# Disconnect:

## The PC's findings do not support its recommendations

SUBMISSION IN RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT

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## ABOUT INDUSTRY SUPER AUSTRALIA

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# DISCONNECT

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# KEY POINTS

- The Draft Report is marked by a fundamental “disconnect”- between its key findings on the one hand, and its policy recommendations on the other hand.

- In short, the Draft Report finds the main sources of underperformance to lie in the retail, choice and SMSF segments – but insists that it is the industrial default segment (where most funds are operated on a not-for-profit basis) that requires radical change.

- The Draft Report finds that “Not-for-profit funds, as a group, have systematically outperformed for-profit funds.” Further, “many default funds have demonstrated strong investment performance, to the benefit of their members.”

- In terms of underperformance, the Draft finds that “Most (but not all) underperforming products are in the retail sector.” In particular, “Underperformance appears to be more pronounced for the 11 million who have chosen their own products…Members get excessive choice at the expense of less comparability, and even highly engaged and financially literate members struggle.” Further, many SMSFs have performed “significantly worse than institutional funds.”

- Despite the strong performance of the industrial default safety net and the not-for-profit segment, rather than consider how to make what works perform even better the Draft Report recommends tearing-up present default arrangements and replacing them with an untested and high-risk alternative named “Assisted Employee Choice” (AEC).

- If implemented, AEC will substantially increase the risk that millions of employees will find themselves marketed, advised and sold into the very segments that the Draft Report has identified as poor performing: retail, choice and SMSFs.

- While the Draft Report recommends dismantling an industrial safety net that has worked well for the vast majority of default members, its proposals to tackle the main sources of underperformance in the superannuation system are either absent or weak:
    - In relation to underperformance in the SMSF sector, the Draft Report makes no recommendations.
    - In relation to underperformance among retail funds and choice products, the Draft Report relies on dashboards to improve outcomes for members – a policy tool that has no track record of success and which assumes a level of engagement and financial literacy among members that does not exist.

- The Draft Report’s apparent willingness to tolerate underperformance in the retail, choice and SMSF sectors indicates that the Inquiry does not understand what the superannuation system is for. Contributions were mandated in 1992 for social policy purposes: to increase future retirement incomes for all, and to allow future governments to allocate more resources to

other social needs. In this context, the performance of *all* parts of the superannuation system should be a public policy priority.

- Reform should focus on improving the industrial safety net – not dismantling it while letting the underperforming parts of the system continue as before.

- The evidence from Australia and the leading retirement income systems in the world (e.g. Denmark and the Netherlands) is that the most effective way to connect members to good funds is via the system of industrial relations. Representatives of employees and employers act as a counter-weight to the influence of the financial sector, and provide an environment where the interests of members can be prioritised over all others.

- The Fair Work Commission (FWC) provides for this already – we do not need to re-invent the wheel. The FWC default selection process that was legislated in 2012 should be allowed to operate. The Draft Report's pejorative assessment of the FWC's capacity to act in the interests of members is speculative at best. Moreover, if there is a concern that the FWC would not remove underperforming funds from the default system if the 2012 legislation were implemented, this is very easy to fix by directly requiring it. Such changes are far more straightforward than a new regime built around the AEC.

- ISA supports a strengthened version of the industrial safety net with the following features:
    - Every four years the FWC will determine the universe of good performing and industrially-relevant funds that are eligible to be named in industrial instruments for default purposes. Selection will prioritise proven long-term net returns and the capacity of funds to offer products and services tailored to specific industries and occupations when appropriate.
    - For default superannuation purposes, the funds listed in awards will apply to all workplaces that are covered by awards and those workplaces that would otherwise be covered by an award but for a registered agreement.
    - As part of its 4 yearly reviews, the FWC will also decide a list of 'general default funds' for use in workplaces that are not protected by an award or agreement. The National Employment Standards will be amended to require use of these funds.
    - To better protect members in workplaces covered by agreements, only those funds listed in the relevant award can be named in an agreement for default purposes.

- The Choice and SMSF sector require substantial reform if they are to be maintained in a credible system. To protect members from being sold out of the industrial safety net, products that wish to solicit default members must meet a member best interest threshold. This would be a 'better-off test' in which the trustee of the incoming assets must make a reasonable determination that the member would better-off financially if they joined the non-FWC reviewed product(s) being offered. Separately, non-FWC approved funds could be subject to an 'earned-profits' requirement in which it (or the average fund member) must attain above-median net returns for a specified period before it was allowed to pay profits to shareholders while soliciting default members.

- SMSF formation should be subject to much stronger regulation: (1) Formation should be pursuant to the recommendation of an independent, licensed financial advisor; (2) The

advisor’s recommendation should be subject to liability for the quality of the advice, accuracy of the representations therein, and for the sufficiency of the process by which the advice was prepared (however, satisfactory process would not excuse poor quality advice or misleading statements or omissions), and (3) SMSFs could only be formed with a sufficient starting minimum balance amount, that would be indexed.

# 1. Findings on Performance & Engagement

Many of the findings set out in the Draft Report in respect of the performance of the system and its segments are welcome and consistent with what other researchers have found in previous years: that the “industrial model” of delivering superannuation – workplace default products determined by industrial instrument, managed by not-for-profit trustees, governed by equal representation boards – is demonstrably superior to the retail model in terms of the net returns it delivers to members and how it fulfils its fiduciary duties to disengaged and low-information employees in a compulsory system.

## 1.1 Investment Performance

In relation to investment performance the Draft Report found that outperformance is mostly concentrated in the not-for-profit sector of the industry, revealing ‘a systematic performance divide’ with an underperforming retail sector. Strong overall performance also characterises the default segment.

The Draft Report notes:[1]

> ‘Most (but not all) underperforming products are in the retail segment’ (p. 2)
>
> ‘As a group, not-for-profit funds delivered returns above the benchmark tailored to their average asset allocation, but retail funds as a group fell below theirs’ (p. 9)
>
> ‘Not-for-profit funds, as a group, have systematically outperformed for-profit funds…retail funds dominate the tail of underperformance’ (p. 45)

In the Draft Report’s analysis of the 12 years to 2016 the default segment, defined as all MySuper products and their precursors, generated returns above their tailored benchmark. The Draft concludes that ‘many default funds have demonstrated strong investment performance, to the benefit of their members’ (p. 25).

Fees can play an important role in explaining relative performance. Again, the Draft finds significant differences between the two groups:

> ‘Fees for not-for-profit funds have been largely flat over time, but on average remain well below the fees charged by retail funds. And fees charged by retail funds remain relatively high, at least for choice products’ (p. 16)

The Draft Report’s analysis of the choice segment does not distinguish between not-for-profit and retail products. This analysis should be undertaken and published for consultation prior to the Final Report.

