropriate funds for each award is maintained outside awards.

> We recognise the removal of nominated superannuation funds from awards could provide difficulties for some employers, particularly small to medium sized enterprises. Therefore to cater for those employers who do not want to assess the market in order to choose an appropriate default fund for their employees, we recommend that a process be established to maintain a list of appropriate superannuation funds for each award (but outside the award), taking into account the specific demographics and characteristics of the relevant employee group. This list should contain a variety of funds and be subject to regular review and monitoring. (sub. 34, p. 3)

Mercer also suggested that if funds continue to be listed in awards, employers should not be bound by this list.

> Should the Productivity Commission determine that superannuation provisions should remain in modern awards … we recommend that should an employer wish to select another MySuper product for the [superannuation guarantee] contributions of their employees, then such an outcome should be permitted. After all, it is likely the employees of some employers covered by each award will have particular demographic features or be within a particular location(s), where it may be preferable for them to join another superannuation fund. In other cases, particularly for larger employers, the employer may be able to negotiate superior superannuation arrangements for their employees. (sub. 34, p. 3)

Number of funds to be listed in awards

Some submissions emphasised the need to restrict the number of funds listed in awards to ease the burden on employers from having to choose among too many funds (Cbus, sub. 15; COSBOA, sub. 7; legalsuper, sub. 19; SDA, sub. 24).

Many participants thought that this would be best achieved by setting a range for the allowable number of funds. Comments by the AIST were reflective of the views of many as to why such a range is preferred to a target number.

> A limit should be set that is appropriate to the industry where the modern award is to apply … an unfeasibly large list of default funds, or even open-ended criteria, such as, 'all funds meeting condition Y...' imposes administration costs on business looking to reduce their compliance costs and seeking to streamline the payment of default contributions. At the same time, there should be choice available to businesses … subject to the modern awards. We do not support the mandating of one fund as a default, except in circumstances where that fund is the only appropriate choice ... (sub. 20, p. 20)

In terms of what the range should be, several participants stated that there should be a minimum of two funds named in awards (ACTU, sub. 29; AIST, sub. 20; AustralianSuper, sub. 36; ISN, sub. 27), and a maximum of between six and ten funds (Australian Hotels Association, sub. 10; Cbus, sub. 15; ISN, sub. 27; legalsuper, sub. 19; Unions NSW, sub. 13).

8.2 Option 1

Under this option, each employer would choose a fund from all of those that offer a MySuper or other approved default product (including an EPSSS or defined benefit fund).

Underlying this option is an assumption that no criteria additional to those contained in MySuper are necessary when selecting a fund for those employees to whom the superannuation provisions in a modern award apply. The Commission has not identified any additional criteria. However, this option runs counter to the Commission's conclusion that there is merit in considering a range of factors when selecting funds, to ensure that the best interests of members are accounted for when selecting default funds. This option would not require each employer to consider those factors when choosing a fund. Nonetheless, the Commission has assessed the case for this option given that it was favoured by a number of participants.

Commission's assessment of Option 1

Best interests of members

This option does not have the best interests of members as its explicit focus. It assumes that the best interests of members lie behind the decisions made by employers and are adequately dealt with by the Stronger Super reforms. As discussed throughout this report, the Commission has assessed that this is not necessarily the case, primarily because the MySuper legislation serves largely to standardise features and promote disclosure to improve comparability between funds, rather than filter out any fund which may not represent the best interests of members.

This option does not address the principal–agent problems inherent in a default superannuation system (chapter 3). Rather, it shifts the burden of the decision from industrial parties to employers, who do not necessarily have the interest or expertise to make a decision that is aligned with the best interests of employees and who, like the industrial parties, can be faced with conflicts of interest.

Contestability

This option's key advantage is the extent to which it achieves contestability, as it is more of a market-based approach where market participants — in this case employers — are required to make a choice among all funds that offer a MySuper or other approved default product. There are no restrictions on entry into that market other than the requirement to offer a product authorised to receive default contributions.

Therefore, this option would yield some additional benefits compared to other options by providing maximum supply-side competition, given that the barriers to entry for funds offering MySuper products would essentially be removed.

It would not, however, solve the issue of a lack of demand-side pressure. Employers are the demand-side participants in this option, and they would not necessarily have the incentives to actively participate in the market by choosing and switching between funds based on the best interests of the fund members, due to the inherent principal–agent issues.

Transparency

Under this option, there would be little improvement in transparency about the way a default fund is chosen for a member. In the current process, while FWA generally

provides an explanation for its decision, its grounds for assessing each application do not lend themselves to the need to disclose much detail or relate the decision to the best interests of members. Further, there is a lack of transparency about the basis upon which industrial parties nominate funds for inclusion as default funds in modern awards (chapter 7).

Under this option, that opaqueness would shift to the way that an employer selects a fund for their workplace. There would be no disclosure as to why an employer chose that particular fund and no assessment of the appropriateness of that choice other than the assurance that a MySuper product was chosen and the performance of that product would appear on a product dashboard.

Procedural fairness

It is somewhat difficult to assess the procedural fairness principle under this option, as the 'decision maker' is the employer, not a government organisation and there is no procedure that would be followed that could be deemed as being fair or unfair.

Minimum regulatory burden

This option would reduce the regulatory burden for those involved in the default fund selection process in many ways, given the lack of any prescribed procedure for selecting a default fund. There is no role for industrial parties or FWA or any other decision making body.

Funds would no longer need to put forward their case against the factors for consideration. However, they might instead turn their efforts to spending more on marketing and advertising to entice employers to select them. This activity is of little benefit to members and is costly, with the costs ultimately borne by the existing members of that fund. This occurred in Chile (appendix B) and, as a consequence, regulations were put in place to limit switching.

Even if the Commission had considered that MySuper authorisation presented a sufficient hurdle for a fund to be listed in awards, without the need to consider a range of factors, the Commission does not consider that it would be practical or desirable for all employers to be required to choose from such a wide set of MySuper products. Some industry participants estimate that, at the commencement of MySuper, there will be around 200 MySuper products (declining over the years as the industry consolidates) (see, for example, FSC, sub. 30). Requiring all employers to choose amongst all funds that offer a MySuper product would involve large search costs, and most employers lack the expertise to make an informed

choice. Submissions from some employer groups (COSBOA, sub. 7; Electrical Contractors Association, sub. 17) explicitly opposed such an arrangement.

Avoiding instability

This option has the greatest potential to cause instability in the system — especially in the short term. Opening up the market for default funds in awards could induce a high degree of switching initially, and then frequent switching thereafter. This would particularly be the case if funds choose to embark upon aggressive marketing campaigns and were persistent in doing so, as occurred in Chile in the 1980s and 1990s before regulations to limit switching were introduced (appendix B).

Consistency with other policies

At a minimum, this option is consistent with the disclosure regime that underlies MySuper and promotes choice by employers, much as the 2005 superannuation reforms promoted choice by employees. However, it runs counter to the recent Future of Financial Advice (FOFA) reforms that reduce the potential for conflicts of interest where financial decisions are made by third parties (chapters 5 and 6). Many small employers readily concede that they do not have the expertise to choose superannuation funds for their employees, and do not have the resources available to gain that expertise (see, for example, COSBOA, sub. 7).

Regular assessments

There is no assessment mechanism built into this option. Employers would not be obliged to assess the appropriateness of the default fund at any time. This would be at the employer's discretion. Given the principal–agent issues, many employers would probably face little incentive to assess their choice, once it is made, to check if it is still in the best interests of members (though they might switch for other reasons such as administrative convenience or improved financial outcomes for the business where superannuation is bundled with other services by a financial institution).

8.3 Common features of Options 2 to 4

Options 2 to 4 all involve some form of a process for implementing the range of factors for consideration that are outlined by the Commission for the selection and ongoing assessment of superannuation funds for listing as default funds in modern

awards. There are some elements of this process that the Commission considers crucial to ensuring that it is aligned with the best interests of members.

All funds can apply and be assessed

Chapter 7 highlights the problems with the current process in terms of contestability and procedural fairness, where only those with standing are likely to have their application to list a default fund in an award considered.

In light of this, the Commission considers that, under the reformed process, it is essential for all funds that have MySuper authorisation (and EPSSSs) to be able to apply to be listed in awards and have their case considered on its merits. Each applicant fund would need to build a case against the factors for consideration identified by the Commission, and their application would be considered by the decision maker on this basis.

This approach would reduce regulatory barriers to entry (chapter 3), strengthen contestability and ensure consistency with the principle of procedural fairness.

DRAFT RECOMMENDATION 8.1

All funds that are authorised to offer a MySuper product (and exempt public sector superannuation schemes) should be able to apply to be listed in an award and have the application considered on its merits. An applicant's case should be outlined and assessed against the factors for consideration identified by the Commission. Other factors could be taken into account for individual awards at the decision maker's discretion.

Employer discretion to choose a fund not listed

While there was substantial evidence that many employers value having default funds listed in awards to reduce the burden on them of needing to choose a fund, it is the Commission's view that having a number of funds listed in awards should not impede the flexibility of employers to choose any fund not listed as long as:

- that fund is approved, under the Stronger Super legislation, to receive default contributions (that is, is a fund offering a MySuper product, or an EPSSS or a defined benefit fund)
- in doing so, their employees are no worse off than if a listed fund had been chosen.

There are several reasons why employers should be given this flexibility. First, many pre-modern federal awards allowed employers to choose any fund. Forty-five per cent of pre-modern federal awards did not list a default fund. Of the remaining 55 per cent that did list at least one default fund, 12 per cent gave employers discretion to choose any other fund and just over half gave employers the ability to choose a different fund in limited specified circumstances (including, for example, by agreement with employees or unions, and/or on application to the Australian Industrial Relations Commission). The Commission is not aware of any problems that arose from these arrangements.

Second, allowing employers to use their discretion would help to alleviate the problems associated with contestability identified in chapter 7. Giving employers the ability to choose a fund other than one listed in the relevant award would introduce the threat of competition for listed funds. Even if few employers actually utilised this discretion, the threat of competition can be enough to strengthen contestability and strengthen the incentive for listed funds to produce outcomes that are in the best interests of members.

