PRODUCTIVITY COMMISSION
ISSUES PAPER

Assessing the Competitiveness and Efficiency of the Superannuation System

ISA SUBMISSION

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ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia (ISA) is an umbrella organisation for the industry super movement. ISA manages collective projects on behalf of a number of Industry SuperFunds with the objective of maximising the retirement savings of five million industry super members. Please direct questions and comments to:

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KEY POINTS

1. There are a number of methodological challenges with the approach that the Commission is proposing to take in its Issues Paper to assessing the efficiency of the superannuation system that, if unaddressed, could result in conclusions that lack rigour. These problems include the following:

    - The Commission's approach retains a persistent preoccupation with promoting competition as a key means of increasing the efficiency of the superannuation system. This is despite ample evidence previously supplied to the Commission that competition does not improve outcomes for members, but has instead been used to sell a growing number of members into poor performing products at the expense of their future retirement incomes.
    - Despite being directed by the Terms of Reference to include evaluation of choice products and self-managed funds in its Inquiry, the Issues Paper largely ignores these segments in favour of a disproportionate fixation with the default system. This focus is a distraction from key sources of inefficiency in the superannuation system: the relative underperformance of the choice and self-managed segments.
    - There appear to be several important gaps in the data that the Commission is proposing to collect. For example, there appears to be no intent to collect data on the sources, quantum and distribution of profits made by retail funds, and the consequential impact on members and system efficiency.
    - Some of the Commission's proposed indicators seem to lack relevance to the related assessment criteria. For example, the Commission appears to regard the extent of member-switching between products as an indicator of members exerting competitive pressure on funds, when in fact high levels of switching are more likely to be evidence of retail funds selling members into new products in order to generate additional fee revenue.
    - The Commission is asking funds and CEOs to self-report evidence on topics such as default system contestability and governance, without making clear the evidentiary standards it will apply to the information provided to ensure that only evidence that is tested, accurate and representative, will be used to inform the Commission's conclusions.
    - The Commission will publish its draft and final reports in early and mid-2018 before APRA has published its data on the first year of full MySuper implementation (the financial year 2017-18). This runs counter to the view of the Financial System Inquiry that further reform should await the full implementation and proper evaluation of MySuper.
    - The Commission is proposing to reach conclusions about the efficiency of existing default arrangements despite the fact that existing arrangements have been effectively suspended since 2014.
    - It is not clear if the evidence-base generated by the Commission will be made available to the public (after being suitably anonymised) for the purposes of independent analysis and scrutiny. It is vital that evidence that may be used to justify significant system-wide change, and which may place the future value of retirement incomes at risk, is available for examination.

KEY POINTS (continued)

2. A key regulatory impediment to increasing the efficiency of the superannuation system is the ease with which members can be allocated or sold-into poor quality choice and SMSF products. This can be remedied in part by allowing the revised award default selection process under the jurisdiction of the Fair Work Commission (FWC), so ensuring that only the best performing and industrially-relevant funds are named in awards. In addition product providers could be prohibited from soliciting members unless they can reasonably demonstrate that such members would be better-off in terms of net retirement income if they left their existing default fund.
3. In relation to 'contestability' in the default system, the case has not been made that existing default rules constitute an unreasonable barrier to entry to good quality funds. Unfortunately, because necessary appointments to the Expert Panel have not been made the revised system has not been operative since 2014. The Commission should therefore test any claims that the default system constitutes an unreasonable barrier by seeking evidence from the FWC on the record of retail fund award applications.
4. The Commission should take a 'cohort approach' to developing benchmarks for assessing the potential for realising scale economies and the efficiency of returns at the level of the system and individual asset classes. Using cohorts of actual funds would generate an empirically-grounded evidence base of real-world achievement that the system could be meaningfully assessed against. The Commission's preferred methods of using econometric modelling and constructing ideal portfolios is an excessively abstract approach that risks generating results of limited practical significance.
5. In contrast to the four new default selection models being considered by the Commission, the current default selection process for awards has a demonstrable record of connecting default members to good quality funds that operate in members' best interests with a high degree of success. Under the currently suspended FWC process, a review of default funds named in awards would take place every 4 years, ensuring that default members would not remain in a fund that was underperforming and unable to turn its performance around.
6. In its Issues Paper, the Commission wrongly assumes that competition is needed to generate cost efficiency in the superannuation system. However, the evidence is that industry funds, which utilise a low-cost workplace distribution system, routinely charge lower expenses per member than retail funds which sell their products via 'competitive' channels such as mass marketing and advice.
7. In its Issues Paper the Commission wrongly assumes that the default system requires the most policy attention in terms of increasing efficiency, when the evidence is that the default system is the most efficient compared to the choice and SMSF segments.

   Studies evaluating member performance when shifting from default to choice products (including SMSFs) show members received lower average net returns than if they had stayed in the default product.

   'Choice' entails (i) significant marketing, distribution, product creation, and liquidity costs, (ii) significant public costs to regulate and police the sales that drive choice, and (iii) significant opportunity costs on members in terms of time and attention to consider an overwhelming array of products, review issuer Product Disclosure Statements (PDS), periodic statements, and other disclosures, as well as consume personal finance general advice and advertising. In sum, the total costs of operating a retail market in a compulsory system for members and the broader retirement income system are enormous.

1. Problems with the Stage 3 Issues Paper

As part of the Commission's assessment of the competitiveness and efficiency of the superannuation system, the Stage 3 Issues Paper outlines an ambitious programme of data collection from members, funds, CEOs, regulators and others. However, there are a number of problems with the research that the Commission is now intending to implement (and the assumptions that inform it) – problems that will weaken the authority and explanatory power of what the Commission is aiming to achieve. These problems include the following:

1.1 A persistent pre-occupation with competition

The Issues Paper states: 'competition is not an end in itself, but an intermediate objective insofar as it drives more efficient outcomes for members.'

However, having made this important contextual point, the Paper then routinely assigns competition the same normative status as efficiency, suggesting that they are effectively equivalent and inter-changeable when it comes to the outcomes that policy should be seeking to achieve. This is clearly evident in the questions posed in the Issues Paper relating to current default arrangements: 'What is the evidence that there is competitive pressure that drives innovation, cost reductions and more efficient long-term outcomes for members? How could existing arrangements be improved to achieve this goal?'

Previous Industry Super Australia (ISA) submissions to the Commission have detailed the systematic failure of competition to safeguard and enhance the interests of superannuation members – and the causal connection between choice and system inefficiency.[1] The key driver of these outcomes is the vast asymmetry in information, understanding and motivation between funds and members, an asymmetry that retail funds often exploit to sell members into relatively poor quality products as part of their for-profit business model.

ISA has also drawn attention to the best performing retirement income systems in the world (those in the Netherlands and Denmark) because, in common with not-for-profit funds in Australia, they deliver highly efficient outcomes for members on the basis of their culture of service to others. In the Netherlands and Denmark second-pillar product providers are private industry or multi-industry plans, product distribution is via the workplace and the default product is decided via collective agreement between employers and unions at industry or company levels.