ISA has identified a number of important methodological problems with the benchmarking analysis reported in the Draft Report. We intend to make a supplementary submission detailing our concerns and offering an alternative analysis.

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[1] The page numbers below refer to the Commission’s Overview document.

Choice in superannuation is often presented by some in politics, the media and the superannuation industry as an inherent good: a vital mechanism that enables consumers to assert their interests over those of funds, compelling funds to offer better performing products in order to capture the custom of engaged members.

The findings in the Draft Report on the overall investment performance of the choice sector strongly suggest this representation of how choice operates under existing policy settings is largely mythical – lending credence to the maxim that financial products are mostly sold, not bought. And one mechanism used to sell poor quality financial products is to crowd the market with a proliferation of choices that most consumers do not have the resources to navigate in their best interests. The Draft notes:

> 'Underperformance appears to be more pronounced for the 11 million who have chosen their own products within APRA-regulated funds' (p. 14)
>
> 'There is much rivalry between funds in the choice segment, but it does not always deliver the best outcomes to members' (p. 24)
>
> 'There are signs of unhealthy competition in the choice segment (including the proliferation of over 40000 products)' (p. 2)
>
> 'Members get excessive choice at the expense of less comparability, and even highly engaged and financially literate members struggle' (p. 20)

In addition, for many who have chosen the SMSF sector – often advertised as the embodiment of consumer sovereignty and control – the results, particularly for those with less than $1 million in assets, have been 'significantly worse than institutional funds, mainly due to the materially higher average costs they incur due to being small' (p. 14).

The picture that emerges from the findings on performance is a system where many of those who have apparently made a 'choice' (or who have been sold into a product because of marketing or advice) are losing out. Where a choice has been made in favour of a non-APRA fund, a retail fund, or a choice product many will retire with less than they otherwise should.

Using their current methodology, the Draft also reports some underperformance among industry funds. The analysis of the composition of underperforming funds for the period 2006 to 2016 (with a 2016 static asset allocation) finds that 17 per cent of industry fund assets are in underperforming funds. In the retail sector 94 per cent of assets are in underperforming funds.[2]

So while there is some underperformance in parts of the industry fund sector, the risk that an employee will find themselves in an underperforming fund if they 'choose' (or are sold into) a retail fund is significantly greater.

This should warn against reforms that make it easier for employees to be sold, advised, marketed or nudged into retail funds. Unfortunately, despite the evidence the Commission has itself generated, it appears intent on recommending changes to the industrial default system that are very likely to do exactly that. We discuss the significant problems with the Assisted Employee Choice model later in this submission.

[2] Table 4.23 in Technical Appendix 4.

## 1.2 Member Engagement

Industry super funds have long argued that low levels of financial literacy and understanding of superannuation is widespread and that this has profound implications for how employees should be connected to funds that not only deliver good net returns, but which do not attempt to exploit disengagement by attempting to cross-sell and upsell them into products that are not in their best financial interests.

This view is in sharp contrast to the public statements of retail funds, their representatives and political supporters. For them problems of literacy and understanding, with resulting poor choices, are rarely acknowledged. Under this view, the primary goal of policy is to remove obstacles to choice, allegedly so that members can more freely exert pressure on funds to supply better products. The improbable rationale behind this line of argument is that retail funds want members to exert greater competitive pressure on them, so making it harder for them to generate revenues for their corporate parents.

We welcome the Draft Report's conclusion that many fund members do not possess levels of engagement, literacy and understanding that enable them to engage effectively with the superannuation system to secure their best financial interests. The Draft notes:

> 'Members at all stages find the super system too hard to navigate, and do not know where to turn for help. While there is no shortage of information, many find it complex, overwhelming and inconsistent with their needs' (p. 20)
>
> 'While many Australians have good broad knowledge of the superannuation system, many lack the detailed understanding necessary for effective engagement' (p. 49)

Attaching figures to levels of engagement is difficult. But based on the estimates reported in the Draft, around 68 per cent of members possess levels of understanding that are likely to generate poor decisions. While the remaining 32 per cent are thought to have 'good financial and super literacy', whether this actually leads to effective choices in practice is not known.[3]

The Draft Report is too cautious. Systematic underperformance in the choice and SMSF sector would tend to suggest even good levels of financial literacy is not sufficient. And this is not a surprise because literacy and information are only part of good decision making.

At times the Draft Report acknowledges that the causes of low levels of 'effective engagement' cannot be explained only by reference to the useability of available information. The causes run deeper than this:

> 'Cognitive constraints and behavioural biases also contribute to disengagement. Examples include myopia, complexity of long-term decision making, loss aversion, reliance on mental shortcuts, a tendency to procrastinate and general apathy' (Draft Report, p. 13).

These deep and persistent sources of poor effective engagement should warn against an over-reliance on disclosure to deal with the inefficiencies that have been identified across parts of the superannuation system. Some of the problems of doing so will be discussed in the next section.

While many of the reported findings on engagement are welcome, if not surprising, there is little exploration in the Draft Report of the dynamic between limited capacities for effective

[3] Box 5.2 in the Draft Report, p. 225

engagement among members and how this is actively used by some funds to secure their commercial goals.

The Commission's Draft Report into competition in the financial system offers an insightful picture of this dynamic. While that report did not deal directly with superannuation, the motives and behaviours it observed are mimetic across retail finance. It painted a bleak picture of how many for-profit financial institutions actively cultivate and exploit poor customer understanding – a picture that will resonate with anyone who has been following the proceedings of the current Royal Commission. That Report included the following observations:

> 'Much of what passes for competition is more accurately described as persistent marketing and brand activity designed to promote a blizzard of barely differentiated products' (p. 2)
>
> 'Few consumers either read or understand terms and conditions for products purchased, and it would not be hard to conclude that a segment of the financial system is motivated to keep it that way' (p. 29)
>
> 'While not all financial institutions are the same, the vast majority are using tactics designed to lure new customers in and then exploit the system complexity to retain them' (p. 27)

However, in relation to the superannuation system, the Draft Report appears reluctant to ascribe motive and intent to institutions who are manifestly exploiting low levels of engagement and understanding to market and sell members into poor performing funds and products.

On the one hand, the Draft cites lack of evidence to avoid endorsing such a view (pp. 296-297). On the other, the Draft acknowledges that there has been resistance to the introduction of choice product dashboards (p. 39). The fact of this resistance provides important insights into the motives and behaviour of retail funds in the choice space. But the Commission does not make obvious connections between fund behaviour and member outcomes to reach important conclusions.