Third, employers have the legal obligation under the *Superannuation Industry Supervision Act 1993* (Cwlth) to choose a fund on behalf of their employees (chapter 2). Where they have the interest and expertise for making an informed decision, they should be allowed to exercise choice in the way they carry out that obligation. With the increasing information disclosure and administrative efficiencies that the Stronger Super reforms will entail, the number of employers with the ability to exercise choice in a way that does not disadvantage their employees is likely to increase.

Finally, employer discretion allows for closer tailoring to the needs of a particular workplace than can a system based on awards. It therefore has the potential to provide superior outcomes for those members.

In terms of implementing this provision to give employers discretion, as with the process for selecting funds to be listed in awards, the best interests of members need to be of primary concern. The Commission therefore proposes that an employer should, in some way, demonstrate that its employees are made no worse off than if a fund listed in the relevant award had been chosen. It is important, however, that any mechanism for doing so not be so onerous as to prevent employers from ever using their discretion.

The Commission proposes that employers should have to justify their choice to the relevant body, if called upon, against the factors for consideration identified by the Commission and demonstrate that their employees are at least no worse off than if a

listed fund had been chosen. Like tax, this would be a self-assessment regime, but no 'return' or notice would be required in the first instance. However, evidence of reasons for the choice would have to be produced on request.

The Commission recognises that giving employers the discretion to choose a fund not listed in the relevant award, provided that they can demonstrate that their employees are no worse off, is a substantial departure from current arrangements. Therefore, the Commission is seeking feedback from participants on the precise mechanism for implementing this proposal — for example, who should monitor compliance and how, and what evidence would employers be required to produce that demonstrated that their employees were no worse off.

DRAFT RECOMMENDATION 8.2

Employers selecting default funds for employees to whom the superannuation provisions in modern awards apply should be able to choose a fund not listed in the relevant award. However, in this circumstance, employers should be required to justify their choice, if called upon, by demonstrating that:

- ***the factors for consideration identified by the Commission were taken into account when making the decision***
- ***their employees are at least no worse off than if the employer had chosen a fund listed in the relevant award.***

INFORMATION REQUEST

The Commission is seeking feedback on which body, under each of the options presented below, would monitor compliance with the requirement that employers choosing a fund not listed in the relevant award justify their choice if called upon, and how they would do so.

Giving employers the discretion to choose a fund not listed in the relevant award means that they could continue to make contributions to the fund they are currently using if they can demonstrate their employees are no worse off than if a listed fund had been chosen. In light of this, the Commission sees no case for retaining any type of grandfathering arrangements.

DRAFT RECOMMENDATION 8.3

Grandfathering provisions relating to superannuation should be removed from all modern awards.

A target range for the number of funds listed

Any agent exercising judgement about which funds should be listed in awards, taking into account the factors for consideration outlined by the Commission, needs to decide on how many funds should be listed in each award. In the Commission's view, it is not appropriate to prescribe a specific number of funds, given that a different number of funds might apply for listing in different awards, and the assessment of these applications against the factors for consideration might produce different outcomes. Further, the range of characteristics of employees covered varies between awards. Therefore, the Commission sees merit in specifying a target range for the number of funds that can be listed in an award.

An upper bound on the number of funds listed in each award would avoid employers facing excessive search costs when choosing a fund from those listed in awards. If there are too many funds to choose from, this will present too high an administrative burden on employers who might need to commit time and effort to researching which of the listed funds they should select.

On the other hand, the Commission also considers that it is important to encourage competition amongst funds listed in awards to ensure that they have an incentive to meet the best interests of members. Therefore, a lower bound on the number of funds listed is also required. This lower bound needs to be high enough to account for the fact that there is likely to be ongoing consolidation in the industry (which means that, all else equal, the number of listed funds will decrease over time). It also needs to be high enough to cater for the different needs of employees where coverage of an award is broad (chapter 2).

The Commission also notes that, currently, around one third of modern awards list between five and ten funds (chapter 2).

On balance, it is the Commission's view that no fewer than five and no greater than ten funds should be listed in modern awards. This should promote competition while avoiding excessive search costs for employers.

Where an award does not currently list default funds (currently around 10 per cent of awards), there will be no requirement for this situation to change.

DRAFT RECOMMENDATION 8.4

Modern awards that list default superannuation funds should list no fewer than five and no more than ten funds.

Regular assessment of listed funds

Chapter 7 outlined the inadequacy of the current assessment mechanism. In considering an appropriate mechanism, the Commission has attempted to strike a balance between ensuring that the list of funds contained in awards remains in the best interests of members on an ongoing basis, and ensuring that the mechanism for doing so is not overly burdensome.

The Commission considers that there are two important components of any assessment mechanism. First, there needs to be a 'watching brief' by way of ongoing assessment that would enable the removal of funds in exceptional circumstance. These circumstances might include a fund's MySuper authorisation being revoked, the fund being consolidated into another fund and therefore no longer existing as a separate entity, or the fund failing some other legislative or regulatory requirement. Without such a mechanism, employers could end up making contributions to a non-compliant or non-existent fund. No funds would be added as part of this ongoing assessment process (though the names of those listed could change, such as through fund consolidation).

Second, there needs to be a wholesale reassessment of the list of funds on a periodic basis to ensure that the funds listed are those that are most appropriate for meeting the best interests of members over time. A four-yearly process would have the advantage that it could potentially be conducted as part of FWA's general review of modern awards and so reduce costs and complexity for all involved. On the other hand, a wholesale reassessment every four years could be administratively costly, and also costly from a system stability point of view. The benefits might also be difficult to capture if there is insufficient change in the industry and in the suitability of funds over such a short period — especially as there would be an ongoing assessment to remove funds through that period.

The Commission proposes that every eight years, a wholesale reassessment should take place. This could coincide with every second four-yearly review of awards. At this time, the process for selecting funds would be essentially repeated. Funds not previously listed would have the chance to apply, and those listed would need to reapply. The Commission considers that an eight-yearly wholesale reassessment would strike the best balance between the costs of conducting such an exercise and the benefits from doing so in terms of ensuring that the best interests of members are accounted for over time.

Mid-way between each reassessment, a light-handed assessment should be undertaken to ensure that everything is in check and anything outstanding that has been raised as part of the ongoing assessment is attended to. These assessments

could coincide with every other four-yearly review of awards. At this time, funds could be removed from the list but new funds would not be added.

DRAFT RECOMMENDATION 8.5

There should be an ongoing assessment of the list of superannuation funds in modern awards to ensure that any demonstrably unsuitable, unauthorised or non-existent funds are removed as required. In addition, a wholesale reassessment should occur every eight years at which time the full selection process would be repeated and all funds that wish to be listed in awards would need to apply or reapply. Mid-way between each reassessment, a light-handed interim assessment should be undertaken, at which time funds could be removed from, but not added to, awards.

Appeal

At present, decisions made under the *Fair Work Act 2009* (Cwlth) (including decisions regarding the listing of default funds in modern awards) can be appealed to the full bench of FWA, and to the Federal Court of Australia in certain circumstances. The Commission is not aware of any particular problems associated with the operation of the existing appeal mechanisms, though they have rarely been used (and thus have not yet been fully tested in relation to superannuation). There was, however, some uncertainty amongst inquiry participants about the existence and operation of appeal mechanisms.

The appeal mechanisms implemented for the chosen option need to be clear and accessible to all participants. They must also strike a balance between allowing all parties with sufficient interest the right to appeal where there are sufficient grounds to do so, while discouraging vexatious claims. To the extent that current appeal mechanisms achieve this balance, they should be retained. The Commission will seek advice on any changes to appeal mechanisms that may be required in regard to each of the options presented below (and notes that some options may require more change than others). Regardless of the appeal mechanisms adopted, they should be explained in a manner that makes them clear and accessible to all relevant parties.

DRAFT RECOMMENDATION 8.6

The process used in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should allow for appeals. Appeal mechanisms should strike a balance between allowing all parties with sufficient interest the right to appeal, where there are sufficient grounds to do so, while discouraging vexatious claims.

8.4 Options 2 to 4

The details of Options 2 to 4 are outlined in the following sections, along with the Commission's assessment of each of these options.

Option 2 — Minimal change

One reform option considered by the Commission was to have 'minimal change'. Under such an approach, all funds would be able to apply to FWA to be listed as a default fund in an award as outlined above. The application would need to set out the fund's case against the factors for consideration identified by the Commission. These factors would replace the three grounds which have been used to date by FWA to assess applications (chapter 7).

All applications would be placed on FWA's website. Industrial parties would then be given a period within which to respond by submitting to FWA their preferred subset of five to ten funds for each award in which default funds are currently listed, from amongst the applications. In doing so, the industrial parties would have an obligation to:

- consider all funds in good faith
- assess the performance of the applicant funds against the factors for consideration
- demonstrate to FWA that they are making their decision according to the best interests of the employees to whom the superannuation provisions in modern awards apply, while having regard to the administrative and compliance impact on employers.

The case put forward by the parties would need to be documented in a transparent manner and be made available publicly. Industrial parties would also be required to disclose any conflict of interests, such as the potential conflict that arises because the industrial parties are shareholders of the relevant industry fund, in an open and transparent manner. As noted in chapter 5, APRA's prudential standards (APRA 2011) state that conflicts of interest can be actual, perceived or potential in nature.

A period for comment would follow where any party with sufficient interest (that is, FWA could decide not to consider the submission if the party was seen to have insufficient interest in the subject matter) could respond to the case put forward by the industrial parties. In doing so, they too would have to disclose any actual, perceived or potential conflicts of interest.

In assessing the case put forward by the industrial parties, and in making its decision, FWA would need to be satisfied that the industrial parties had adequately discharged their obligations. In this sense, FWA's role would be to assess whether due process had been undertaken, not to independently assess the merits of the case put before it. In practice, FWA would assess due process primarily based on whether any interested parties had raised objections to the subset of funds put forward by industrial parties. If FWA required further evidence it could hold a public hearing.

If no objections were raised and FWA was satisfied that the industrial parties had carried through with their obligations, FWA would approve the subset of funds.

FWA decisions would be made public on its website, along with an explanation of the decision.

FWA would maintain a watching brief by way of an ongoing assessment (described above — in this option relying primarily on being alerted by the industrial parties or others with sufficient interest that a fund's listing needed to be assessed). FWA would also conduct the light-handed interim assessments and wholesale reassessments as outlined earlier.