These systems are widely regarded as the best in the world, and yet product design, distribution and default status is decided not by competition – but by a set of industrial institutions who take seriously their duty of care to millions of disengaged fund members.

To date the Commission has shown no interest in culture and values as factors that help to explain why not-for-profit funds routinely outperform the retail sector in Australia, and why the retirement income systems in Denmark and the Netherlands routinely out-rank the rest of the world. Instead, and despite the ample evidence presented to it over the past year, the Commission appears to continue to assume that it is an absence of competition that is the primary problem confronting the superannuation system, with the inevitable conclusion being increasing competition is the only legitimate and logical path of reform.

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[1] See: Industry Super Australia (2016) ISA submission to the Productivity Commission, May 2016; Industry Super Australia (2016) Living in an Empirical World, October 2016. Available at: http://www.industrysuperaustralia.com/assets/Submission/PC-submission-on-alternative-default-FINAL.PDF

In the context of the current default system, a more appropriate set of questions than those asked in the current Issues Paper would be: 'Why do default funds substantially outperform choice funds and self-managed funds? How could members be better protected from being sold into poor performing choice and self-managed funds?'

1.2 Neglect of the choice and self-managed fund sectors

The Commission's pre-occupation with competition is further reflected in the Issues Paper's relative neglect of issues pertaining to the choice and self-managed fund sectors. While the Terms of Reference direct the Commission to evaluate 'the default, choice (including self-managed) and corporate fund member segments', segment-specific discussion within the Issues Paper is overwhelmingly focused on default arrangements. In contrast to defaults, the Paper contains no 'General Questions for Participants' relating to choice and SMSFs.

Given that these segments routinely under-perform default funds, and so constitute the most inefficient parts of the superannuation system, this apparent disinterest is both striking and of considerable concern. It is further reflected in the list of published indicators that the Commission now intendeds to measure.

For example, in the context of assessment criteria E1 ('Are long-term net investment returns being maximised over members' lifetimes, taking account of risk?') there is an interest in measuring the 'proportion of default products that persistently underperform the benchmark', but not choice products and SMSFs.

An important issue that could be usefully explored by the Commission is how and to what extent funds utilise choice products and options as part of their marketing strategies to maximise revenues and profits. This would contextualise product/option proliferation and advice-driven sales – not as evidence of contestability and competition – but as indicators of how for-profit funds extract value from the system as the core aim of their business model.

Instead, the Commission's apparent lack of sustained critical interest in choice and self-managed funds seems to indicate that because membership of these segments is nominally the result of 'choice', and therefore indicative of competitive processes, their performance and place within the for-profit business model can be accorded a low-priority status. However, the evidence is that in common with other retail financial products, membership of choice and self-managed funds 'is sold, not bought' – a consequence not of individual rational choice but of successful marketing and sales.

1.3 Important gaps in the data to be collected

Despite publishing an ambitious list of indicators to be measured by quantitative and qualitative means, some important potential data appears to be being overlooked. For example, there appears to be no intent to collect data on the sources, quantum and distribution of profits made by retail funds. Retail funds exist to make profits for their corporate parents. However, there has been a lack of public transparency about exactly how superannuation as a distinct business operation acts to generate profit for other members of the same corporate group. Profits, however generated and accounted for, are a drain on member benefits and are therefore an important source of leakage and system inefficiency. Retail profits should be quantified and their significance for efficiency assessed as part of the current Inquiry.

Another gap concerns leakages from member accounts (criteria E5). There is no specification of up-selling as a leakage. One profit-generating strategy within the retail sector is to generate additional fee revenue by selling members into other superannuation products. Again, there has been a lack of public transparency about the extent to which this strategy is being utilised by funds and its implications for member benefits at fund, sectoral and industry-wide levels. It is not clear why this leakage data is not being collected as part of the Commission's research.

1.4 Indicators that lack relevance to the assessment criteria

It is not always clear that the specified indicators will provide meaningful answers to the assessment criteria. For example, in the context of criteria C1 (‘Is there informed member engagement?’), it is not clear that quantifying the ‘use of advisers by members and/or member intermediaries’ is relevant. Given that the large majority of financial advisers in Australia are directly or indirectly employed by the big banks and insurance companies, and so prioritise the sale of these institutions’ products in the form of ‘advice’, that some members may make use of their services says nothing about the extent of informed engagement.

Similarly, in the context of criteria C2 (‘Are active members and member intermediaries able to exert material competitive pressure?’), one indicator is the ‘switching rate between and within default and choice products and between institutional funds and SMSFs.’ If the research were to find a higher switching rate within the choice sector compared to the default sector, would this mean that choice members are exerting more material competitive pressure than default members? More likely is that choice members are subject to more successful sales pressures to switch because doing so generates revenues for profit-orientated funds.

A further example concerns criteria C8 (‘Do funds compete on member-relevant non-price dimensions?’), one indicator is the ‘number of accumulation products (aggregate and per fund).’ The Issues Paper states that this indicator ‘is common to both competition and efficiency.’ In the context of an industry such as a financial services, where product proliferation is a common marketing and sales strategy by for-profit product providers, it is not clear why the number of products offered by a fund should be regarded as an indicator of competitiveness or efficiency. The evidence is that choice proliferation in superannuation is strongly associated with poorer financial outcomes for members – not better.[2] The most relevant indictor of efficiency is not the number of products, but net returns to members.

1.5 The meaning of ‘case study evidence’

Case study research can play an important role in providing a degree of detailed insight into institutional dynamics and practices that surveys typically do not. When undertaken by experienced researchers, case study analysis can reveal patterns of motivation and causation within organisations and industries that are rarely visible to outsiders such as consumers and public regulators.

To fulfil this role case study research must be undertaken in a systematic manner, usually involving in-depth interviews with key personnel and securing access to internal documents and databases. Arriving at meaningful evidence-based conclusions requires a complex iterative process of collecting, checking and re-interpreting data as the case study progresses and as patterns of cause and effect become clear.[3]

The Issues Paper identifies ‘case study evidence’ from funds as a data source in relation to a number of topics, such as ‘contestability’ (‘the height of barriers to entry arising from default rules and market impediments to funds accessing distribution channels’).

However, the ‘evidence’ on this issue will not be generated and tested by independent researchers. It will instead take the form of self-reporting by individual funds. In place of a rigorous and systematic collection of evidence that will test what funds are likely to say on this issue, the Commission is effectively inviting

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[2] See Industry Super Australia (2017) Options to Lose: How ‘sales’ became ‘choice’ and the impact on superannuation returns. Available at: http://www.industrysuperaustralia.com/assets/Reports/ISA-Research-Note-Options-to-Lose-Choice-and-Performance-FINAL.pdf

[3] On the meaning and potential explanatory value of well-designed case study research see: Yin, R.K. (1984) Case Study Research: Design and Methods, Sage.

funds to provide a set of unstructured and self-serving anecdotes – which will be accorded the status of 'case study evidence' by the Commission despite the absence of any independent evaluation and testing.