When the Draft Report does acknowledge risks associated with the retail model, such as upselling in the context of the proposed Assisted Employee Choice models, the proposals to deal with the risks are woefully inadequate. We discuss these later.

## 1.3 Material Gaps in the Findings

A fundamental gap in the Draft Report's analysis is that it does not explore *why* it finds that not-for-profit funds systematically outperform. And the Draft does not explore *why* products members have chosen – whether retail fund or SMSF – tend to underperform.

And because the Draft does not seek to attribute causes to these phenomena, rational policy responses cannot be constructed.

For example, the effective stance of the Draft appears to be that those who are in underperforming sectors are probably there by choice, but the best that regulation should do is improve the quality of disclosure in the hope that they eventually realise they could do better.

The logical approach would have been to first establish why millions of employees are in poor performing choice products, and then design recommendations that deal directly with those causes. But the Draft Report does not do this. No explanation is offered. Instead the assumption is simply made that poor quality information is probably a cause and so improving that information is the solution.

This gap in the Draft Report's analysis leads to recommendations on dealing with the most inefficient segments of the system that will do little to protect members and lift their retirement living standards. Although the Inquiry has spent several years examining the efficiency of the superannuation system and how to improve it, there remains time to address this conspicuous failure. However, failure to develop robust evidence that outlines the *causes* that underlie the headline findings of the Draft Report will undermine the credibility of any policy recommendations in the Final Report.

We discuss the draft recommendations next.

# 2. Inadequate Responses to Inefficiency

The Draft Report concludes that the most inefficient segments of the superannuation system can be located mainly in retail funds, choice products and SMSFs.[4] All three have grown in part because they are widely promoted as providing opportunities for individuals to join a product that is best suited to their particular needs and circumstances. And all three have, on average, been found to underperform.

To tackle these inefficiencies the draft recommendations focus mainly on disclosure:[5]

- Draft Recommendation 9 states that the Government should require funds to publish simple, single-page product dashboards for all superannuation products.
- Draft Recommendation 10 states that the Government should require the ATO to present a single-page product dashboard on a member's existing account(s) on its centralised online service. The Government should also require all funds to actively provide their members with product dashboards when a member requests to switch from a MySuper product to a choice product within the fund.
- Draft Recommendation 21 includes recommendations that ASIC should set and enforce standards for the meaningful disclosure of information to members on superannuation products and insurance policies (in addition to product dashboards).

## 2.1 Neglect of SMSFs

While the Draft Report offers some recommendations relevant to APRA-regulated choice products, it makes no recommendations to tackle the problem of SMSFs. Those with less than $1 million in assets comprised approximately 84 per cent of SMSF members in 2016 – a sub-group that the Commission finds to have performed 'significantly worse than institutional funds' (Draft Report, p. 14).

Given that several hundred thousand people appear to be using a superannuation vehicle that is not in their best interests, it would seem appropriate to ask *why* this is the case. Having identified the reasons it would then have been possible to recommend measures that would help protect these members from engaging in self-inflicted financial harm.

But the Draft Report expresses no interest in *why*, and offers no research that may help to clarify the matter. This neglect of an important source of inefficiency in the superannuation system is difficult to reconcile with the Inquiry's Terms of Reference which explicitly direct it to include SMSFs in its evaluation. When the Government set those Terms of Reference it presumably

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[4] Although the Draft Report found that SMSFs with balances above $2m perform roughly comparably to institutional funds, that is not a reason to separate these SMSFs off into a special category, leaving only the SMSFs of $1m and below under scrutiny. First, SMSFs don't start at $2m, so the period of buildup to the level where SMSFs might be reasonable structures represent major inefficiencies. Second, SMSFs with over $2m are a small share of the total SMSF sector. Third, the comparison that suggests SMSFs above $2m are competitive with institutional funds is dubious – comparing a $2m account with an average account at an institutional fund ignores the scale effects that would occur if SMSFs were placed in institutional funds (were that to happen the economies of scale might lead the $2m SMSF to no longer be competitive).

[5] The Commission also hopes that the AEC shortlist will generate powerful incentives for improvements across all parts of the superannuation system. We discuss why this is unlikely when we discuss the problems of the Assisted Employee Choice model.

expected the Commission to recommend solutions if problems were found problems in the SMSF sector.

However, following publication of the Draft Report, ASIC has recently issued the results of its research into why people establish SMSFs, their experience of running them, and the role of advisers.[6] ASIC founds that:

> ‘Many SMSF members do not properly understand the advantages and disadvantages associated with setting up and running an SMSF’ (p. 10).

Further, in relation to the role that advisors play in establishing SMSFs, an independent expert was asked to review a sample of advisor client files. ASIC then undertook its own review. ASIC states:

> ‘In an unacceptably high proportion of the files reviewed, advice providers did not demonstrate compliance with the best interests duty and related obligations. The non-compliant advice ranged from process failures through to failures that were likely to lead to financial loss. We observed some particularly concerning examples of advice where we considered that clients were likely to suffer significant financial detriment as a result of following the advice’ (p. 55)

In relation to *why* much advice was not compliant, ASIC is clear:

> In 214 files (86%), we found that the advice provider appeared to have prioritised their own interests, or those of a related party of the advice provider, over the client’s interests in breach of s961J. In general, the conflict of interest arose because the advice provider, or a related party of the advice provider, obtained fees or other benefits as a result of the advice provided (e.g. fees for auditing the SMSF, arranging finance for the SMSF and sourcing a property for the SMSF). (p. 69)

These findings reinforce our position, expressed at the Inquiry’s recent public hearings in Melbourne that being ‘sold into’ is an appropriate way to describe how many members end up in poor performing superannuation products.

## 2.2 The Social Policy Purpose of Superannuation

The Draft Report’s apparent indifference to protecting those who have been sold into inappropriate SMSFs is indicative of the broader framework that the Commission has adopted when prioritising problems and recommending reforms: that those outside the default MySuper segment should be regarded as having exercised choice, they therefore deserve less protection, and any financial harm they suffer is ultimately a matter for them as individuals to deal with and rectify.

However, this approach is not appropriate because the system rests upon public policy, and exists to deliver a social policy outcome.

Superannuation contributions were mandated in 1992 for a collective social policy purpose: to help support higher living standards in retirement than would be likely if retirees relied solely on the Age Pension. For some, their superannuation savings will supplement their Pension. For others, super will replace some or all of it.

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[6] ASIC (2018) SMSFs: Improving the quality of advice and member experiences, Report 575.