Commission's assessment of Option 2

Best interests of members

This option improves on the current process. Industrial parties would be required to consider all applicant funds against the factors for consideration, disclose any conflicts of interest and present their case with the best interests of members explicitly identified. In this sense it goes some way to addressing the principal−agent issues identified in chapter 7.

However, where a balance of judgement is required, industrial parties would likely retain the incentive to preserve the status quo or choose industry funds. Applicant funds might also press their ability to provide ancillary services to a membership base which overlaps with that of the industrial parties as a way of promoting a favourable assessment of their fund by the industrial parties making the submission to FWA. There would need to be a strong mechanism to counter these potential issues.

In addition, and in the absence of additional expertise, FWA might lack the expertise to assess whether the industrial parties had discharged their obligation to make decisions in the best interests of members, or to assess the reasonableness of

any objections from interested parties that claim that the parties have not acted in the best interests of members.

Contestability

Contestability would be improved under this option compared with the current process because all funds would be able to apply to be listed as a default fund in an award and industrial parties would be obliged to consider all funds. Contestability would also be aided by the potential for employers to choose a fund not listed in the award, and by the requirement that there be five to ten funds listed in every award.

However, some would argue that full contestability is not possible where the process is still weighted toward the views of the industrial parties.

Transparency

Transparency is increased because industrial parties would be required to disclose the basis on which they nominate funds for inclusion in awards against the factors for consideration. Currently there is no such requirement on those parties (chapter 7).

The disclosure of information at the application, response, consideration and decision stages would also be more detailed and rigorous as, in each case, the factors need to be explicitly considered.

Procedural fairness

Procedural fairness is improved in one sense because all parties would be given the opportunity to put forward their case and be heard. However, it is not clear that each of the applicants would be given equal weighting by industrial parties, given their familiarity with industry funds. At the very least, this process leaves open the perception that it is not procedurally fair.

Minimum regulatory burden

The regulatory burden involved with this process is greater overall than the current process, essentially as a consequence of there being more robustness in the application and assessment of funds. However, as discussed in chapter 7, improving the selection process in ways that increase the regulatory burden can be worthwhile if it leads to substantially better outcomes for default fund members.

From a process perspective (rather than in terms of overall benefits), those involved in the process would be affected in different ways under this option.

- Industrial parties need to put more time and effort into their submission to FWA.
- FWA would need to consider the responses of all interested parties and decide whether, in its view, the industrial parties have met their obligations, which is likely to be more time consuming than the current precedent-based decision making process. This burden would be exacerbated if many objections were raised by interested parties, especially if these objections resulted in FWA requiring the industrial parties to revisit their submission. In addition, FWA is likely to require additional resources as, in its current form, it might lack the expertise for considering whether due process has been followed by the industrial parties. A cycle of assessments and wholesale reassessments every four years would also increase the regulatory burden for FWA under this option.
- The process for funds would be more burdensome in some respects as each would need to make its case against the factors for consideration. However, for funds that currently do not have standing, this process could be less burdensome than the process of finding a party with standing that is willing to apply on their behalf.
- The experience of employers would differ depending on the relevant award. Where some awards list up to 18 funds, restricting that number to no more than ten will make the process of choosing a fund easier for employers. On the other hand, where the list is currently fewer than five, employers will need to choose from a larger pool of funds. Where awards currently list no funds, there would be no change in the arrangements. On balance, the burden on employers is expected to be reduced under this option, especially in light of benefits that flow to them from the incentives for funds to improve their administrative efficiency.

Avoiding instability

The stability of the default superannuation system is difficult to judge under any of the reform options because it will depend on the extent to which funds currently listed would be found unsuitable and, therefore, removed.

If, under this option, there was little movement from the status quo, stability would be retained. However, if it led to many employers having to switch from their current default fund — because it is no longer listed — to one that is listed (and they were unable or unwilling to use their discretion to choose to stay with their existing fund) then some change will occur.

The more a process drives change in the composition of funds listed in a given award, leading to employers switching default funds, the greater the potential for significant changes in the flow of contributions between funds with MySuper products. Some funds that have had a long-standing guaranteed inflow of contributions from their default fund status in awards would lose that position and potentially experience a loss of scale that could have detrimental consequences for members of the fund and contribute to instability in the system.

As discussed in chapter 7, the desirability of stability needs to be weighed against the benefits from contestability.

Consistency with other policies

This option is consistent with other policies to the extent that it promotes the best interests of members and greater transparency. However, it is not totally aligned with the direction of the FOFA reforms to reduce conflicts of interest (chapters 5 and 6).

Regular assessments

Given the current lack of any regular assessment mechanism, this option greatly strengthens that process by ensuring that there is a wholesale reassessment of the list of funds every eight years, a light-handed interim assessment mid-way between each wholesale reassessment, and a mechanism to remove demonstrably unsuitable, unauthorised or non-existent funds on an ongoing basis.

Option 3 — A more open and transparent industrial process

This option introduces further change to the industrial process in order to remedy some of the deficiencies identified with Option 2. FWA becomes the full decision maker, with the assistance of an expert panel.

To deal with issues of contestability and procedural fairness, this option would enable all funds to, on application, be given independent standing before FWA to make their case to be listed as a default fund in a modern award that currently lists default funds. Applications would need to address the agreed factors for consideration.

There would then be a period in which any party with sufficient interest would be able to make a submission to FWA, in response to the individual applications for each award that currently lists default funds. The industrial parties could still choose

to submit a collective view to FWA on their preferred short list of funds. These views would not be formally given any more weight than other submissions. All parties making submissions to FWA would need to publicly disclose any conflicts of interest.

To overcome the lack of expertise in FWA, a specific purpose panel would be convened within FWA to make decisions on which funds are listed in awards. The panel would include individuals appointed to FWA as part-time members with expertise in a range of relevant areas, such as finance and superannuation, in addition to full-time FWA members. The panel could operate much like the existing FWA Minimum Wage Panel (box 8.1). The part-time members of the specific purpose panel would work on the task of listing funds in awards as required, but not on other FWA matters.

Box 8.1 **The Minimum Wage Panel**

The *Fair Work Act 2009* (Cwlth) provides for an annual wage review conducted by the Minimum Wage Panel of Fair Work Australia. The Panel comprises the President of FWA, three other full-time members and three part-time members.

The part-time members' sole function is to work on the annual wage review. Such members must have knowledge of, or experience in, one or more of the following fields:

- workplace relations
- economics
- social policy
- business, industry or commerce.

Decisions of the Panel are made by majority. Where Panel members have a conflict of interest, they must disclose it and not deal with the matter in question.

The part-time members are appointed by the Governor-General for a fixed term of no greater than five years. The full-time members of the Panel are chosen by the President from the full-time members of the tribunal.

Source: *Fair Work Act 2009* (Cwlth)

To strengthen procedural fairness, the process would take place in two stages. First, the FWA panel would consider the applications and responses to those applications, and would publicly issue its draft decision on its website. This draft decision would be based on the panel's best assessment of which funds are most suitable for a particular award, taking the factors for consideration into account and being guided by the overarching objective of the best interests of members.

Following the release of the draft decision, there would be a period for further submissions from any party with sufficient interest. At this point, the FWA panel could hold a public hearing to gather more evidence if required.

The FWA panel would then release its final decision and publish this on its website together with an explanation of the decision with respect to the factors for consideration and the best interests of members.

The secretariat for the FWA panel would be FWA staff. The panel would commission research from (or through) its secretariat as required and, as with the minimum wage review process, all research undertaken for the selection and assessment of funds would need to be published so that submissions can be made on the issues covered in that research.

Instead of looking at each award separately, the FWA panel could, if it thought it appropriate, choose to conduct the process in groups or tranches of awards. This could reduce the administrative burden of the process without compromising the best interests of members if the characteristics of employees across multiple awards were found to be similar.

The FWA panel would conduct a wholesale reassessment of the list of funds every eight years and an interim assessment mid-way between each wholesale reassessment, and its secretariat would maintain an ongoing watch and advise the panel if any action to remove a fund was deemed necessary.

Commission's assessment of Option 3

Best interests of members

This option would more comprehensively address the best interests of members compared with Option 2. It more comprehensively addresses the potential principal–agent issues that can be present when industrial parties have prime input into which funds should be listed in awards. By ensuring that the overarching objective of the FWA expert panel is the best interests of members, there is no need to give the views of industrial parties more weight than the views of others.

Consideration of the best interests of members is also strengthened by having the decision rest in the hands of a specific purpose panel that sits within FWA and has the appropriate expertise for making an objective decision and exercising judgement. Such an outcome, however, relies on the panel members not being conflicted in any way.

Contestability and procedural fairness

This option strengthens contestability compared to Option 2 by giving all funds independent standing before the FWA panel, rather than requiring them to present their case to industrial parties.

In this sense, it also achieves the objective of procedural fairness, as all parties have the right to be heard by an independent decision maker. Procedural fairness is also enhanced by the two stage process, which gives parties adequate opportunity to respond to the draft decision.

Some issues with contestability and procedural fairness might remain to the extent that one or more of the FWA panel might be biased, or perceived to be biased, towards the views of any party that they were, or remain, affiliated with.

Transparency

Like Option 2, transparency is increased under this option because industrial parties and funds seeking to be listed in awards would be required to provide comprehensive public submissions to FWA, addressing the factors for consideration. The submissions would be scrutinised by FWA and, given they would be public, they would also draw the attention of other stakeholders. Moreover, each participant would be able to view the arguments of the other parties and respond accordingly. Submissions and responses to submissions through public hearings before FWA would also enhance the transparency of this option.

Minimum regulatory burden

From a process perspective, and as with Option 2, the burden placed on each party involved in the process is likely to vary.

- The burden on industrial parties would decrease compared with Option 2 if they chose not to put their collective view forward. Where they did put forward their view, it would still be easier for them, as they would not be explicitly required to consider all applicant funds when doing so.
- The burden on superannuation funds applying for inclusion in awards would be similar to that in Option 2, as they would apply in the same way, presenting their case against the factors for consideration.
- Resources would be required to set up the expert panel and staff the panel's secretariat. The fact that there is an established similar process within FWA (the minimum wage panel) could help to minimise these additional costs. The

administrative burden may be reduced further if it was deemed appropriate by FWA to consider awards in groups or tranches.

- The effect on employers would be similar to that in Option 2, though the administrative burden some face could be higher if there was a higher degree of turnover in listed funds (see below).