Which anecdotes are accorded more explanatory weight than others will then become a highly subjective process, at risk of being skewed toward confirming the policy preferences of those who control the evidence and the explanatory narrative that the evidence is used to construct.

1.6 No data regarding MySuper after full implementation

The 2014 Financial System Inquiry (commonly referred to as the Murray Inquiry), issued the recommendation that was the genesis of the Productivity Commission's Inquiry into superannuation. The Murray Inquiry recommendation called for a Productivity Commission review of superannuation "by 2020" to ensure enough experience had been gained with the Stronger Super reforms after they had been fully implemented to inform the Commission, and for the high one-off costs of implementing those reforms to normalise. As explained by the Murray Inquiry:

> *The Productivity Commission (PC) should hold an inquiry by 2020, following the full implementation of MySuper (part of the Stronger Super reforms) to determine whether further reform would be beneficial. …*
>
> *It is too early to draw firm conclusions about the long-term effects of [the Stronger Super] reforms on average fees and net returns to members. Funds have only been able to offer MySuper products since 1 July 2013 and many are still absorbing one-off costs of the reforms. Additionally, accrued default amounts do not need to be rolled over into MySuper products until 2017. …*
>
> *Funds and their members have incurred significant costs as the Stronger Super reforms have been implemented. Although the Inquiry has some reservations regarding the extent to which the reforms will increase superannuation system efficiency, it recognises the need for full implementation of MySuper to allow it the opportunity to work before embarking on further reform. The outcomes of these reforms should be reviewed after all accrued default amounts have been rolled into MySuper products in 2017, by which time MySuper products will have been in operation for at least four years.…*
>
> *Recognising it is too early to evaluate their effectiveness, the Inquiry recommends a review of the superannuation system by 2020 before proceeding with further reform.*[4]

Currently, the Productivity Commission is to issue its draft report assessing superannuation efficiency and competitiveness in January 2018, and final report in June 2018.

Under this timeline, the draft and final reports will be complete before the data about fully-implemented MySuper are available.

Full MySuper implementation occurred on 1 July 2017. As a result, the data for the first year of the superannuation system with MySuper implementation will be for the year-ended June 2018. The Australian Prudential Regulation Authority will publish its annual fund-level and MySuper statistical data for the year-ended June 2018 in February 2019.[5]

Accordingly, the Productivity Commission will be unable to meaningfully consider that data, unless the Commission issues a draft report around the third quarter of the calendar year 2019, and the final report in the first calendar quarter of 2020.

[4] Financial System Inquiry, Final Report (2014), pages 101, 106, 111 and 112-113.

[5] Annual MySuper statistics for the year ended June 2016 were issued by APRA in February 2017. We anticipate this pattern of timing will continue in respect of APRA statistics for the year ended June 2017.

1.7 Survey of fund CEOs

There is a striking lack of detail in the Issues Paper about the precise scope and intent of the proposed survey of the CEOs of large APRA-regulated funds. The Paper states that the survey will be of CEOs in 'their individual capacity.' CEOs are appointed by, and are accountable to, trustee boards of directors. In the retail sector CEOs can occupy a complex position of multiple obligations and loyalties to a set of corporate interests – not simply to those of the RSE. The notion that in this context CEOs will temporarily detach themselves from these interests, and respond to surveys as individuals in ways that may be critical of established Registrable Superannuation Entities (RSEs) and corporate practices, is naive. In light of the commercial interests at stake, it is likely that many RSE boards will expect to approve the content of completed CEO surveys before they are returned to the Commission.

For example, an important distinction between investment governance in the retail and not-for-profit sectors is the widespread use by retail funds of investment services provided by members of the same corporate group. As a consequence, the evidence is that retail funds often pay more for such services than not-for-profit funds, who negotiate on an arms-length basis. It follows that for many retail funds, the governance of investment involves a conscious decision to *not* obtain investment services on an arms-length basis.[6] It is not clear if the CEO survey will explicitly test for this aspect of investment governance. If it does not, it is naive to expect the CEOs of retail funds to volunteer such information and offer a critical commentary on a key aspect of their for-profit business model.

More generally, if the CEO survey makes use of open-ended questions in relation to sensitive business operations (such as preferencing related corporate parties when contracting investment services), the scope for selective and evasive responses will be considerable. Surveys provide no scope for the iterative testing of responses in light of other evidence and data collection. This can be done by following-up surveys with a sample of representative in-depth interviews. However, that does not appear to be the intention in this case. As with case study evidence, the risk is that the CEO survey generates a large quantity of evidence that amounts to little more than a set of highly selective and self-serving anecdotes.

1.8 The absence of an evidence-base for current default arrangements

The default fund selection process for awards has been frozen since 2014 because necessary appointments to the Expert Panel have not been made. It is not only that the process legislated by the Fair Work Amendment Bill 2012 has not been allowed to operate (as implied in the Issues Paper) – the absence of a properly constituted Expert Panel means that no default selection process for awards currently functions.

Therefore, there has been no evidence base relevant to the present legislated award default selection process for three years.

In this context the Commission is proposing to "assess the current arrangements both 'in practice' (today's implemented arrangements) and 'in prospect' (with the legislation fully implemented)."

There are two problems with this approach.

Firstly, as noted above, there is no current set of default selection arrangements in operation for awards. The process has effectively been frozen for over three years. There is nothing to assess.

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[6] See Liu, K. and Bruce R Arnold, 'Australian Superannuation Outsourcing – Fees, Related Parties and Concentrated Markets', APRA Working Paper, 12 July 2010, p 2; see also Ellis, K., Alan Tobin and Belinda Tracey, 'Investment Performance, Asset Allocation, and Expenses of Large Superannuation Funds', APRA Working Paper, October 2008.

Secondly, inviting respondents to the Issues Paper to comment on how the fully implemented process is likely to function 'in prospect' effectively amounts to asking those hostile to the FWC process to engage in evidence-free speculation about how damaging it is to 'competition' (i.e. the commercial interests of those funds who wish to dismantle the current system because it inhibits their for-profit business strategies).

Using self-interested speculation as the basis for potential significant policy reform violates all the norms of evidence-based policy making. While the absence of a relevant evidence base is not the responsibility of the Commission, as a body responsible for conducting high-quality and rigorous research that aspires to be in the public interest it is incumbent on the Commission to make clear when some or all of the Terms of Reference it has been given cannot be fulfilled because there is insufficient data to draw evidence-based conclusions that are likely to command public confidence and prove resilient to Parliamentary scrutiny.

That is clearly the case in relation to the lack of evidence relating to the current FWC default process. It is incumbent on the Commission to make clear that in the absence of vital evidence any recommendations it makes in relation to reforming or replacing the current system are inevitably speculative – and should only be considered for implementation once the current FWC system has been allowed to fully function for at least a period of 4 years.

1.9 The importance of making evidence publically available

The Issues Paper does not make clear if the evidence-base that is generated by the Commission will be made available for independent scrutiny. It is vital that it is.