The performance of the system has collective social implications. If it underperforms, in whole or in part, retirees will have lower living standards than intended.  In addition, they will be less able to provide for themselves than otherwise and more public resources will be needed to support the retirement income system. Underperformance will negatively impact the fiscal position of future governments, reducing their capacity to direct public resources to meeting other social needs.

At ISA's request, Rice Warner has modelled the historical and projected impact on tax receipts, government expenditure on the Age Pension and retirement income adequacy of leaving individuals to fend for themselves in the "choice" part of the super system. A full copy of Rice Warner's report will be provided to the Commission when all of the requested modelling complete.

The modelling conducted by Rice Warner includes forward looking projections that estimate the implications for Age Pension expenditure and earnings tax payments over a 20 year period to 2037 under four scenarios:

- Earnings, fees & premiums for retail funds set at levels consistent with industry funds
- Earnings, fees & premiums for industry funds set at levels consistent with retail funds
- Earnings, fees & premiums for retail funds set at levels consistent with not-for-profit funds
- Earnings, fees & premiums for not-for-profit funds set at levels consistent with retail funds

The projection results for Age Pension expenditure are presented in Figure 1.

## Figure 1 Impact on Age Pension expenditure (in today's dollars) relative to BAU

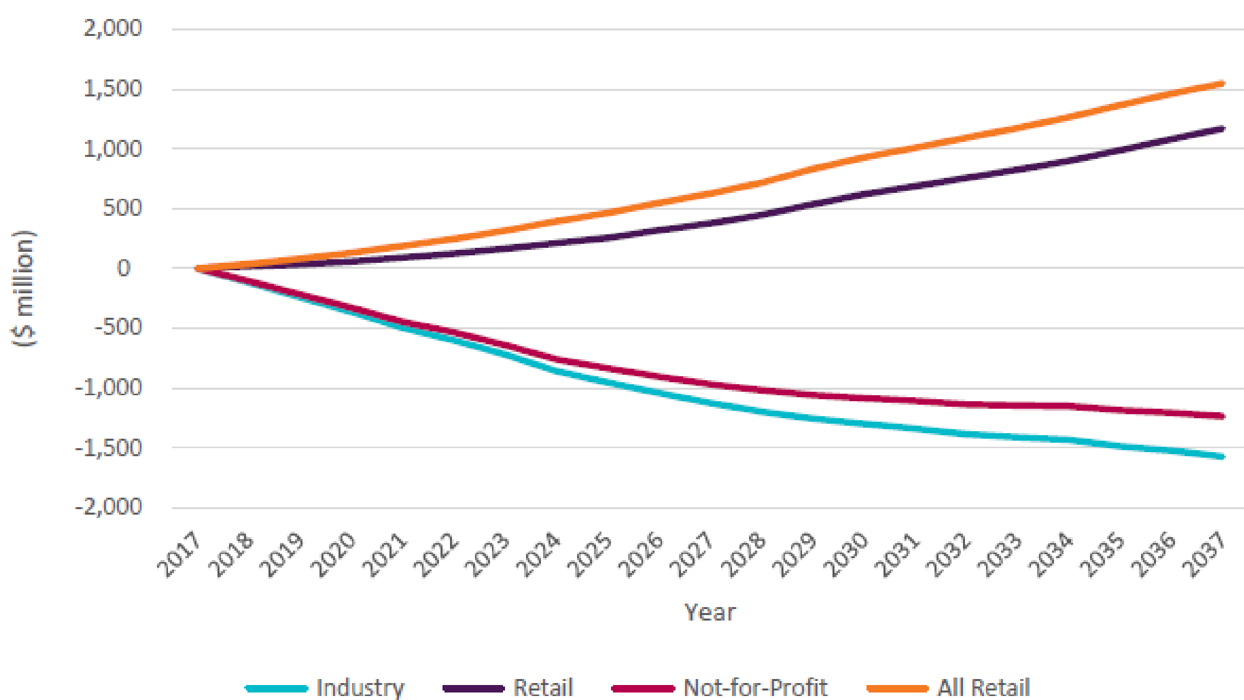
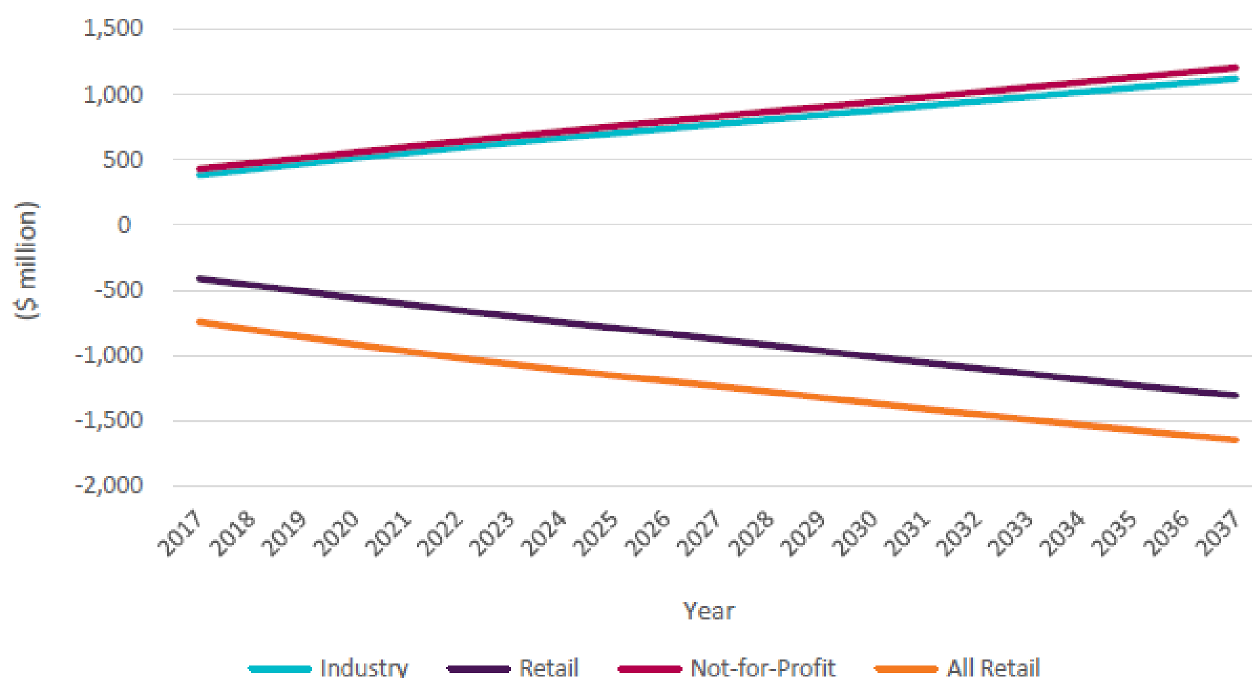



Figure 1 shows that because of the superior performance and accumulation of assets by not-for-profit funds, the not-for-profit scenario is projected to reduce Pension expenditure by $1.2 billion (or 1.7 per cent) in 2037. By contrast, where the system operates on the basis of retail earnings, fees and premiums Pension expenditure is projected to be $1.5 billion (or 2.2 per cent) higher.