Avoiding instability

This option might result in greater change to the list of funds in awards because the weight of the view of the industrial parties is diminished compared with Option 2. Therefore, there could be a higher risk of instability associated with this option.

Consistency with other policies

This option is consistent with the approach taken to national minimum wage cases where interested parties can make representations to FWA, which acting as the independent umpire, makes decisions on the basis of public evidence by these parties as well as commissioned research.

Given that this option represents greater contestability and transparency, it is also consistent with the objectives of other policies such as Stronger Super and FOFA.

Regular assessments

This option strengthens the assessment process in much the same way as Option 2.

Option 4 — New independent body chooses funds for FWA to list in modern awards

This option attempts to deal with concerns that the industrial process, as it stands, is focused on the views of industrial parties, and that any variation of this process (Options 2 and 3) will not be sufficient to alleviate this concern.

Under Option 4, the decision of which funds are listed in awards would be taken outside the industrial process, and made by a new body independent of FWA.

The independent body would be established with the sole purpose of performing the task of selecting and assessing funds to be listed in modern awards. The body would be made up of a panel of experts, in areas such as finance and superannuation, that would be appointed on a fixed-term basis. The membership of the panel would need

to be constituted to reflect the best interests of members, rather than directly represent particular stakeholders. Thus, while the new panel would require an appropriate mix of people with the necessary qualifications and experience to guide its work, members would need to be appointed in their own right, through a transparent appointment process, rather than as representatives of particular organisations.

The stages of the process would be very similar to Option 3, the key difference being that the consideration and decision is made by the independent body rather than FWA. In this option, FWA (in its current form) plays a minimal role — it would essentially administer the decision of the independent panel.

Industrial parties would be able to submit their views but, as with Option 3, these views would not be formally given any more weight than other submissions.

The panel would make its assessment based on the factors for consideration. Its reasons for selecting particular funds would be made public. It would consider all applications and be guided by the primary objective of serving the best interests of members.

As the body would do most of its work initially and then only every four years when interim assessments and wholesale reassessments are conducted, it is unlikely that a full secretariat capability would be required on a full-time basis. It would be more efficient for the secretariat to sit within an existing organisation and provide its services as requested. APRA might be best placed to provide this service.

The new body would conduct a wholesale reassessment of the list of funds every eight years and an interim assessment mid-way between each wholesale reassessment. Its secretariat would maintain an ongoing watch and advise the body if any action to remove a fund was deemed necessary.

The main features of Options 2 to 4 are summarised in table 8.1.

Commission's assessment of Option 4

Best interests of members

The best interests of members could be further enhanced under this option if it results in a more objective and independent decision, although the Commission acknowledges the view of some participants that by weakening the role of industrial parties, the best interests of members may not be as well served as under Option 3.

Careful consideration of who sits on the panel of the independent body would be important to ensure that they are not conflicted in their role of selecting funds in the best interests of members.

Contestability and procedural fairness

Contestability and procedural fairness could be strengthened further under this option as all funds that offer a MySuper product (and EPSSSs) have an equal opportunity to be considered by a body which would likely be viewed as exercising more independence and objectivity than the FWA panel.

Transparency

The outcomes in terms of transparency are similar to Option 3, given that the steps involved are the same and all information at each step is disclosed publicly. Having a body with the sole purpose of selecting default funds to be listed in awards can also possibly engender a further sense of public confidence.

Minimum regulatory burden

This option would require resources to establish a new body, design new administrative processes and resource the agency providing secretariat services.

For all other aspects, the regulatory burden would be similar to Option 3. As with Option 3, the administrative burden arising from the process could be minimised by selecting funds in groups or tranches, rather than award by award.

Avoiding instability

The risk of instability under this option is broadly similar to that in Option 3.

Consistency with other policies

This option is consistent with Stronger Super and FOFA but it is not necessarily consistent with the way that industrial matters in awards are currently dealt with. While superannuation would remain an industrial matter where funds are listed in awards, there would in effect be no industrial process.

Regular assessment

The assessment process is improved in the same way as under Option 3.

Table 8.1 **Summary of main features of Options 2 to 4**

	Option 2 — Minimal change	*Option 3 — FWA expert panel*	*Option 4 — new independent body*
Decision maker	FWA (in current form)	FWA with panel of experts	Sole purpose independent body
Application	All superannuation funds can apply, making their case against factors for consideration.		
Response	Industrial parties nominate 5-10 funds per award. Have obligation to consider all applicant funds, assess according to factors for consideration and choose based on best interests of employees. Submissions placed on FWA website. Opportunity for any party with sufficient interest to respond to submissions.	Any party with sufficient interest can respond. Submissions placed on FWA website.	Any party with sufficient interest can respond. Submissions placed on website of independent body.
Consideration	FWA, based on whether industrial parties have discharged their obligations. In practice, primarily based on any objections raised by others. Hearing can be held to gather more evidence. Considered award by award or in groups.	FWA expert panel, like minimum wage panel, using judgement to assess appropriateness of case against factors for consideration, and choosing in best interests of employees. Hearing can be held to gather more evidence. Considered award by award or in groups.	Independent body, using judgement to assess case against factors for consideration, and choosing in best interests of employees. Hearing can be held to gather more evidence. Considered award by award or in groups.
Decision (5-10 funds per award)	Decision published on FWA website along with explanation.	Release of draft decision and explanation based on factors for consideration. Any party with sufficient interest can respond to draft decision. Final decision published on FWA website along with explanation.	Release of draft decision and explanation based on factors for consideration. Any party with sufficient interest can respond to draft decision. Final decision published on website of independent body along with explanation.
Regular assessment	FWA keeps a watching brief on the list. Every 8 years, conducts wholesale reassessment where initial process is repeated. Mid-way between reassessments, conducts a light-handed assessment to remove funds.	FWA panel keeps a watching brief on the list. Every 8 years, conducts wholesale reassessment where initial process is repeated. Mid-way between reassessments, conducts a light-handed assessment to remove funds.	Independent body keeps a watching brief on the list. Every 8 years, conducts wholesale reassessment where initial process is repeated. Mid-way between reassessments, conducts a light-handed assessment to remove funds.
Employer discretion	Employers can choose a fund not listed in relevant award, but need to demonstrate, if called upon, that employees are no worse off.		

8.5 The Commission's preferred approach

The Commission sees no case to proceed with Option 1. First and foremost the Commission has concluded that, when considering the best interests of default fund members, there is a case to consider factors over and above the disclosure criteria required for authorisation of MySuper products. Not all MySuper products would be judged equally highly against those factors, and so allowing employers to choose any fund that offers a MySuper product (or other approved default product) would not meet the best interests of members.

Even if the Commission considered that the MySuper authorisation requirements presented a sufficient hurdle for listing in awards, it would not be practical or desirable for all employers to have to choose from such a wide set of funds given the search costs involved. While increasing the set of funds to choose from would entail benefits from greater contestability, this can also be increased by giving employers the option, should they wish, of choosing a fund not listed in awards.

One way of ensuring that the best interests of employees are explicitly considered under Option 1 is to introduce a test on all employers similar to that described above for Options 2 to 4. That is, under this variation to Option 1, all employers would choose any fund offering a MySuper or other approved default product for its employees, but all employers would need to be able to demonstrate, if called upon, that they had considered the factors for consideration identified by the Commission, and that the decision was made in the best interests of their employees.

The key difference between this test and that outlined above is that there would be no benchmark against which employers could demonstrate that their employees were no worse off. It would therefore need to be a broader, more subjective demonstration that the best interests of their employees overall had been accounted for when the choice was made.

The Commission sees this as problematic, however, as it would exacerbate the administrative burden placed on all employers, and would require a level of information and expertise that many employers do not possess. Therefore, the variation to Option 1 is also ruled out by the Commission.

It is the Commission's view that under Option 2, there remains a risk that the process will not be, or will not be seen to be, sufficiently open and contestable, and that the outcomes may not be in the best interests of members. In particular, the Commission is concerned that Option 2 does not adequately deal with the principal–agent issues related to the industrial parties nominating funds on behalf of employees when the industrial parties have potential conflicts of interests in making

those decisions (even though those interests would need to be declared). It also requires FWA to consider matters (such as whether the industrial parties have adequately discharged their obligations, and the merits of any objections raised by interested parties) for which it does not currently have expertise. Therefore, Option 2 is not supported by the Commission.

This leaves Options 3 and 4. The key difference between these two options is that Option 3 keeps the decision with FWA and within the industrial process, whereas in Option 4, the decision rests with an independent body following the same process, but outside of the industrial process, and FWA has a minimal role in administering the decision.

With both of these options, some instability might be experienced due to funds currently listed no longer being found suitable and, therefore, removed. Both of these options also represent a greater overall regulatory burden than the current process. However, it is the Commission's view that the higher costs involved would be outweighed by the benefits from a more open and transparent process focused on the best interests of members.

At this stage the Commission considers that both of these options have merit in terms of reforming the default fund selection process and that they should be examined further. The Commission welcomes views from participants on which option would achieve the best interests of members.

DRAFT PRINCIPAL FINDING 8.1

The Commission has identified and assessed four options for reform to the process for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.

- *Option 1 involves all employers choosing from all funds that offer a MySuper product or other approved default product.*
- *Option 2 represents a minimal change, where the industrial parties assess all potential funds and nominate a subset to Fair Work Australia (FWA) for listing in awards.*
- *Option 3 represents a more significant change to the current industrial process, with decisions being made by an expert panel within FWA, and the selection process being opened up to allow all funds to present their case for inclusion in awards to FWA.*
- *Option 4 is similar to Option 3, but decisions would be made by an expert body independent of FWA, with FWA playing a minimal role in administering the decision.*

Option 1 does not, by itself, sufficiently protect the best interests of employees and would result in high search costs for employers. Option 2 does not sufficiently open up the process by which funds are listed in awards to greater contestability or ensure that, in perception as well as in reality, the best interests of members are taken into account. Therefore, Options 1 and 2 are ruled out by the Commission.

The Commission considers that Options 3 and 4 best adhere to the principles for an effective process for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. In particular, Options 3 and 4 are most aligned with the best interests of members while also addressing the needs of employers when they are choosing a default fund.

INFORMATION REQUEST

The Commission is seeking feedback from participants on the relative merits of Options 3 and 4.