In light of the concerns expressed above about the quantity and quality of data that is being collected, and given the scope for a range of interpretations that can be applied to all data (and qualitative data in particular), it will be important for interested parties to have access to the full set of survey, case study and purchased research (suitably anonymised) that the Commission makes use of to reach its eventual conclusions.

Such transparency will help to cultivate public trust in the quality and integrity of the Commission's research process.

2. Responses to Issues Paper Questions

In this section answers are provided to a number of the questions posed by the Commission in the current Issues Paper. Many of the issues raised by the questions have been answered before in the context of the three earlier submissions by ISA to the current Inquiry:

- Superannuation Competitiveness and Efficiency (May 2016) ("SCE")
- Living in an Empirical World (October 2016) ("LEW")
- Risky Business (April 2017) ("RB")

Where this is the case the answers provided here are summary in nature and references to fuller explanations in those earlier submissions (which also cite relevant supporting evidence) are provided.

2.1 What are the material policy or regulatory impediments to the competitiveness and efficiency of the superannuation system?

For reasons discussed earlier in this submission, the Commission makes a serious error when it implies equivalence between competition and efficiency in the context of how the superannuation system should operate. Efficiency is an end. Competition is one of several means to an end. Competition as a means is only appropriate where certain market conditions are present, such as persistently engaged and informed consumers who are free of biases. Such consumers do not exist in the context of superannuation and so competition is of limited relevance.

An efficient superannuation system is one that maximises all inputs to maximise members' eventual retirement income. In a context where most employees are compelled by law to participate in the superannuation system, but lack the knowledge, motivation and cognitive resources to make rational choices, it is incumbent on government to act to ensure that contributing employees are connected to the best quality funds.

A key source of inefficiency in the present system, one that is permitted by current policy settings, is that members of good quality default funds can be sold into poorer quality choice and SMSF products. In short, the present system allows compulsory contributions, which are mandated for social policy purposes, to become a source of private profit at the expense of future retirement incomes.

This impediment to greater system efficiency should be removed.

There are two aspects to this: making sure that default members are routinely connected to good quality funds via a strong and comprehensive default system; and protecting them from being sold out of that system once they are there.

The industrial default system, under the jurisdiction of the Fair Work Commission, has a proven record of connecting default members to good performing funds (see RB, section 1.1). The most efficient and effective way to enhance system efficiency is therefore to strengthen a default system that the evidence shows has a proven record of working in the interests of default members. In part this means making sure that only good quality funds are listed in modern awards for default purposes, and that only such funds can receive employer contributions.

This is partly what the revised award default system was intended to do when it was legislated by the Fair Work Amendment Act 2012. The revised process allowed for a 4 yearly review of default terms in modern awards in which an Expert Panel would make a Schedule of Approved Employers MySuper Products

(effectively, the best quality MySuper products) from which up to 15 funds can be chosen to be listed in each award.[7]

In the process of deciding this naming of funds in awards all individual employees and employers covered by each award (and their industrial representatives) would have the right to make submissions to the Commission and have them considered.

This revised system of default selection is an improvement on the previous system because it combines expert input into the selection of the best MySuper products with input from employers and employees in relation to which of these products are best suited to particular awards. The revised system also specifies that the Expert Panel must consider criteria such as net returns, fees and administrative efficiency when selecting funds for potential award inclusion.

The additional advantage of a selection process organised within the FWC is that it is resistant to the lobbying and marketing pressures commonly associated with a highly-resourced and politically influential financial sector. These advantages are discussed later in this submission.

In addition to implementing the revised FWC system, further measures could be adopted to further protect members from being sold out of the high quality default system, into poor quality choice products. Because joining funds that underperform imposes individual and collective social costs, it is reasonable that funds should meet certain criteria if they wish to obtain members who have already been allocated to good quality products as a result of the provisions contained in modern awards and enterprise bargaining agreements.

Potential criteria that funds could be required to meet are discussed further in LEW, section 3.3.

2.2 Priority Areas Listed in Table 2 of the Issues Paper: Contestability

The Commission has requested that funds provide 'case study evidence' on the matter of contestability ('the height of barriers to entry arising from default rules and market impediments to funds accessing distribution channels').

Funds will provide their own views on this issue. However, in light of the data quality issues raised by the self-reporting of 'case study evidence' by funds with a clear commercial interest in dismantling the current default system, the Commission will need to apply appropriate evidentiary standards to the material provided if it is to avoid drawing conclusions on the basis of highly selective, unsubstantiated and self-serving anecdotes.

It is not clear from the Issues Paper how the Commission intends to do this.

Informed consideration of contestability in the context of the default system must take account of the following issues:

- In the context of mandatory contributions by disengaged employees to privately operated funds, some of whom exist solely to generate profits for third-parties, it is essential that funds meet certain performance and quality criteria before they are allowed to receive default contributions. The need for effective protections, which are often characterised by those opposed to them as 'barriers to entry', has been recognised by the Cooper Review in 2009, the Productivity Commission Inquiry into default funds in modern awards in 2012, and the Financial System Inquiry in 2014. If the case for protections is accepted, the issue then becomes the nature of the protections that are implemented.

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[7] While the Act specifies up to 15 funds, section 156(H)(3) allows for the FWC to name more than 15 if the range of occupations covered by an award means that a greater number is warranted.

- The revised FWC selection process generally provides for listing up to 15 superannuation funds in each award based on merit and industrial relevance. It is impossible to specify precisely what would happen under this process in practice because necessary appointments to the Expert Panel have not been made. However, we can be sure that:
  - Any fund named as a default in a modern award would have been exposed to substantial tests in an adversarial context. To be named as a default fund in a modern award, a fund must have applied, be scrutinised by an expert panel, as well as subject to scrutiny by other applicants, the industrial parties, and the full bench of the FWC. This means any fund named after that process will have been robustly tested not just by an independent panel (who might suffer from group think) but by others as well.
  - If an employer is covered by an award that contains, say, 10 different good quality default funds decided through the Fair Work process, this would satisfy two conditions for an effective default system: (i) default members would be guaranteed membership of a good quality fund, and (ii) the ability of each employer to choose from 10 named funds reflects and allows for contestability.

The argument that the FWC selection process has not allowed for an appropriate degree of contestability until 2014 should be tested by the Commission, rather than merely accepted on the basis of what opponents of the process claim on an anecdotal basis. The FWC process as it operated until 2014 allowed for any fund that could gain the support of a relevant employer or employee (or their representatives) to apply for listing as a default fund in any award.

The Commission should seek evidence from the FWC in relation to (i) how many retail funds sought to be listed in awards, (ii) how many were successful, (iii) how many were denied, and (iv) what were the grounds for any denials. The Commission should then reflect on whether being required to make an application for award listing via the FWC constitutes an unreasonable hurdle for those funds that wish to receive default contributions.

The evidence is that it is not.

For example, in anticipation of the full implementation of the revised award selection process in 2014, the FWC invited applications from funds to have their standard MySuper products named on the Default Superannuation List. Seventeen for-profit funds made applications to be named. A number of those applications sought inclusion in multiple awards. As the Commission would be aware, those applications were not processed to completion because the selection process was effectively suspended.[8]

The behaviour of the for-profit funds does, however, suggest that the default fund selection process was not considered such a high barrier to entry that it was not worth participating.