Figure 2 illustrates a similar pattern of underperformance by retail funds generating additional costs for government, in this case a decrease in earnings tax paid by members by $1.7 billion (or 12.9 per cent) in 2037 under the all retail scenario. Under the not-for-profit scenario earnings tax paid is higher by $1.2 billion (or 9.5 per cent) in 2037.

### Figure 2 Impact on earnings tax paid by members (in today's dollars) relative to BAU




The significance of this modelling is that it helps to illustrate that underperformance has collective implications. In this context the efficiency and performance of *all* parts of the superannuation system should be of equal concern from a public policy perspective. If some employees are sold, defaulted or advised into poor products, this has negative social consequences.

Minimising the risk of such harm should be a first-order reform priority. It is a risk that is endemic to the system as a whole because nearly all working Australians are (correctly) compelled to make contributions – but they do so in a context where levels of understanding and effective engagement are low, and some providers exist primarily to help generate profits for shareholders.

So while the performance of the default segment should be a matter of ongoing public interest, the Commission is wrong to rely almost exclusively on better disclosure – and dashboards in particular – to improve the lot of the millions of employees who currently sit outside that segment.

## 2.3 The Limits to Dashboards

The Draft Report invests a lot of faith in the capacity of dashboards to improve decisions and improve outcomes for members, particularly those in the choice space or those who may be advised to enter that space.

ISA supports the provision of readily accessible and useful dashboards for all superannuation products to those members and others who wish to make use of them. But there is little reason to believe that increasing their quality, availability and applicability will help drive better outcomes for most members.

MySuper dashboards have been in widespread use across the industry for several years. However, there is no evidence that they are used by significant numbers of members to make better decisions.

According to analysis in the Draft Report, there are nearly 2 million accounts in MySuper products that underperform.[7] If the members impacted by this underperformance made effective use of dashboards, presumably there would be many fewer. But because they do not appear to, it has fallen to APRA to intervene on their behalf to challenge some trustees about the performance of their MySuper products.

This strongly suggests that members are as disengaged from MySuper and MySuper dashboards as they are from the rest of the system.

The Draft Report position seeking 'to make dashboards even more useful' (Draft Report, p. 38) is therefore not well-founded.

There is currently no evidence-base from which conclusions about the usefulness of MySuper dashboards to most members can be drawn. However, there is anecdotal evidence from retail and not-for-profit funds that by far the most frequent users of MySuper dashboards are those who work in the superannuation industry and who use them for generating market intelligence on what other funds are doing.

Before assuming the utility of dashboards for driving better outcomes for members it would have made sense to investigate the extent of their current use by members, and if such usage actually resulted in better outcomes. Unfortunately, in its surveys of members and funds the Commission failed to do this.

In Draft Recommendation 10 the Commission suggests that all funds should be required to actively provide their members with product dashboards when a member requests to switch from a MySuper product to a choice product within the fund.

There are some obvious flaws with this proposal.

Firstly, the requirement will only apply to switching within a fund, not from a MySuper product in one fund to a choice product in another.

Secondly, the requirement does not cover members who are already in a choice product and who may be approached by their fund, or another fund, to join a different choice product. Again, this obvious flaw suggests that the Commission regards those in the choice space as being in less need of protection when the evidence supports the opposite view.

Thirdly, and most importantly, the effectiveness of the dashboards will depend partly on their content and, critically, the immediate relevance of that content to each member's particular circumstances.

One weakness of the MySuper dashboard is that it assumes, in the interests of simplicity, a balance of $50,000 for the purposes of disclosing fees. Because of this, some retail funds game

[7] Draft Report, p. 12.

their disclosure so that their fees at $50,000 are similar to that charged by other funds. However, for balances above the $50,000 benchmark fee levels charged by retail funds can increase significantly. But this will not be apparent from comparing dashboard metrics.[8]

One response could be to provide more information about fees at various balances. But this would complicate the dashboard and invite new forms of gaming. Similar complications arise with the present disclosure of a single short-term risk metric appropriate to members approaching retirement when most members of a fund are likely to have longer-term investment horizons.

This points to a key dilemma for policymakers when they ascribe a normative priority to choice and then want to rely on dashboards as 'a prime mechanism' (Draft Report, p. 237) to guide that choice.

On the one hand, because member understanding and capacity for effective engagement is low, there is a need to simplify dashboards if they are going to stand a chance of being used by at least some members. On the other, because the actual circumstances of most members will deviate from dashboard simplifications, and these deviations open opportunities for gaming and confusion marketing, there is a need for a level of information on dashboards that will make their use even more unlikely.

An additional problem is that of using dashboards to make meaningful comparisons between MySuper and choice products. Tailoring the asset mix of choice products is a key means by which some funds market such products: promising members 'flexibility' and 'control' over deciding which mix of investments will allegedly meet their 'personal investment objectives.'

Members are often offered hundreds of different managed and listed investment options to choose from. However, once a choice product is tailored to deviate from its simplified representation on a dashboard it will become very difficult for even highly engaged members to make effective judgements about the relative costs and benefits of what they are being offered.

There is no evidence that current dashboards are effective or that relying on new dashboards will be sufficient to protect members from being sold into one of the many thousands of poor quality choice offerings.

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[8] A report in The Australian (06.01.2017) illustrates this point: 'For example, while a $50,000 balance would attract total fees of about $560 a year for a member with Hostplus or CFS First Choice Employer, the difference in the administration component of the fees for higher balances is stark. With a $250,000 balance, administration fees for Hostplus remain steady at $92 compared to CFS FirstChoice fees of $1560.'

# 3. Problems with Assisted Employee Choice

The Draft Report acknowledges that the current award-based default system, as it operated until 2014, has performed well and in the interests of most members. However, rather than consider how the system could be reformed to make it even more effective, the Draft instead proposes to abandon it and adopt a new and untested model: Assisted Employee Choice (AEC).