One of the issues addressed by this inquiry is the process by which default funds are chosen for employees to whom the superannuation provisions in modern awards apply. The Commission considers that the factors for consideration outlined earlier could also be useful in the decision-making process for all default fund members. For example, the factors could provide useful guidance for employers where an award does not list default funds, and for parties who negotiate default fund arrangements under enterprise agreements.

9 Transition issues and future review

Key points

- This chapter examines the implementation and transition issues associated with the Commission's recommended reforms to the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.
- The Commission proposes that its reforms should be legislated in full by 2014, so that the new process, together with the consideration of factors relevant to the selection of funds, can be conducted in 2014, potentially in conjunction with the review of the modern awards that will take place that year.
- The reforms will affect stakeholders in different ways:
  - Default fund members will benefit from the increased competition in the default fund market. However, some members may need to change funds or may find themselves with multiple accounts.
  - Some employers will benefit from the improved administrative capabilities of the funds they deal with, and some will incur additional costs, as they will be required to change default funds or select a fund that is in their employees' best interests.
  - The addition and removal of funds from default listing will mean that the reforms will not affect all funds in the same way. However, all funds that wish to be listed as a default fund in awards (including those that are currently listed) will need to submit an application for inclusion.
  - The body that becomes the default fund decision maker will have a range of responsibilities and functions, and will need to be resourced appropriately.
- From a community-wide perspective, the reforms will have the considerable net benefit of improving outcomes for default fund members.
- When superannuation funds are listed in awards, fund names and details need to be used in a clear and consistent manner.
- Special considerations may apply in relation to exempt public sector superannuation schemes and non-public-offer funds for inclusion as default funds in modern awards.
- An independent public review should be conducted after the first eight-yearly wholesale reassessment of the default funds listed in awards, to ensure that the criteria for default fund selection remain useful and relevant and that the selection process is working as intended. Ideally, such a review would occur in 2023.

9.1 Timing

Participants' views

Inquiry participants suggested a number of timeframes for implementing changes to the process used in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. BT Financial Group (sub. 46) suggested that the introduction of the Commission's proposed reforms could coincide with the introduction of MySuper in 2013.

The Industry Super Network suggested that the funds currently named in awards should not be 'subject to consideration by Fair Work Australia until the next full award review process' (sub. 27, p. 39). This amounts to suggesting that the reforms should not be implemented before 2014.

Several others participants (including John McAuley, sub. 53; REI Super, sub. 26 and Tasplan, sub. 6) suggested that the implementation of the reforms should be delayed further — potentially by several more years. Similarly, Unions NSW said:

> There should be no change to the current default arrangements in awards until MySuper is fully bedded down and experienced. This in our view is 5 years. (sub. 13, p. 7)

The Commission's view

There are a range of potential timeframes for implementing either Option 3 or Option 4 as set out in chapter 8. For instance, the introduction of the reforms could occur in 2013 to coincide with either:

- the introduction of MySuper in July 2013
- the removal of funds that do not offer a MySuper product from awards, which must be undertaken by Fair Work Australia (FWA) by 31 October 2013.

However, in practice, the time required for the drafting and passage of relevant legislation would preclude such rapid implementation. If Option 4 were to be selected, additional time would also be required for the independent panel to be established and commence operations, although in the case of either Option 3 or Option 4, a panel would need to be selected and a competent secretariat established.

A more realistic timeframe would be to implement the necessary legislative and policy changes during 2013 and 2014, so that the new process for listing funds in awards can commence during 2014. This approach has considerable merit.

- It would allow sufficient time to implement the necessary legislative and procedural reforms

- It would minimise unnecessary delay.
- If Option 3 is chosen, it would potentially allow consideration of the superannuation provisions in awards to be undertaken in conjunction with FWA's review of modern awards scheduled to take place early that year, thereby minimising the overall cost of undertaking the award variations that will be required.

While delaying the reforms for several more years would have the benefit of allowing the industry to fully adapt to the MySuper reforms before starting additional reforms, it postpones realisation of the benefits of the reforms.

DRAFT RECOMMENDATION 9.1

The legislative and policy changes necessary to give effect to the Commission's recommended reforms should ideally be put in place in 2013 and 2014, so that the new process, together with the consideration of factors relevant to the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards, can be conducted during 2014, and potentially coincide with the review of modern awards.

A staggered approach?

Though the Commission is recommending that the review of the default superannuation funds listed in awards take place during 2014, there remains the possibility of staggering consideration of the funds listed in the 122 modern awards over several years. This could be done in a number of different ways.

- A subset of modern awards could be reviewed each year for four years. This could be similar to the award modernisation process, in which awards were grouped in 'tranches'.
- The reviews of two or three modern awards could start every month, so that every award is reviewed over the course of approximately four years.
- Modern awards in similar industries and sectors could be grouped, with the same funds listed in every award in the group.

Adopting an approach along these lines could:

- reduce the burden placed on superannuation funds that wish to make applications to be listed in multiple awards
- limit resourcing constraints and workload pressures on the decision maker.

The Commission does not intend, however, to establish how the decision maker — be it FWA or an independent panel — should structure the administrative aspects of selecting superannuation funds for inclusion as default funds in awards.

9.2 Consequences of the preferred reform options

As discussed in chapter 8, the Commission expects that overall benefits will flow from either of the preferred reform options. As is appropriate, the benefits will primarily be realised by members of default superannuation funds. A range of benefits will also accrue to the wider community, as well as to some employers and superannuation funds.

However, the Commission's proposed reforms will also impose some costs, and will affect all stakeholders in the superannuation industry — members, employers, funds and regulators. Regardless of the process option ultimately selected, many of the costs of reform will be borne by funds that are no longer selected for inclusion in awards, and by the members and employers who were using those funds.

In order to fully realise the potential benefits of the reforms, the costs of their implementation will need to be minimised to the greatest extent possible while still achieving the stated aims. One overarching consideration in this regard is the frequency with which the list of funds in awards is assessed, because the frequency of reassessment will be a major driver of the costs. This is why the Commission is recommending that the wholesale reassessment of which funds are listed in awards occurs as infrequently as is compatible with achieving better outcomes for default fund members — that is, every eight years (chapter 8).

Consequences for default fund members

Participants' views

ACCI described how employees might respond to a proposed change of fund.

> Some employees might decide to choose the former fund, perhaps because the employee has selected an investment option with that fund. Some employees might decide to exercise choice, and nominate a totally different fund, perhaps because they do not like the proposed new default. There is no particular time by which an employee must return a choice form. Under the current regime employees not choosing the former default fund would end up with an additional account, although the implications of this may be reduced under SuperStream. (sub. 37, pp. 5–6)

Mercer sounded a note of caution about multiple account holdings.

> As new contributions are paid to a different default fund, disengaged members will incur two sets of fees and potential doubling up of insurance cover and associated costs. (sub. 34, p. 7)

The Commission's view

As discussed in previous chapters, the reform options are designed primarily to benefit members of default superannuation funds. Options 3 and 4 both aim to ensure that employees who choose, or are placed into, a default fund listed in an award will have their best interests served by that choice or placement. As such, the reforms are likely to have benefits for the vast majority of default fund members.

Nevertheless, some employees are likely to have their contributions paid to different funds as a result of the Commission's reforms. The number of employees who change funds as a result of the reforms will depend on a range of factors including:

- the number of funds that do not retain their current listing in awards
- the rate of uptake by employers of the option to make default contributions to funds that are not listed in the award
- whether employees will exercise choice of fund in the face of a proposed fund change, in favour of their current fund or another fund.

Though changing funds is not costless for default fund members, this cost is likely to be more than offset by the benefits of being in a fund that is better suited to their needs.

Changing funds is only likely to be disadvantageous to some default fund members if it leads to multiple account holdings and members do not consolidate their accounts (which they are able to do at any time). The potential for multiple account holdings to persist will be partially mitigated by the introduction of account auto-consolidation as part of the Stronger Super reforms.

Another potential effect is that, to the extent that a fund that is no longer listed in awards experiences a decline in investment returns (see below), this decline is likely to flow through to the returns of remaining fund members.

Consequences for employers

Participants' views

A number of inquiry participants commented on the potential consequences of reforms to the default system for employers, particularly if the reforms required them to change default funds. REST Industry Super said that:

> … there is no question that changes to the nominated default superannuation fund would cause some inconvenience, be it the need for system configuration, the use of disclosure material to employees and associated material to all recruitment locations, as well as the need to liaise with additional parties for contribution reconciliations and insurance claims. (sub. 47, p. 10)

ACCI commented:

> When an employer changes the fund into which default fund contributions are being made the employer must give the affected employees (employees who have not chosen a fund whose contributions are being paid into the former default fund) a new standard choice form which identifies the new default fund. The employer may have to enter into a standard employer sponsorship with the new default [fund] unless there is already such an arrangement in place. The employer will have to enrol all affected employees except those who return a properly completed standard [choice] form before that happens. (sub. 37, p. 5)

The Association of Superannuation Funds of Australia (ASFA) suggested that if employers are not required to change from their existing default fund, they may be unlikely to do so.

> Incumbency is also very important for determining which fund or funds are being used as a default. Changes to default funds listed in an award (in terms of any additional fund or funds being listed) are unlikely to lead to many employers reconsidering the default fund they use. (sub. 31, p. 6)

ASFA also noted that, at present, there is no obligation on employers to compare superannuation funds or to select a default fund that is suited to the needs of their employees.

> There is no recorded legal case where an employer has been held liable for making a 'bad' choice of default fund for its employees. (sub. 31, p. 6)

The Commission's view

For those employers who are affected by the reforms, there will be ongoing benefits for some, and additional costs for others, albeit generally of a transitional nature.

One of the factors for consideration in the selection and ongoing assessment of funds is their administrative capabilities. It is also a consideration for employers should they choose a fund which is not listed in an award. The Commission anticipates that the greater competition between funds will improve this aspect of their operation (amongst others), to the benefit of all employers. In addition, there will be direct benefits to employers who are newly able to engage with funds that have better administrative capabilities.

Some employers will be affected by the Commission's proposed reforms if they were making contributions to a fund that was, but is no longer, listed as a default fund in the relevant award. Under either of the proposed reform options, these employers must either:

- change to one of the default funds listed in the award, or
- investigate other possible default funds and select one that is in the best interests of their employees. This may or may not be the employer's existing default fund.

Both of these actions entail costs for the employer.