2.3 What methodology would you use to estimate unused scale economies and pass through of realised scale economies, and why?

ISA favours an approach that would establish benchmarks based on cohorts of best-practice funds which deliver scale benefits. This would be derived for a number of size groups, with similar sized funds measured against it. Over time, the benchmark standards would be uplifted to incorporate an efficiency dividend, against which funds would be assessed and incentivised to improve their delivery of scale benefits to

[8] The full list of applications and submissions made in relation to the Default Superannuation List is at: https://www.fwc.gov.au/awards-and-agreements/modern-award-reviews/superannuation-fund-reviews/applications

members. It would be a matter for regulators to determine an appropriate efficiency dividend quantum based on the benchmark established for each size-group.

This approach has the advantage of being able to point to empirical best-practice and actual benefits to members as the basis for assessing other funds, in place of attempting to generate a model of a highly complex system that many funds are likely to claim does not recognise the concrete obstacles they face in realising scale economies and passing all the resulting benefits to members. The Commission's apparent preference for an econometric approach risks inviting a complex and inconclusive debate about the realism of modelling, rather than how an empirically-grounded evidence base can be used to provide useful insight.

Should the Commission wish to pursue an econometric approach to estimating scale-related issues, it would be appropriate to begin by engaging with the work of Mr Wilson Sy, a former senior researcher at APRA, who has undertaken econometric research on scale benefits in superannuation.[9]

2.4 System-level & asset-class level benchmarking

In the Issues Paper the Commission poses a number of questions on how best to use benchmarks to assess efficiency at system and asset-class levels. A technical working group will also consider these issues at a later date.

The formulation and use of benchmarks to measure the efficiency of superannuation in terms of returns raises a number of complex definitional and measurement issues. It is important that serious consideration of these issues informs how the Commission proceeds in this area.

To this end ISA is willing to nominate an appropriate person from within the industry fund sector with extensive professional experience of developing and using asset class return benchmarks to contribute to the technical working group.

There are a number of problems with the approach to benchmarking contained in the current Issues Paper.

In particular, the Commission's intention to assess historical system-level returns by means of a set of passive and liquid reference portfolios is a highly abstract approach that risks establishing benchmarks with little or no empirical relevance to how actual funds construct their portfolios, manage risk and deliver actual net returns to members.

In this context hypothetical reference portfolios risk establishing benchmarks that are too conservative, a consequence being that segments of funds that could construct better performing portfolios, but do not, are nevertheless assessed to be efficient. Alternatively, a conservative benchmark could be used to argue that the inefficiency of particular segments is less than it really is because those funds that routinely outperform the benchmark – and who could provide a useful basis for analysis – are excluded from how efficiency is defined.

Table 1 compares average 10 year net returns for retail and not-for-profit funds against a benchmark of a simple 70/30 passive portfolio – similar to that suggested in the Issues Paper. As indicated by the Standard Deviation, the level of risk for each is similar. The inefficiency of the retail sector as measured by net returns is 0.6 per cent when compared to the simple portfolio. However, it is three times higher at 1.8 per cent when compared with the average returns actually achieved by the not-for-profit sector. Clearly the retail/not-for-profit comparison implies a more significant and worrying 'efficiency gap' than that implied when the passive portfolio is used.

[9] See: Sy, W. (2012) Scale and Competition in Australian Superannuation, submission to the Productivity Commission Inquiry into Default Superannuation Funds in Modern Awards.

The Commission risks reaching conclusions that underestimate the inefficiency of parts of the system and missing what could be plausibly done to reduce that inefficiency by making empirically-grounded comparisons with those segments that demonstrably perform best.

Table 1 - Comparison of 10 year Net Returns from Retail and Not-For-Profit Funds with a Simple 70/30 Portfolio

	10 yr net returns (%)	Std. Deviation (%)
Simple 70/30 portfolio	4.10	9.3
Retail funds	3.50	9.2
Not-for-profit funds	5.30	8.9

Source: ISA analysis of data from APRA, Bloomberg, S&P Dow Jones and Vanguard for 10 years ending May 2017.
Note: The 'Simple 70/30 portfolio' comprises 35% global equities, 35% international equities, 15% cash, 15% fixed interest.

Alternatively, benchmarks may be too demanding, embodying assumptions about patterns of market growth that are not representative of long-term historical trends or how actual funds appropriately manage risk through diversification.

A more grounded and useful approach would be to design benchmarks based on the actual net returns received by a cohort of funds with a track record of strong long-term net performance. The benchmarking system should assume all members would have their superannuation managed by trustees which achieve the net performance outcomes of this cohort.[10]

Using a cohort of actual funds to generate a long-term return average for benchmarking purposes has the considerable advantage of being able to make use of real fund behaviours under real market conditions, on the basis of which meaningful contrasts with the strategies of underperforming funds can be drawn. It also better captures the operational costs to funds of investment management, monitoring and valuation. These costs have been estimated by some to amount to between 5 and 10 basis points, depending on the scale and composition of each particular fund portfolio.[11]

Using benchmarks that lack a grounding in definite historical practice and experience will likely invite arguments from underperforming parts of the industry that any findings of inefficiency merely reflect the highly abstract nature of the assessment and the failure to take account of the complex practicalities that actual funds have to deal with. In contrast, being able to point to achieved efficiency based on actual practice would help to illuminate the real potential for the system to improve.

In relation to the choice of indices for designing benchmarks for assessing performance at asset class level, there are a number of complexities the Commission should take into account if it is to arrive at robust and useful conclusions.

In short, the chosen indices should reasonably reflect the geographical, industrial and risk composition of what is being assessed. In this context there are a number of issues to be considered. These include the following:

- An index should not measure the performance of investments that overlap significantly with the investments that the index is being used to benchmark. A significant overlap between the two

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[10] This argument was made in the first ISA submission to the current inquiry (see SEC section 5.2). It is not clear from the Issues Paper why the Commission has decided against a cohort approach to benchmarking returns.

[11] Private communication from an investment consultant to ISA.

groups means the index will effectively reflect what is to be assessed, rendering judgements of performance efficiency of little value.