The model will operate as follows:

- Every four years an Expert Panel, appointed by the relevant Minister, would compile a shortlist of up to 10 funds.
- Shortlist selection would be guided by a number of factors including net returns, intra-fund advice and governance.
- The intention is that this shortlist would provide a safe list of high quality funds from which new labour force entrants, and existing employees who change jobs, can choose if they wish.
- The availability of the shortlist on an online system will nudge employees toward a high quality fund if they are uncertain about which choice to make.
- New labour force entrants, and those existing workers who change jobs, will be free to choose from the shortlist or any other product they wish. Employees that do not choose at all will be allocated to one of the shortlisted funds on a cab-rank basis.
- Those employees who do choose and are therefore defaulted will retain membership of that default product unless and until they make a choice. There will be, at most, one default-event: when they first join the workforce and do not make a choice.
- A fund that loses its place on the shortlist will retain the members it has gained from being on it – unless those members actively choose to leave.
- Enhanced MySuper standards will mean that the interests of members of de-listed funds will be protected. Only when a fund loses MySuper authorisation will it be obliged to surrender its members to another fund as determined by APRA.
- Universal participation by employers and employees would be facilitated by means of an online ‘choice of fund’ service run by the ATO through MyGov. This would be used by new workforce entrants to choose a product and by existing members to consolidate existing accounts and/or switch.

Among the claimed benefits of the AEC model is that by “encouraging members to interact with their super and make an active choice, this model would likely drive member engagement.” In addition, the model will contribute to reducing multiple accounts by no longer obliging members to join employer-specific default funds.

## 3.1 Multiple Accounts

A key justification offered in the Draft Report for scrapping the successful industrial default system in favour of an untested alternative is the problem of multiple accounts. We agree that multiple accounts and account proliferation are significant problems and require action. In previous submissions we have detailed how inactive accounts are present across the superannuation system, and are actually much more common in the retail fund-choice sector than in the industry fund-default sector.[9] We called for strong action then to deal with the problem.

The Government has recently announced measures to deal with unintended inactive accounts as part of its Protecting Your Super package. ISA is responding to the issues raised by the Government's announcement in the context of that proposed legislation.

On the matter of preventing future account proliferation, we recommended that a member's entitlements automatically transfer to the member's new active fund when they change employment. If a member starts a second job, their contributions from the second job should be placed in their existing active fund.

Where an employee already has two or more jobs, all their contributions should be placed in the fund with the highest balance.

These proposals result in the same outcome as the proposals contained in the current Draft Report: members who enter the super system in the future will have one account unless they affirmatively choose to have more than one.

A key advantage of this approach is that it helps to minimise the risk of members remaining in products that are not suitable for them. A member would enter the workforce and join a product under the protections offered by the industrial safety net, and then automatically transfer their entitlements to another fund in the safety net – unless they decide otherwise.

Unlike the Draft Report's current proposals, this model reduces the risk that members are sold into poor quality and inappropriate products, which they may then remain in for a prolonged period of time.

The Draft's emphasis on encouraging continuity in membership (based on hope rather than evidence that disengaged members will make good choices if they do momentarily engage), substantially increases the risk that employees will join a poor product and stay there.

We discuss why this is the case in greater detail below.

## 3.2 The Limits to Nudging

Central to the AEC model is the notion of 'nudging.' New workforce entrants and those changing jobs will not be compelled to join a good fund, or allocated to one by other agents on their behalf, but will instead be 'nudged' into doing so by being presented with an online shortlist from which they can choose. They can ignore the list if they wish. But the hope is that being presented with an approved list that has the status of comprising a set of publically endorsed 'trust products,' those who feel less able to make an informed choice will be nudged into choice universe within which their interests will be protected.

[9] See Table 2 in our 2017 submission 'Risky Business: Why the proposed models would not protect members'.

The Draft Report states that its reliance on nudging in the context of the AEC model flows from the lessons of behavioural economics, and this has led to recommendations that reflect 'how people actually behave, not how they should behave' (Draft Report, p. 34).

However, the engagement with behavioural economics and nudging in the Draft Report appears superficial and selective. For reasons discussed earlier, if the Commission was really concerned with 'how people actually behave' it would not rely on dashboards to protect members who have been sold into underperforming choice products.

In relation to nudging there is a substantial research literature that critically assesses nudging and specifies the conditions under which it should – and should not – be used.[10] The Draft Report demonstrates no awareness of this literature. Instead, the Draft merely asserts that the lessons of behavioural economics invariably lead to nudging as *the* policy tool. All the other tools that behavioural economists make use of in addition to nudging (e.g. mandates, strong defaults, budging) are simply ignored.

A more thorough engagement with the behavioural economics literature would highlight important flaws with the draft recommendations. It would also give the Commission more tools with which to address the problems identified.

For nudging to be justified and effective in a particular market several conditions usually have to be present:[11]

a) The broad pattern of actual choices is already sufficiently rational to not require more substantive intervention.

In general, nudging is sufficient when consumer autonomy is already delivering desirable individual and social outcomes much of the time. What is required is marginal and light-touch nudging of those relatively few individuals who, because of particular behavioural and cognitive biases, need some form of non-binding and covert encouragement to make better decisions. But because irrational decisions are a marginal problem, there is no justification for imposing a regulatory burden on the majority. Nudging the few, while prioritising consumer autonomy, is sufficient.

However, this condition is not present in the market for superannuation. There is ample evidence that most members of superannuation funds lack the knowledge, skills and cognitive capacities for effective engagement and rational choices. Some of the consequences of this are reported in the Draft Report in the form of millions of accounts in underperforming choice products whose membership has supposedly been decided by individuals making rational financial decisions.

Poor choices are not a marginal problem within the superannuation system, they are endemic and widespread. On the demand side they reflect persistently low levels of financial literacy, disengagement, the use of heuristics, and limited cognitive capacities. On the supply side they

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[10] For example: Conly, S. (2013) Against Autonomy: Justifying Coercive Paternalism, Cambridge University Press; Finighan, R. (2015) Beyond Nudge: The Potential of Behavioural Policy, Melbourne Institute; Goodwin, T. (2012) 'Why We Should Reject Nudge', Politics, Vol. 32(2); John, P., G. Smith and G, Stoker (2009) 'Nudge Nudge, Think Think: Two Strategies for Changing Civic Behaviour,' The Political Quarterly, Vol. 80(3); Leggett, W. (2014) 'The politics of behaviour change: nudge, neoliberalism and the state,' Policy & Politics, Vol. 42, No. 1; Oliver, A. (2013) 'From Nudging to Budging: Using Behavioural Economics to Inform Public Sector Policy,' Journal of Social Policy, Vol. 42, pp. 685-700; Oliver, A. (2015) 'Nudging, shoving and budging: behavioural economic-informed policy', Public Administration, Vol. 93(3).