Changing funds

The number of employers who change funds as a result of the reforms will depend on a range of factors that mirror those affecting employees, namely:

- the number of funds that do not retain their current listing in awards
- the rate of uptake by employers of the option to make default contributions to funds that are not listed in the award
- whether employees will exercise choice of fund in the face of a proposed fund change, in favour of their current fund or another fund.

As participants highlighted, changing default superannuation funds would involve a range of (largely transitional) administrative costs. Given the eight years between wholesale reassessments, these transitional costs would occur infrequently for the vast majority of employers, if at all. However, and while in no way offsetting each other, the costs and inconvenience incurred by employers is likely to be small compared to the ongoing benefits that will accrue to an employee who is moved to a superannuation fund that delivers higher net returns. In other cases, changing funds could bring ongoing benefits to employers, if it means that they are able to select a default fund that has better administrative systems or is more efficient in responding to their needs. From a communitywide perspective, the reforms are therefore worthwhile.

The Commission is mindful of the fact that employers will need to be given a reasonable period of time to make changes for their employees once a new list of default funds is determined in any award.

Choosing a fund that is not listed in the award

Under either Option 3 or Option 4, employers that choose a default fund that is not listed in the relevant award will need to be able to demonstrate that their employees will be made no worse off than if a listed fund had been chosen. Doing so will entail search costs, as employers will need to research available funds, compare them and decide on a preferred fund. It will also mean that additional responsibility is being accepted by employers who choose this option, as they will now be responsible for ensuring that the fund they choose is at least as good as default funds listed in awards, for their employees.

In some cases, employers who choose a default fund other than those listed in the award will also need to change from their current fund, with all of the transition costs that that entails. In other cases, they will be able to remain with their existing fund. In particular, this means that, provided their employees are no worse off than had they been members of a default fund listed in an award, employers who currently make default contributions to a corporate fund — either a grandfathered fund or one listed in the award — will continue to be able to do so.

Consequences for superannuation funds

Participants' views

Several inquiry participants canvassed the potential consequences for superannuation funds of any reforms that led to different funds being listed in awards. REST Industry Super said that:

> If a fund loses membership through the opening up of default fund status in modern awards, this could impact on its ability to continue to offer the benefits of scale to its members … Loss of [funds under management] results in higher cash outflows and increases the need for liquidity in the fund's default investment option. This could limit the ability of a fund to invest in less liquid assets such as infrastructure projects which typically are expected to provide higher returns than other assets classes but are illiquid and require significant capital investment … The removal of infrastructure based on the assumptions outlined above results in reduced gross returns. (sub. 47, pp. 11–13)

Mercer similarly submitted that:

> … a decision to remove a fund from the list of default funds in an award can have major implications for that fund … For example, severe liquidity issues are likely to follow as contribution inflow would be significantly reduced and some members are likely to want to transfer their accrued benefits to their new default fund. (sub. 34, p. 6)

The Commission's view

Funds that are no longer listed in an award

As noted above, many of the costs of reform will be borne by funds that are no longer listed in awards. In particular, these funds may experience a reduction in membership and funds under management. They may also have less certainty about future income, and need to adjust their investment portfolios in response. They will also lose any reputational benefits that being listed in an award may bring.

However, the only funds that will experience these reduced returns are those that do not meet the requirements of the new process — that is, funds that have been judged as delivering outcomes that are less suited to default fund members covered by a given award than those offered by other funds. As such, the Commission considers that these funds were advantaged by having previously been listed as default funds in awards, rather than disadvantaged by no longer being listed. Moreover, given the dynamic nature of the superannuation industry, the funds that are no longer listed can work to become listed again by better addressing the factors for consideration used to select default funds. Funds also have the option of directly approaching employers and employees to obtain default status at the enterprise level, or to become the fund of choice for individual employees.

Other consequences for funds

Some funds will also be affected because they will face greater competition in the default market. This will particularly affect the funds that are included in the 54 modern awards that currently list between one and four default funds but will, in future, list between five and ten funds.

In addition, any fund that wishes to be listed as a default fund in an award will bear the costs of participating in the application and selection process. At a minimum, this will require funds to articulate their claims for selection against the factors for consideration recommended by the Commission. Funds that are not successful in obtaining inclusion will bear this cost for no return.

Consequences for affected government agencies

Additional functions

Reform Options 3 and 4 propose, respectively, that FWA or a new independent panel become the default fund decision maker and take on additional roles in the default fund selection process. Under either option, the affected body (with the support of a secretariat) would need to perform a range of new functions. These include:

- calling for applications from superannuation funds that wish to be included as default funds in awards, and for information on the needs and best interests of potential default fund members
- considering the information provided by superannuation funds, industrial parties and other interested stakeholders
- exercising judgement about how the applicant funds compare against each of the factors for consideration recommended by the Commission (and potentially other factors) for each award or group of awards
- selecting between five and ten funds for inclusion in each award or group of awards
- publishing draft and final decisions and other relevant information
- maintaining an awareness of the performance and governance of listed funds through an ongoing assessment process and a light-handed interim assessment mid-way between the eight yearly wholesale reassessments
- conducting a wholesale reassessment of the list of funds every eight years
- undertaking associated administrative tasks.

In addition, the Australian Prudential Regulation Authority (APRA) will need to be involved in some way, by providing information and advice to FWA or the independent panel. As mentioned in chapter 8, APRA could also be more closely involved, by hosting the secretariat functions for the independent panel.

Resourcing the additional functions

Regardless of the reform option that is ultimately adopted, the relevant agency will require additional resourcing to undertake its expanded role. The resourcing will need to be sufficient for it to obtain the necessary expertise to conduct all of the new functions in a professional and rigorous manner.

Resourcing will also need to be sufficient to enable the agency to obtain relevant data in a timely manner. This may be particularly important with regard to obtaining data on employees to whom the superannuation provision in a modern award applies.

The exact level of resourcing needed to accomplish this will depend on which agency is selected and its existing resourcing and expertise. The Commission will seek advice on the costing of the options, for inclusion in the final report.

Consequences for other stakeholders

Other stakeholders will also be affected by either of the Commission's preferred reform options.

- The involvement of industrial parties in the default fund selection process will be more structured than has previously been the case. In particular, they will now have the option of preparing submissions to the default fund decision maker and addressing the factors for consideration.
- Insurance companies may be called on by superannuation funds to assist them in preparing applications for inclusion as default funds in awards.

9.3 Other considerations in implementation

Public reporting

A recurring theme of this report is that, for the best interests of default fund members to be fully realised, an open and transparent process is needed to assess which funds should be included as default funds in modern awards. This openness and transparency must extend to all aspects of the decision-making process.

Participants' views

Suncorp was the only inquiry participant that made detailed suggestions about openness and transparency.

> Suncorp suggests that FWA should be required to publish an annual report into the default superannuation in modern awards system. Key statistics that should be included in the report are the:
>
> - number of applications received
> - number of applications approved or denied

- reasons for denial
- average time taken to assess applications
- longest time taken to assess an application
- estimated number of employees working under awards that had applications denied
- estimated annual dollar value of superannuation contributions made under awards that had applications denied
- number of awards reviewed and not reviewed for default superannuation fund purposes.

In all cases these statistics should be provided both in total and broken down by fund type. (sub. 38, p. 6)

The Commission's view

Suncorp's suggestions appear to have merit, though the capacity for reporting to occur on an annual basis will depend on the choices made by the default fund decision maker about the conduct of the process. Unless some form of staggered or rolling assessment is adopted, four-yearly reporting may be more appropriate.

The Commission does not intend, however, to specify in detail exactly how the decision maker — be it FWA or an independent panel — should report on the process it uses to select superannuation funds for inclusion as default funds in awards. It is already FWA's practice to publish a statement of its decisions, and an independent panel would be expected to adopt a similar practice. In terms of publishing information about the process used to select default funds, the most useful information to report and the most appropriate reporting formats will depend on a range of factors that are best assessed by those with day-to-day involvement in the process.

Clearly identifying funds in awards

There is currently considerable variation in the way in which default superannuation funds are listed in modern awards. For example, Asset Super is listed in different awards as either Asset Super, Asset Limited or the Australian Superannuation Savings Employment Trust. In addition, some funds named in awards no longer appear to be operating.

> Although the 122 awards name 103 funds the number of active funds has been reduced to approximately 86, with 6 funds wound up; 7 funds merged and the status of 4 funds is unknown but not active. A number of funds do not exist as named in awards. (Industry Super Network, sub. 27, p. 36)

The variation in fund names and the presence of non-operational funds in awards can make it hard for employers to be sure that they have correctly identified exactly which funds they are required to make default contributions to.

The Commission's reforms provide an opportunity to rationalise the naming of funds. Each fund is known by one name to APRA, and has numerical identifiers such as an Australian Business Number (ABN) and a Registrable Superannuation Entity (RSE) licence number. These identifiers are available for use in modern awards.

DRAFT RECOMMENDATION 9.2

The superannuation fund names and identifying numbers used by the Australian Prudential Regulation Authority should be used by Fair Work Australia to list superannuation funds in modern awards.

Funds and products that may require special consideration

Though most default superannuation products will be APRA-regulated MySuper products, there will be certain exceptions. This could affect the way in which the funds that offer these products are considered for inclusion as default funds in awards.

Exempt public sector superannuation schemes

Exempt public sector superannuation schemes (EPSSSs) will not be able to offer MySuper products, but will nevertheless be eligible for selection as a default fund in a modern award. Some of the recommended factors for consideration could have a different degree of importance in relation to EPSSSs. Comparing EPSSSs with funds that offer MySuper products on an equal basis may also pose challenges, as EPSSSs are not bound by the same regulatory framework and may collect and report different information to other funds.

Non-public-offer funds

Funds that are not public offer will be eligible to offer MySuper products. However, it is possible that these funds will not be open to all of the employees covered by a given award. The potential for this to occur may need to be factored into the default fund selection process. In particular, it will be important that every modern award contains a large enough list of public offer funds to provide every employer with a reasonable number of funds to choose from.

INFORMATION REQUEST

The Commission seeks further information on the way in which default products offered by exempt public sector superannuation schemes and non-public offer funds should be treated as part of its proposed reforms.

9.4 Review of the new process for selecting default funds, including the factors for consideration

The Commission's proposed options for reform offer the prospect of gains to default fund members and to the community more generally. Nonetheless, as discussed in preceding chapters, changes ensuing from other reform initiatives (particularly the introduction of MySuper) will have implications for default funds and their members. These implications cannot be fully known in advance. And there is inevitably some degree of uncertainty about precisely how either of the Commission's proposed options would play out in practice.