- The composition of assets measured by different indices can vary widely, despite apparent similarities. For example, the category of ‘unlisted infrastructure’ can comprise a wide variety of assets, ranging from overseas greenfield holdings in emerging markets to domestic publically-regulated brownfield assets. Different kinds of infrastructure, such as transport and energy generation, have different historical and expected profiles, and the relative weighting of these kinds of assets in indices or investor portfolios can affect comparability. Variations in gearing matter. Debt-equity ratios will tend to vary by project.
- Within sub-categories such as ‘energy’, holdings can vary depending on the precise nature of the asset e.g. electricity, gas, nuclear or hydro; generation or distribution; overseas or domestic.
- Geographical variation also implies variation in currency and political risks, with resulting variations in how these are priced and hedged. The scale and nature of currency risk can play a significant role in shaping returns. However, there is no ideal-benchmark for assuming such risk because currencies often are correlated with other kinds of risks that may or may not be desirable in the context of a given portfolio composition[12] and the time period over which the risk is held.
- Some indices, particularly those that claim relevance to relatively small and illiquid markets, are based on voluntary subscription and performance reporting, with the consequence that the index may misrepresent performance in the broader markets in which non-subscribing investors are present (giving rise to ‘survivorship bias’ in the event that poor performers withdraw their subscriptions).
- Indices can be made up of the performance of operating firms, or investment intermediaries. This means similar sectoral exposures (e.g., semiconductors) or asset classes (e.g., equities) might or might not be net of taxes and certain fees and costs. Insofar as the indices will be used to benchmark superannuation fund performance, these differences should be avoided or subject to adjustment.
- Indices should measure performance over periods of at least 20 years to minimise the risk of being skewed by unrepresentative economic shocks, such as the 2008 global financial crisis.

2.5 How do the existing default arrangements mitigate the paramount risk of any default system – a member defaulting to a (long-term) underperforming default product?

ISA does not accept the implication of the question, namely that in the present Australian default system there is a significant risk of members being defaulted into a long-term underperforming default product.

Our submission to the Commission dated 3 August 2017 presented statistical evidence that shows the probability of a member being defaulted into an underperforming fund is not significant.

The degree of risk is a function of the probability of a harm (in this case, low net returns), and the magnitude of that harm (in this case, the degree to which the returns are low).

In terms of probabilities, only a small proportion of accounts in award-listed default funds[13] received long term net returns in the bottom quartile.

[12] For example, a portfolio with higher exposure to commodities or “risk on” sentiment than desired might seek to retain exposure to the US Dollar in its investments rather than fully hedge it.

[13] Including all funds named in awards, both not-for-profit and retail.

There are about 15,328,671 accounts in funds that are named as default funds in one or more modern awards. More than two thirds of these accounts (10,354,464) are in funds with long-term net returns *in the top quartile*. This means that, probabilistically, there is greater than a two in three chance that an account that was established through the default system will have received top quartile long-term net returns. By contrast, there are only 375,659 accounts in award-listed funds that have had long-term net returns *in the bottom quartile*.[14] Put another way, there is about a 2.5 per cent chance that an account established through the modern award default system will be in the bottom quartile. In terms of magnitude, the difference in aggregate default fund long-term net returns attributable to those funds in the bottom quartile is very small, because they have relatively few accounts.

The difference in performance between these default funds (i.e., award listed) in the bottom quartile and, say, median returns is, however, not insignificant: median long-term (i.e., 10 year) net returns across the system are 4.3 per cent per year. The weighted average[15] long-term net returns of default funds in the bottom quartile is 3.0 per cent, or a difference of about 1.3 per cent. Again, this difference is in respect of a relatively small number of accounts.

With just 2.5 per cent of accounts being in award-nominated funds in the bottom quartile, it is very difficult to credibly suggest that the biggest risk to a member is being defaulted into a poor-performing default fund.

In addition, while the evidence is that the risk of a 'poor default' is minimal, what risk there is could be further minimised by strengthening the default system that already exists.

The existing default arrangements were legislated by the Fair Work Amendment Act 2012 and were intended to commence operation in January 2014. They have been prevented from doing so because necessary appointments to the Expert Panel have not been made. There is therefore no evidence-base of behaviour and outcomes directly relating to current arrangements from which to draw to answer the question.

However, if pre-2014 practice is taken as a proxy for plausible post-2014 practice, then the evidence is that default funds in awards have outperformed non-default funds in the 10 years to September 2016: an average of 5.86 per cent for award defaults compared to 4.89 per cent for non-award defaults (see LEW, section 1.1).

Further, in 2012, following its inquiry into default funds in modern awards, the Commission concluded that 'Current default arrangements have provided stability, and investment returns of default funds have generally exceeded those of non-default funds.'[16]

This proxy evidence-base for the current system, while imperfect, stands in contrast to the four alternative models being considered by the Commission – none of which have a grounding in Australian evidence and experience.

Building on the outperformance of established default arrangements, the new arrangements legislated in 2012 contain a number of changes to prior procedures that are intended to mitigate the risk of members remaining in a poor performing product:

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[14] This methodology is not perfect, because some of these accounts were opened during the 10 year period over which the returns were generated, so there will be some differences due to sequencing. However, the performance characteristics of award-listed funds in the top quartile is not random (as shown in our last submission): not-for-profit funds in the top quartile of performance in the five years to 2011 were also often in the top quartile of funds in the five years to 2016.

[15] The weighted average is a smaller difference.

[16] Productivity Commission (2012) Default Superannuation Funds in Modern Awards Inquiry Report, No. 60.

- The establishment of an Expert Panel which will decide which of the applicant MySuper products should be included on a Default Superannuation List, and so be eligible for inclusion in one or more modern awards. The criteria to be applied by the Expert Panel include:
  - The appropriateness of the MySuper product's long-term investment return target and risk profile.
  - The superannuation fund's expected ability to deliver on the MySuper product's long-term investment return target, given its risk profile.
  - The net returns on contributions invested in the MySuper product.[17]
- The default funds listed in awards will be subject to 4 yearly reviews, at which time the Expert Panel will again determine which funds should be included on the Default Superannuation List, and the FWC will again determine which of those funds should appear in each award.

These new arrangements provide for underperforming and inappropriate funds to be excluded from consideration by the Expert Panel or (if necessary) by the FWC.

This process of review and exclusion is clearly superior to the Assisted Employee Choice, Fee Based Auction and Multi-Criteria Tender models being considered by the Commission – all of which have proposed that it be left to disengaged default members to act to protect their interests if a fund they are a member of subsequently fails to be selected for default purposes. Under the FWC process a fund that is not listed in the award will not be entitled to receive default contributions. This model does not mistakenly assume that disengaged members will suddenly act rationally in the event that their fund loses one of the suggested alternative selection processes.

2.6 What is the evidence of long-term underperforming default product providers exiting the default market?

As noted earlier in this submission, the Terms of Reference for the Inquiry direct the Commission to evaluate 'the default, choice (including self-managed) and corporate fund member segments.' It is not clear why a large majority of the segment-specific questions posed by the Commission in the Issues Paper focus exclusively on the default system, often excluding any corresponding reference to choice segments.

It would be useful for the Commission to consider (i) why many choice products underperform many default products, (ii) why these choice products nevertheless retain members, (iii) what this says about why members really join and remain members of choice products, and (iv) what are the consequential policy implications for increasing overall superannuation system efficiency.

In relation to the specific question posed by the Commission, there is evidence of underperforming default providers exiting. For example, in the period June 2004 to June 2016, the number of not-for-profit funds (the primary recipients of default contributions) has fallen from 1208 to 109. Over the same period, the number of industry funds has fallen by 45 per cent: from 75 to 41.[18] The reduction in industry funds has been driven by mergers between funds as trustees decided that in order to continue to fulfil their obligations to members it was appropriate to combine with one or more other funds.