[11] Several important conditions are discussed in an Australian context by Finighan (2015).

reflect the deliberate use of confusion-marketing, 'advice' and product proliferation by the retail sector in order to shift product and meet internal sales targets.

In this context, a light-touch 'nudging' approach that ascribes priority to consumer autonomy is an inadequate response.

b) Nudging can be appropriate when a failure to secure the desired behaviour does not impose negative externalities on others. A light-touch 'nudging' approach is warranted because the social costs of persistent poor choices by individuals are not significant.

This condition is not present in the market for superannuation. Superannuation was mandated for social policy purposes, and the underperformance of any part of the system (default, choice/SMSF) is a matter for public concern and poor outcomes not only are significantly harmful to individuals, but also create negative externalities. If large numbers of members find themselves in poor performing products in whatever segment, there will be negative consequences for each individual member, the broader economy and future public policy.

Such externalities make nudging an inappropriate basis for default design: 'if people are imposing negative externalities on others, why should we feel beholden to protect their liberty?'[12]

It is also important to recognise that choosing a financial product is not a form of liberty recognised as a fundamental human right, and little if any weight should be placed on restraining this "liberty".[13] Ironically, to the extent the recommendations in the Draft Report impinge on fundamental human rights, it does so in respect to the fundamental rights to association and union activity.[14] These conventions influence the development of the common law in Australia. In addition, they are used for statutory interpretation consistent with the view of the High Court that "a statute is to be interpreted and applied, as far as its language permits, so that it is in conformity and not in conflict with the established rules of international law" and that "Parliament, prima facie, intends to give effect to Australia's obligations under international law."[15]

c) Nudging may be effective when there are few 'counter-nudges' that are likely to render the policy-induced nudge ineffective. Counter-nudges can include efforts by those with an interest in ensuing that the nudges promoted by policy are not successful, perhaps because the success of such nudges would harm their commercial interests.

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[12] Oliver (2015), p. 18

[13] Cf., United Nations Instruments on Human Rights.

The Australian Government has ratified nearly all of the treaty instruments, including the following treaties: International Covenant on Civil and Political Rights; International Covenant on Economic, Social and Cultural Rights; Convention on the Elimination of All Forms of Racial Discrimination; Convention on the Elimination of All Forms of Discrimination against Women; Convention Against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment; Convention on the Rights of the Child; Convention on the Rights of Persons with Disabilities.

These instruments do not refer to financial product choices in any way.

[14] Although the Covenant on Economic, Social and Cultural Rights does not refer to financial instrument choices in any way, the Covenant does, however, give significant weight to the right to organise and act collectively through unions.

As a result, the Draft Report's effort to strip superannuation from industrial determination impinges on fundamental liberties

[15] *Minister for Immigration and Ethnic Affairs v Teoh,* [1995] HCA 20 (Mason and Deane JJ).

‘Counter-nudges’ in the form of marketing, sales, employer-deals, ‘advice’ and product proliferation already permeate the superannuation system, and their consequences for many members of choice products and SMSFs are indirectly acknowledged in the Draft Report.

The existence of a shortlist will provoke a massive effort by many funds not on that shortlist to attempt to effectively ‘drown it out’ and side-step it by increasing their efforts to counter the intended nudge-effect. One way they will do so is by increasing their marketing to employers. We discuss this in more detail below.

In summary, many behavioural economists view nudging as appropriate to markets with particular features. In general, this means markets where most behaviour is already broadly rational, the costs of not responding in desired ways to nudging will be less than the costs of stronger regulations, and there are few if any powerful counter-nudges that may significantly dampen the impact of the policy.

These features do not characterise the market for superannuation in Australia. The potential costs to individuals and the economy of a nudging mechanism that does not actively ensure members are connected to the best funds justify stronger measures.

While some behavioural economists advocate nudging under certain conditions, where those conditions do not prevail other approaches to solving behavioural problems are deemed appropriate. These include ‘budging.’[16]

In contrast to nudging’s focus on stimulating desired demand-side behaviours, ‘budging’ focuses on the supply-side. It recognises that in some markets for complex products there are deep asymmetries of knowledge and engagement which enable some providers to establish highly exploitative relationships with consumers. The complexity of the good or service is such that consumers are rarely aware of the full nature and scale of costs they are bearing. For most, acquiring the necessary knowledge to effectively challenge providers is impractical.

Where there is clear evidence of sustained and widespread exploitation of consumers by providers ‘budging’ involves pro-active intervention on the supply-side. This can involve prohibiting certain providers from participating in a market, or setting clear hurdles of behaviour and performance that they must meet if they wish to continue to participate.

In light of the exploitative relationship that many retail financial institutions and their superannuation funds have with members, and the costs these impose on individuals and society, a ‘budging’ approach should inform how members are connected to superannuation products.

To some extent the Draft Report’s approach does this. A degree of ‘budging’ is proposed, but it is limited to the default sector in the form of an elevated MySuper regime. Given the normative priority that the Draft assigns to member autonomy and choice in a market rife with opportunities for exploitation, the coherence of the Commission’s claim that it wishes to ‘ensure’ that members are connected to the ‘very best funds’ rests partly on the nature of the MySuper regime it wishes to see.

However, it is far from clear that the degree of budging being proposed in this context will be sufficient to guard against the risks to members posed by the AEC mechanism. These problems are discussed below.

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[16] Oliver, A. (2013) ‘From Nudging to Budging: Using Behavioural Economics to Inform Public Sector Policy’, Journal of Social Policy, Vol. 42, pp. 685-700.

## 3.3 Elevated MySuper Standards

The Draft Report acknowledges that a quality filter to help connect members to good super funds is necessary in the form of elevated MySuper standards. We agree on the need for a filter, but take a different view about how it should be applied.

In the context of our 'strengthened industrial safety net' model, in which a comprehensive quality filter is applied by the FWC and there are protections to inhibit members being sold into poor quality non-default products, minimum-standard product regulation (such as MySuper) is not strictly necessary. Quality is ensured by having the FWC determine the universe of good funds that can be listed in awards with expanded coverage, enterprise bargaining agreements, and the National Employment Standards.

Section 4 of this submission ('A Stronger Industrial Safety Net') discusses our approach in more detail.

However, we do not oppose elevated MySuper standards in principle, provided they are not mistakenly viewed as an alternative to a strengthened industrial quality filter and selection process.