Against this backdrop, and in keeping with a best-practice policy-making process, the Commission considers that provision should be made for an independent public review of the impact of the proposed new arrangements for selecting superannuation funds for inclusion as default funds in modern awards.

Timetable for the review

In chapter 8, the Commission recommends that the list of default superannuation funds in awards be the subject of a wholesale reassessment every eight years, with a light-handed interim assessment mid-way between each reassessment. The initial selection process is scheduled to commence in 2014, which suggests that an interim assessment would occur in 2018 and a wholesale reassessment in 2022. When it comes to examining the effectiveness of the default fund selection process and criteria, it is therefore logical to consider whether a review of the reforms should take place before or after 2022.

Reviewing the process and factors for consideration before 2022 would appear to be premature, as the wholesale assessment process would only have operated once (in 2014). There would not be a chance to correct any teething problems experienced in 2014, which could otherwise have been corrected in 2022. The Commission therefore considers that reviewing the process and factors for consideration after they have operated in both 2014 and 2022 would be appropriate. Ideally, the review would be conducted in 2023.

Who should undertake the review?

Rather than specify who should conduct a review that is recommended to occur in over a decade's time, it is more appropriate to specify the characteristics of the reviewer.

The Commission therefore considers the review should be undertaken by a body that:

- is independent of industrial parties and superannuation funds
- has relevant skills and expertise
- has the capacity to provide a transparent public review.

DRAFT RECOMMENDATION 9.3

An independent public review of the arrangements for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should be conducted in 2023. Amongst other things, the review should examine whether:

- ***the factors considered in selecting funds for listing in awards remain useful and relevant***
- ***the selection process is working to deliver outcomes that are in the best interests of default fund members***
- ***there is an ongoing need to list default funds in awards.***

A Public consultation

The Commission has actively encouraged public participation in this inquiry.

- Following receipt of the terms of reference on 6 February 2012, it advertised the inquiry in major metropolitan newspapers and sent a circular to likely interested parties.
- In late February 2012, it released an issues paper to assist those wishing to make written submissions. Some 54 written submissions were subsequently received (table A.1). These submissions are available online at: www.pc.gov.au/projects/inquiry/default-super

The Commission thanks all those who have contributed to this inquiry and now seeks additional input. It welcomes further submissions to discuss the draft report. The Commission also invites participation in public hearings to be held on 30 July 2012 in Melbourne and 31 July 2012 in Sydney.

Table A.1 **Submissions received**[a]

Participant	*Submission number*
Accommodation Association of Australia	28
Actuaries Institute	45
AMP	52
ANZ Wealth	48
Asset Super	32
Association of Financial Advisors	50
Association of Superannuation Funds of Australia (ASFA)	31
Australian Chamber of Commerce and Industry (ACCI)	37
Australian Council of Trade Unions (ACTU)	29
Australian Hotels Association	10
Australian Industry Group (Ai Group)	25
Australian Institute of Superannuation Trustees (AIST)	20
Australian Manufacturing Workers' Union (AMWU)	49
AustralianSuper	36
BT Financial Group	46
Burke, Michael	3
Cbus	15
Centre for the Study of Choice, University of Technology Sydney (UTS)	22
Clubs Victoria	5
Colonial First State	42
Corporate Super Association	14
Corporate Superannuation Specialist Alliance# (CSSA)	35
Council of Small Business Organisations of Australia (COSBOA)	7
CPA Australia	39
DFA Australia	21
Doyle, Peter	2
Electrical Contractors Association	17
Employment Law Committee of the Law Society of NSW	11
eo Financial Services	12
Financial Services Council# (FSC)	30
HOSTPLUS	8
Industry Funds Forum (IFF)	51
Industry Super Network (ISN)	27
Infrastructure Partnerships Australia#	9
Johnston, Adam	54
Law Council of Australia	23
legalsuper	19
Mahon, Vincent	1
Master Builders Australia	41
Master Plumbers and Mechanical Services Association of Australia (Master Plumbers)	33
McAuley, John	53
Mercer	34
MLC Ltd–NAB Wealth	44
National Tourism Alliance	4
NGS Super	18

(Continued next page)

Table A.1 (continued)

Participant	*Submission number*
REI Super	26
Restaurant and Catering	43
REST Industry Super	47
Shop Distributive and Allied Employees Association (SDA)	24
State Public Services Federation Group of the CPSU#	16
Suncorp	38
Tasplan	6
Transport Industry Super Fund	40
Unions NSW	13

a # indicates that the submission includes attachments.

Table A.2 **Meetings**

Participant
Australian Capital Territory
Australian Industry Group (Ai Group)
Council of Small Business Organisations of Australia (COSBOA)
Department of Education, Employment and Workplace Relations (DEEWR)
The Australia Institute
The Treasury
Victoria
Australian Institute of Superannuation Trustees (AIST)
Australian Chamber of Commerce and Industry (ACCI)
Australian Council of Trade Unions (ACTU)
Corporate Super Association
Fair Work Australia
Mercer
Industry Super Network (ISN)
Rice Warner Actuaries
Deloitte Access Economics
New South Wales
Association of Superannuation Funds of Australia (ASFA)
Jeremy Cooper
Industry Funds Forum (IFF)
Australian Prudential Regulation Authority (APRA)
Financial Services Council (FSC)
AMP
SuperChoice
Susan Thorp and Steve Satchell, University of Technology Sydney (UTS)

B International experience

This appendix examines default arrangements within pension systems in other countries that may be compared to default arrangements in Australia's superannuation system. The four countries examined are:

- New Zealand — for its selection process determining default KiwiSaver providers
- Sweden — for the national default fund which all members are allocated to when they do not exercise a choice of fund
- Chile — for the high administration costs imposed on individuals as a result of extensive marketing expenditure by funds, and the recent reforms that have led to a single default fund
- the Netherlands — for its industrial relation system which determines pension funds for workplaces and industries.

New Zealand

In 2007, New Zealand introduced KiwiSaver, an automatic-enrolment, voluntary savings system administered by Inland Revenue. Employees are automatically enrolled in the system and can contribute a minimum of two per cent, and a maximum of eight per cent, of their gross wage to the system. Individuals can opt out of KiwiSaver if they wish, and can opt back in at any time. There are several incentives to join and contribute to KiwiSaver schemes, including Government contributions, fee subsidies, employer contributions and tax incentives. In general, contributions to KiwiSaver products (schemes) are preserved until members reach superannuation age (65). However, members may make a one-off withdrawal when buying their first home (Commission for Financial Literacy and Retirement Income nd).

As in the Australian system, all individuals in New Zealand are free to choose their own KiwiSaver scheme. Where an employee has not made a choice, they are automatically enrolled in their employer's chosen scheme (if the employer has made such a choice) or in one of six default schemes. According to section 50 of the *KiwiSaver Act 2006* (NZ), default members are allocated on a 'sequential' basis

between the appointed default schemes. The default providers were determined by the New Zealand Government prior to the commencement of KiwiSaver, and a retendering process is expected to take place in 2014.

Default provider selection process

The Ministry of Economic Development conducted an 'open, competitive tender process' (Inland Revenue 2011a) in 2006 to appoint default providers. In making their decisions, Ministers were assisted by advice from independent external experts who carried out detailed evaluations of the applicants.

Criteria used to select default providers included:

- security and organisational credibility
- organisational capability
- proposed design of the provider's Default KiwiSaver Scheme
- administration capability
- competitive fee levels
- investment capacity/capability (Cullen 2006; 2007).

Littlewood (2012) made several criticisms of the 2006 process for selecting default providers, arguing for changes to be made to the process when the default providers are reviewed in 2014. Criticisms included that the 2006 process:

- was not transparent, with:
  - poor disclosure of the Government's reasons for decisions
  - decisions seemingly made on a 'least risk to Government' basis, rather than in the best interests of members
- provided a competitive advantage to default providers without any compensation, through:
  - the automatic enrolment of default members
  - the reputational effect of being endorsed by Government, which attracts additional members
- appointed too many default providers, given the small size of the New Zealand market.

Default KiwiSaver providers

The New Zealand Government appointed six default providers:

- ASB Group Investments Limited.
- AMP Services (NZ) Limited.
- ING (NZ) Limited.
- Mercer Human Resource Consulting Limited.
- National Mutual Corporate Superannuation Services Limited (trading as AXA New Zealand).
- TOWER Employee Benefits Limited (Cullen 2007).

Each of the default providers have aspects of their products set by Default Provider Notices. These notices took effect from the time the providers were appointed, and are valid until 30 June 2014.

The Notices specify:

- that between 15 and 25 per cent of member assets are invested in growth assets
- that default providers must ensure that non-default investment products are available to members of the default KiwiSaver scheme
- fee types and amounts that may be charged to members
- reporting requirements for default providers.

The set of default KiwiSaver schemes applies consistently to all individuals in New Zealand. This contrasts with Australia, where default superannuation products are determined by award through the industrial relations process, or by workplace through the enterprise bargaining process. No suggestions have been made in commentary of the KiwiSaver system that different default schemes should apply to different individuals.

However, one notable difference between the two systems is the absence of bundling of other components with KiwiSaver schemes — that may optimally vary by industry — such as insurance.

Some features of default KiwiSaver products have set benchmarks for the rest of the industry to follow. For example, the requirement for default products to have low fees is thought to have encouraged price competition amongst all providers (Ministry of Economic Development 2010). This indicates that mandated features of default products can play a role in shaping competition in the industry more broadly.

The decision to impose a conservative investment strategy on default schemes has been a point of debate in New Zealand. Although conservative strategies have meant members of default KiwiSaver schemes fared relatively well during the recent economic downturn, they may not be in the long-term best interests of members. Over a long time horizon, growth strategies will outperform conservative strategies (Basu and Drew 2009). However, the investment time horizon of some KiwiSaver members may be quite short as they can withdraw the balance of their account to purchase a home.

Role of stakeholders

The New Zealand Government, Inland Revenue, KiwiSaver providers and employers all play a role in administering the KiwiSaver system for employees and other members.