Historical information is of some utility, but we note that, as discussed above, current default arrangements provide for an Expert Panel to determine membership of a Default Superannuation List, and for 4 yearly reviews during which the inclusion of all funds in awards will be subject to review.

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[17] A full list of the selection criteria to be used by the Expert Panel is at section 156F of the Act.

[18] ISA analysis of APRA Annual Superannuation Bulletin June 2016.

2.7 How do the existing default arrangements create incentives for funds to maximise long-term net returns and allocate members to products that meet their needs? How could the existing arrangements be improved to achieve this goal?

Current arrangements provide for an Expert Panel to determine a Default Superannuation List partly on the basis of each applicant fund's long-term investment return target and record of net returns. These criteria create a clear incentive for funds to maximise returns in anticipation of applying to be included on the List, and to maintain strong performance in anticipation of each 4 yearly review.

The selection criteria also allow the Panel and the FWC to consider issues such as the appropriateness of any insurance offering, fund governance and conflicts of interest, and fund administrative efficiency.

2.8 What is the evidence that existing default arrangements encourage open participation (contestability) and rivalry between funds for the default market (competition for the market)?

The existing default arrangements allow every fund to apply for their MySuper product to be included on the Default Superannuation List every 4 years. The best and most appropriate funds for inclusion on the List will be decided by the Expert Panel, and their subsequent inclusion in particular awards decided by the FWC. This process is open to all funds that can offer an APRA-approved MySuper product (encouraging contestability) and encourages funds to improve their product performance and service quality in anticipation of each 4 yearly review (encouraging rivalry).

2.9 What is the evidence that there is competitive pressure that drives innovation, cost reductions and more efficient long-term outcomes for members? How could the existing arrangements be improved to achieve this goal?

The worldview embedded in the question, namely that competitive pressure is needed to drive innovation, cost reductions and more efficient long-term outcomes for members, is misplaced.

The evidence is that not-for-profit funds, which utilise a low-cost model of workplace distribution in the context of default selection decided by awards and enterprise bargaining, routinely outperform retail funds that typically distribute their products via 'competitive' market means i.e. advice channels, direct sales channels (e.g., cross selling and general advice from bank branch staff) and mass marketing.

The outperformance of not-for-profit funds can be attributed to the 'industrial ecosystem' in which they operate. Funds in this ecosystem routinely outperform retail funds because (i) they return all profits to members, (ii) utilise a low-cost workplace distribution model for most of their products, (iii) are selected by collective industrial agreement, and (iv) are governed by representatives of employees and employers whose first and only duty is to fund members.

Evidence on the sources and quantum of the outperformance of not-for-profit funds, and the reasons for retail underperformance, is presented in SCE section 4 and LEW section 1.1. Evidence that the best retirement income systems in the world (those in Denmark and the Netherlands) do not make use of competitive pressures to deliver world-leading outcomes for members is discussed in LEW section 1.5.

The member expense data reported in Table 2 demonstrates that 'competitive pressure' does not drive lower costs for members in the Australian system. In every year since 2004, industry funds which utilise an industrial distribution system have substantially lower average expenses per member than retail funds, which make extensive use of marketing and direct sales. This again shows the decisive importance of the not-for-profit business model and its related culture of service to members – rather than 'competition' – in explaining better outcomes for members.

Table 2 - Comparison of Industry and Retail Fund Expenses per Member, selected years 2004-16

	2004	2007	2010	2013	2016
Industry ($)	74	119	147	210	273
Retail ($)	165	249	246	333	440

Source: ISA analysis of APRA data. Notes: Data is for estimates of fund expenses per member.

2.10 Do the existing default arrangements minimise overall system-wide costs, taking into account costs on members, employers, funds and governments? How could the existing arrangements be improved to achieve this goal?

As discussed earlier in this submission, the evidence is that the default system is the most efficient segment of the superannuation system. In part this is because most funds in the industrial default system are mostly free of the additional costs generated by choice. It is unfortunate that despite its Terms of Reference, in the current Issues Paper the Commission has not posed general questions for participants on the role of choice as a source of additional cost and as a consequential contributor to system-wide inefficiency.

Some of the costs associated with choice include:

Additional product development, management and compliance costs. For-profit funds on average offer 244 investment options, while not-for-profits on average offer 11 options. This suggests that competition is based on breadth of product range and options, rather than benefit for the member.[19]

Additional marketing, promotional and administrative costs. Since the advent of choice, funds across the industry have (rationally) invested significantly greater amounts on marketing, sales and member engagement to retain existing members and to attract new members. Rice Warner attributes a 5bp increase in fees system wide as a result of increased marketing activity resulting from choice.[20] As explained by the Grattan Institute, "When many funds are taking similar steps, few funds gain market share, so average costs rise. And the extra services may not provide much real value to account holders."

Excessive liquidity in portfolios, which reduces net returns. A super fund that seeks to invest optimally and for the long term will reasonably seek a substantial allocation to illiquid assets. APRA research attributed 35bps of not-for-profit outperformance to the liquidity optimisation of their portfolios. Providing choice impairs the ability of a fund to make long term investments in illiquid assets due to (i) increased liquidity *requirements* and (ii) increasing liquidity *risk*.[21]

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[19] Grattan Institute (2015) Super Savings.

[20] Rice Warner (2014) Fee report for the Financial System Inquiry, p. 24.

[21] Grattan (2015) p. 12.

Liquidity requirements involve holding sufficient liquid assets to honour obligations as they are due without incurring unexpected costs. Liquidity needs in a choice environment are higher than otherwise would be the case.

Liquidity risk is even more important because managing it involves a fund holding liquid assets substantially in excess of levels needed to honour ordinary course requirements. Managing liquidity risk involves holding liquid assets at a level that would enable the fund to withstand a growing band of future redemption possibilities, as well as major shocks. As policy and marketing reinforce pressure on members to be engaged and to switch, the risk that funds must anticipate grows, reducing their capacity to make long term investments that benefit members.

2.11 What are the comparative transition costs of the four alternative default models in terms of risks to members, funds, employers and government? What are your cost estimates and why? What is the optimal timing and pace to mitigate transition costs?

The four default models being considered by the Commission as potential replacements for existing default arrangements are not in the public interest. The flaws of the models include:

- Each of the Commission’s draft models assume a higher level of consumer capability and capacity for sustained individual agency regarding superannuation products and their providers than exists.
- Each of the Commission’s draft models is vulnerable to exploitation by bank-owned and other for-profit super providers.
- The draft models proposed no protections for consumers being sold products that transfer them out of the default safety net, nor did it consider how banks’ up-sell and cross-sell strategies would influence their behaviour in the selection processes.
- The Commission’s proposed selection panel could lack accountability, and could be susceptible to influence, distorted incentives and politicisation. The selection panel would not be persistent, but would instead be appointed episodically by the Minister. A panel that dissolves shortly after selecting default funds means the panellists could be offered inducements in which providers seek to influence the outcome in a favourable way by offering a panellist future rewards or employment directly or indirectly. In addition, because the panel will be dissolved shortly after default funds are selected, it is not clear how panellists could be accountable for bad decisions.
- If the Commission’s draft proposals were implemented, over time there would be no natural counterweights to banks and the finance sector. Under the current system, trade unions and engaged employers can help well-intentioned public servants limit the influence of the big banks and wealth management firms. Under the Commission’s draft proposals, the selection panel may be comprised of ex-bankers appointed by the Treasurer. The draft proposals would eliminate trade unions from participating in default fund selection, as well as employers (except for one model).