Apart from the Government providing concessions and appointing default providers, Inland Revenue handles much of the administration supporting KiwiSaver. All employee and employer contributions are received by Inland Revenue, and then forwarded on to the relevant KiwiSaver provider. Organisations seeking to register a KiwiSaver product must seek certification from Inland Revenue. To become certified, organisations must meet specific criteria. (Inland Revenue 2011a)

KiwiSaver providers must complete a scheme provider agreement, which defines the relationship between the provider and Inland Revenue. The agreement details both operational and technical requirements. Providers must produce an annual report including audited accounts and membership details, and lodge an annual statistical return with the Financial Markets Authority (Inland Revenue 2011b). Providers must also send and receive information in a secure and timely manner, using automated processes and a single standard for B2B communications with all scheme providers. Providers must ensure that they are integrated with the central KiwiSaver B2B gateway. (Inland Revenue 2007)

Employers are generally required to act as an intermediary between employees and Inland Revenue. They must:

- provide a KiwiSaver information pack to employees who are to be automatically enrolled, and those who choose to opt in
- where the employer has chosen a KiwiSaver scheme, provide employees with information about that scheme

- make compulsory employer contributions of two per cent of the employee's earnings to Inland Revenue, in addition to the contributions deducted from the employee's earnings
- provide information to Inland Revenue about employees enrolled in a scheme (Inland Revenue 2009).

Employees can choose a scheme other than their employer's chosen provider or the default provider they have been allocated to. They may also choose between the contribution rates of two, four or eight per cent of their pre-tax earnings. If they do not wish to be enrolled in a scheme, employees can opt out between two and eight weeks of starting their job (Inland Revenue nd).

Sweden

Sweden has a three-pillar pension system, with a second pillar known as premium pension, which is similar to Australia's compulsory system. The premium pension system is centrally administered by the Swedish Pensions Agency (SPA), which also has responsibilities for other types of pensions. The SPA is funded by an annual fee imposed on each individual pension account of 0.3 per cent of assets.

On behalf of each employee, employers contribute 2.5 per cent of wages to the employee's premium pension account. The contributions are paid together with the employer's monthly tax obligations to the National Tax Authority, which then forwards the premium pension contributions to the SPA.

The SPA acts as a clearing house, forwarding contributions to pension funds chosen by each individual. The pension funds then invest the contributions. The SPA also keeps account records for members of all funds, functioning as a single access point for all individuals seeking information about their accounts. Benefit payments are also administered by the SPA.

To facilitate choice of pension funds for individuals, the SPA maintains a catalogue of premium pension funds. The catalogue lists all funds with a brief description of each, its total capital, fees, returns over the last five years, and a measure of risk. The catalogue is freely available to the public and funds are not charged a fee to appear in the catalogue. When it was first introduced in 2000, the catalogue listed 456 funds. It now includes more than 800 funds. Working-age adults are asked to choose a fund from the catalogue. If no choice is made, the individual's contributions are allocated to a single national default fund (Stewart 2005; Weaver 2005).

The national default fund

Initially, two thirds of individuals chose a fund other than the national default fund, although the default fund attracted more members than any single alternative fund. Women and younger people were more likely to make an active choice. Since the inception of the system, the proportion of individuals choosing a fund other than the default has fallen significantly. As a result, membership in the default fund as a proportion of total members in the system has risen from 33 per cent in 2000, to 42 per cent in 2010 (Cronqvist and Thaler 2004; Johannisson 2010).

The fund has followed a strategy of minimising costs in order to reduce fees for members. It has achieved this through comparatively small marketing and investment expenditures — the majority of the fund's assets are invested passively. The fund has also targeted a high level of growth. Until 2010, between 70 and 90 per cent of assets were invested in equities, with the majority in foreign equities (Weaver 2005). In 2010, the fund has shifted to a lifecycle investment strategy. Now 100 per cent of member assets are invested in equities until members reach 55, then a gradually increasing proportion is shifted to fixed income investments as members age (Johannisson 2010; Palmer nd).

Low costs

The Swedish system demonstrates the benefits that can be achieved by a single national default fund with small marketing and investment expenditures. Rather than having default members allocated across various funds, concentrating them in a single fund achieves scale benefits, spreading fixed costs more thinly across the membership of the fund. The default fund engages in limited marketing activities as its purpose is simply to receive and invest the contributions of individuals who make no choice of fund. Also, the passive investment strategy employed by the fund results in minimal trading costs and fees to investment analysts.

Total fees charged to members of the Swedish default fund amounted to 0.60 per cent of assets in 2005, and this is projected to decline to less than 0.30 per cent by 2025 (Impavido, Lasagabaster and García-Huitrón 2010). This is considerably lower than fees observed in most other pension systems around the world, including the Australian system (Tapia and Yermo 2008).

The use of a passive investment strategy has not diminished returns for members. The investment performance of the default fund has exceeded that of the median pension fund in Sweden (Stewart 2005).

In addition to the Swedish premium pension system achieving low costs for members, costs experienced by employers and funds are also reduced through

centralised administration. The single payment that employers make once a month covers all their employees, and is combined with their tax payment to reduce administrative costs. As payments for all employers are made to a single organisation, it standardises and simplifies employer obligations.

State management

One common concern around state-run funds is the degree to which investment decisions are politically motivated. This does not appear to have occurred with the Swedish default fund (Turner 2006), but the default fund has — to a greater extent than private funds — made investment choices based on social and environmental issues. It has disinvested in companies found guilty of violating international conventions to which Sweden adheres, including conventions on human rights, labour, the environment, bribery and corruption. In 2004, 38 companies were on the default fund's investment exclusion list, including some large multinational companies. This raises the question of whether the investment returns of participants in a national fund should be diminished in order to pursue social goals. (Turner 2006; Weaver 2005)

Marketing issues

The Swedish Government effectively discouraged membership in the default fund. When the system was implemented, the Government commenced an extensive advertising campaign directing individuals to make a choice of fund. The only way individuals could gain membership in the default fund was by not making an active choice, and they were prevented from rejoining the fund if they subsequently made an alternative choice. In addition, free advertising was provided for alternative funds in the form of the catalogue produced by the SPA.

Advertising strategies used by alternative funds, coupled with the Government's discouragement of the use of the default fund, led individuals to make poor choices. Initial advertising by alternative funds focused on their past performance and level of local investment. As a result, the fund to attract the largest share of members (other than the default) was Robur Aktiefond Contura, which had increased in value by 534 per cent over the preceding five years. However, the fund lost 70 per cent of its value over the next three years, and was significantly outperformed by the default fund (Cronqvist and Thaler 2004).

Chile

Chile was one of the first countries to implement a three-pillar pension system as recommended by the World Bank. Pension reform in 1981 introduced mandatory individual accounts. Since its introduction, the system has undergone various changes.

Chilean workers contribute 10 per cent of their earnings, plus a fee for administration and insurance of approximately 2.3 per cent of their earnings, to an authorised pension fund (*Administradoras de Fondos de Pensiones* — AFP) (Iglesias-Palau 2009). The contribution is administered by employers on behalf of their employees. Before 2010, it was the responsibility of employees to choose both an AFP and the investment option within that AFP, but this has since changed (see below).

There are currently six AFPs. The entrance of new AFPs is restricted, and subject to government approval (Business News Americas 2007).

The types of investment options each AFP may offer are defined by legislation. Each fund must offer four options — B through E — and has the option of offering a fifth option — A. Funds are not permitted to offer any other investment options. Each investment option is restricted in the amount of each asset class they may invest in. Option A is a high growth option, with funds permitted to allocate as much as 80 per cent of member assets to equities. The level of risk and growth assets declines through the investment options to option E, which may only invest in cash and fixed interest. Individuals who do not choose an investment option default into option B, C or D depending on their age (Ferreiro Yazigi 2003).

Administrative fees for members were high in the 1980s and 1990s as a result of large marketing expenditures by AFPs. It was common practice for AFPs to recruit large sales forces that were paid commissions for attracting new members to the fund. Incentives such as small appliances were frequently offered to potential members (Turner 2006). Between 1982 and 1998, average marketing costs for AFPs ranged between 21 and 52 per cent of total expenses (James et al. 2000).

The marketing costs in the system have subsided over time as a result of three factors. First, the Government imposed restrictions on the frequency with which individuals could switch between funds, and regulated the use of sales agents. Second, consolidation within the industry has reduced the competitive forces that drove marketing expenditure (Holzman and Hinz 2005). Third, the introduction of an auction process focusing on fees to determine the default provider has helped to create price-based competition (Social Security Administration 2012).

In 2010, the requirement for employees to make a choice of AFP was removed. Instead, all employees commencing work with an employer are automatically allocated to a single default AFP. Employees may still make an alternative choice if they wish. The default AFP is determined every two years by an auction process where the AFP that offers the lowest administrative fee is authorised as the default fund for the next two years. The fund maintains its position as the default provider during those two years unless:

- another fund offers a lower fee for at least two consecutive months
- another AFP provides a higher rate of return sufficient to make up for a higher administrative fee
- it violates AFP regulations (Social Security Administration 2012).

Netherlands

It is not mandatory in the Netherlands for all employees to maintain individual pension accounts. However, industrial relations processes have led to a requirement for most employers to contribute to individual pension accounts for their employees. Where employer and employee representatives in a particular industry agree on pension arrangements for employees in that industry, the Government will usually make such arrangements mandatory for all workplaces in the industry. Where such industry-wide arrangements are not present, many employers voluntarily contribute to individual pension accounts on behalf of employees. As a result, 90 per cent of employees in the Netherlands are covered by such arrangements (VB and OPF 2012).

Most pension funds in the Netherlands serve only one industry or workplace and it is typical that only one fund will cover the workforce of any particular industry. There are 95 industry-wide funds and 543 single-employer funds. Most employees are members of industry-wide funds (Kakes 2006).

Almost all funds in the Netherlands are defined benefit funds, with pension benefits determined by the average wage of the employee over their working life. Most have some unique features not commonly found in defined benefit systems in other parts of the world. For example, where funds are in financial difficulty, employers, employees and members in retirement may be required to contribute to the fund's recovery (VB and OPF 2012).

The governance and operation of Dutch pension funds are highly regulated. Funds are required to:

- be run on a not-for-profit basis

- have a board of trustees made up of employer and employee representatives, in equal proportions
- serve the interests of all stakeholders, including members and employers
- not differ the contribution rate between members
- not require medical examinations for members joining the fund (VB and OPF 2012).

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