The significant problems with each of the four models are discussed in greater detail in RB section 3.

Furthermore, to date the Commission has proposed a set of four highly abstract default models with no supporting cost-benefit analysis. The proposed models lack empirical parameters for how each is likely to operate in practice (e.g. How many members would remain in the default system after the first year? How many funds would exist outside the default system?). In the absence of such parameters we doubt the value of inviting speculation about potential transition costs: transition costs to what exactly?

2.12 How could the process for constituting the body for selecting default products be designed to deliver accountability (and thus not be judicial in nature)?

The Productivity Commission has not made the case for constituting a new body.

The Commission has certainly not made the case for it to lack judicial characteristics. The judiciary is perhaps the part of government that is broadly still seen as competent and respected. This is because the decisions arising from a tribunal enable interested parties with the opportunity to make their case, and have the evidence tested under adversarial conditions.

Given the proven capacity of the financial industry to exert direct and indirect forms of influence on senior policymakers, it is important that the body responsible for default selection, and those who populate and lead it, are politically and institutionally detached from the normal political and commercial channels through which major financial corporations exert influence.

Issues of financial sector influence and regulatory capture are discussed in further detail in RB section 2.4 and LEW section 1.11.

The default selection process currently legislated under the jurisdiction of the FWC should be allowed to proceed.

The FWC has a proven record of acting independently of financial sector lobbying and making default selection decisions that are in the best interests of default members. The success of the FWC can be attributed to a number of factors, such as:

Capacity to contemplate a range of factors. Where the selection process must contemplate a range of factors, with a focus on net benefits rather than cost, the capacity of the Fair Work Commission to receive arguments and evidence from a range of parties, and for claims to be tested in an adversarial format, is useful. The Commission operates as a tribunal. The adversarial mode used by the judicial system is how complex matters are contested, and resolved, in a manner that maintains the confidence of the public.

Transparency. Arguments and materials are accessible to the public, consistent with the Fair Work Commission's status as a tribunal. In this capacity, the Fair Work Commission must hold open hearings, and publish the reasons for its decisions.

Probity. Adversarial testing enables the arguments of different providers seeking to be named as default funds to be examined by those with the information and motivation to challenge them, as well as subjecting them to the scrutiny of an expert panel and tribunal.

Independence and impartiality. Members of the Fair Work Commission "have the same level of independence" as justices of the federal courts. The Fair Work Commission "is required to … determine the matters that come before it impartially."[22]

Procedural fairness and treatment of parties. The Fair Work Commission is subject to common law principles of procedural fairness, underscored by the requirement that the Fair Work Commission act "judicially."[23]

Participation of industrial parties. The participation of industrial parties has had a number of beneficial effects. As noted above, the participation of industrial parties frees government from certain risks. In addition, industrial parties have interests in common with beneficiaries and well-established cultural norms in the context of superannuation that prioritise beneficiaries. They do not have material interests or

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[22] Fair Work Australia (2012) Submission to the Review of the Freedom of Information Act.

[23] Fair Work Commission, Practice Note: Fair Hearings.

conflicting profit motives adverse to beneficiaries. With respect to trade unions, there is a significant body of evidence which shows unionisation is strongly associated with better pay and conditions for workers. Employers do not have adverse interests to workers in respect of superannuation provider because the commercial results of employers cannot be improved by extracting value from employees. In fact, employee retention and productivity can be improved where superannuation is well-managed.

Resistance to finance sector capture. Employers and employees are important stakeholders in the system and have interests in the outcomes of selection processes. A process conducted outside of the Fair Work Commission would, as a practical matter, come to focus almost exclusively on superannuation providers, and rely solely on government and regulators to protect the public interest.

Superannuation is an employment entitlement at law. Conducting the selection process within the Fair Work Commission is necessary to respect that superannuation is an employee entitlement, has the character of wages, and is under the jurisdiction of the industrial system. As the High Court has explained "Entitlement to participate in a superannuation scheme and the means by which that scheme is to be funded are matters which pertain to the relations of employers and employees and fall within" a number of provisions of the industrial relations laws.[24] Superannuation emanates from the industrial wages system; it has the character of deferred wages. As a practical matter, superannuation contribution levels and the workplace default fund are frequently the subject of enterprise bargaining because they are matters of interest to employers and employees, as well as being addressed by most modern awards.

Any proposals by the Commission to remove default selection from the FWC must engage with these attributes and offer plausible evidence-based argument as to why a new body that is more vulnerable to the lobbying of the financial industry and its political supporters could be reasonably expected to improve on the structure and record of the FWC. It is well-known that the big banks and retail funds do not want the FWC involved in superannuation, but their dislike for the FWC is not a basis to remove it. In fact, it is a powerful reason to maintain it.

2.13 The Commission's questions relating to a potential centralised clearing house.

In the Issues Paper the Commission poses a number of questions relating to potential costs and capacity of the ATO, or a commercial provider, to operate a centralised clearing house for the Australian superannuation system.

It is unclear that it is either prudent or necessary to have the ATO, or a commercial provider, operate a centralised clearing house for the superannuation system. This is for a number of reasons:

- The ATO has a poor record of allocating sufficient priorities to those aspects of superannuation for which it already has responsibility, such as collecting unpaid SG contributions. In part this is because the ATO has a record of being very responsive to the policy priorities of government, which rarely settle on matters of superannuation compliance and administration.
- The centralisation of clearing within the ATO would likely make the effectiveness of the system vulnerable to the unpredictable politics of ATO budget-setting. On the other hand, contracting a private company could place the quality of the service at risk, given budgetary pressures to agree contract on a lowest-cost basis, and the commercial incentives for private companies to game contract obligations.

[24] See, Re Manufacturing Grocers' Employees Federation (Aust); Ex parte Australian Chamber of Manufacturers (1986) 160 CLR 341, 355-356.

- A number of private clearing houses have already been established under SuperStream – an initiative that has become widely regarded as a success by the superannuation industry and most employers. It is not clear what will be gained by rendering years of investment by funds and employers in SuperStream obsolete by developing a new system that will largely replicate what already exists.

The problems of introducing a new centralised clearinghouse are discussed in more detail in RB section 1.1.7.

2.14 The Commission's questions relating to merger transparency

The Issues Paper poses a number of questions relating to requiring greater transparency and disclosure as a means of promoting mergers between funds.

However, while ISA supports stronger action to remove barriers to mergers that are in the best interests of members, we doubt that a lack of disclosure is one of them. The more substantive barriers to merger are discussed in RB, section 2.5.