The Draft Report recognises that the enhanced MySuper measures currently contained in the Government's proposed outcomes test are not sufficiently rigorous. We agree. In particular, where the Government is proposing that trustees make an annual determination that the financial interests are being protected, the Draft is proposing an independent verification 'to an audit-level standard' at least every three years that 'members' financial interests are being promoted.'

The Draft Report is further proposing that 'products that persistently underperform an investment benchmark tailored to their asset allocation by a material margin (as determined by APRA) for five or more years lose authorisation' (Draft Report, p. 466).

The Inquiry's proposal to require independent verification that members' financial interests are being promoted is a step forward from letting trustees do it alone. However, the nature of the assessment is equally important. There is a significant risk that choice products will be assessed against customised benchmarks that might show a particular product is reasonable relative to selected comparators, even though that product and its comparators are all fundamentally poor.

The proposal to include a quantitative benchmark that funds must meet in order to retain authorisation is an advance over the ambiguous criteria that feature in the Government's current proposals, but again the nature of the quantitative benchmark is important.

However these proposals, even if they survive intensive lobbying by banks and retail funds to dilute their content or prevent them from being implemented, are very unlikely to ensure that members who use MySuper authorisation to guide their choice will join the very best funds.

There are a number of important problems with the Government's proposed outcomes bill, not least that it doesn't extend the intended disclosures and member protections to choice products – most of which are sold by retail funds. In addition, the proposed bill does not give clear prominence to net returns and to meeting a minimum level of net returns to qualify for continued MySuper authorisation.

In the absence of such clear prominence as a basis for regulatory assessment the significant dispersion in the performance of MySuper products found by the Commission will continue. Some MySuper members will continue to receive net returns of CPI + 3.0 per cent, while others receive net returns of CPI + 5.0 per cent. In both cases the achieved return may meet or exceed the target

that each fund determines for itself. But the long-run outcomes for members will be very different – even though many members may reasonably assume that all members of APRA-endorsed MySuper products can expect similar financial outcomes when they retire.

There is nothing in the Government's outcomes bill that will ensure relatively poor performing MySuper products (including those that meet their relatively low target return rates), will come to deliver returns comparable to the best performing products. All it does, in effect, is require trustees to determine if the product they have an interest in maintaining is "protecting the financial interests of members."

This requirement is suffused with ambiguities and open to multiple self-serving interpretations. APRA will have increased powers to remove the very poorest products from the market, but this will not result in mediocre products delivering higher net returns.

The elevated MySuper standards being proposed by the Commission are more demanding in some respects, but on the critical issue of driving improvements in rates of net returns the proposals are flawed. By setting an investment benchmark tailored to each fund's actual asset allocation, the resulting benchmarks will simply reflect the nature of those assets. A fund that designs its MySuper product around a portfolio of assets that can be expected to generate lower returns than another with a better return profile will be assigned a lower investment benchmark to meet.

In this way the tailored approach proposed by the Commission risks embedding and legitimating mediocre performance, allowing funds to claim that by meeting relatively low performance benchmarks they are still promoting the financial interests of their members.

A related issue is how items such as administration fees are dealt with when calculating the investment benchmark. If an administration fee is deducted from the return benchmark that reflects a fee that is too high, or an average of fees across a particular segment of the industry that are too high, this will reduce the overall benchmark that the fund is expected to meet, effectively assuming that the applied fee level is in members' interests and simply has to be discounted.

If adopted this approach will do little to encourage optimal asset allocations that are in members' best interests, or to reduce excessive fees.

The point is not that all MySuper products should deliver the same performance, but that the floor of minimum acceptable performance should be raised.

On this issue the Commission gives the impression of facing in a number of conflicting directions.

On the one hand, the Commission notes in its Draft Report that being in a product that underperforms by 1 per cent over the course of a member's working life can reduce their eventual retirement balance by 23 per cent (Draft Report, p. 92). In short, small differences matter.

The Commission also states that the default system should 'ensure members are placed in the very best funds' (Draft Report, p. 25).

We agree.

However, comments by the Commission at the recent public hearings in Melbourne suggested that as long as the very worst performing tail of MySuper products was removed, then MySuper

products that deliver outcomes that vary by perhaps 3 per cent or more would be an acceptable feature of the elevated MySuper landscape.[17]

In the Draft Report the Commission states, correctly, that during accumulation 'most members have fundamentally simple needs' such as high net returns (Draft Report, p. 19). And yet the Commission appears ambivalent about ensuring such needs are met.

A more effective approach would be to specify a net rate of return of 'CPI + X%' over a rolling 10-year period for a model MySuper portfolio against which other MySuper products would be assessed for regulatory purposes. The model could be designed around a sustainable low-cost growth portfolio, with levels of fees allowed according to what the leading cohort of MySuper products charge for running a comparable set of assets.

This benchmark would set a standard for assessment based on what it is reasonable for a fund to achieve in terms of net returns for all MySuper members, against which the sources of the inefficiencies of poor performing products would be identified and used as a basis for requiring time-limited change prior to potential de-authorisation.

Such a model would provide a basis for compelling those funds who wish to remain in the MySuper space to adjust their assets, fees and costs accordingly. Some funds will conclude that making such adjustments is not compatible with their business models and exit the market.

## 3.4 Cross-selling and Upselling

In previous submissions to the Inquiry we have highlighted the use of cross-selling and upselling techniques by retail funds in their dealings with existing or potential members. As for-profit institutions whose primary concern is to maximise revenues for related corporate shareholders, being able to sell members into more expensive products or into additional products unrelated to superannuation has become an important commercial practice across the retail sector.

The Draft Report notes these risks but comments that intra-fund and inter-fund switching data does not by itself prove that movement from a default to a choice product is evidence of marketing pressures or a decision by members to join a product more suited to their needs. However, the Draft reports evidence of significant underperformance and high fees in the retail and choice sectors. Because of this many of those who have left default products for retail choice products have suffered poor outcomes. If members are not responding to marketing pressures, it would seem that they are deliberately choosing to lose money. This seems unlikely.

In the context of the proposed AEC model, and allowed by current law, if a retail fund obtains a place on the shortlist and so secures a new flow of incoming default members (who will be disengaged and vulnerable to sales) it is highly likely that those members will be subject to cross-selling and upselling pressures. The incentive to apply those pressures will be intensified if the fund has 'loss-led' its way onto the shortlist by, for example, substantially cutting the fees it will apply to all default members.

It is not appropriate for public policy on the one hand to compel employees to participate in a market for superannuation they do not understand, while on the other applying a default

[17] For example: '…if we've got a system in default where we've elevated MySuper so we've gotten rid of the bad tail and we've got a simple best in show to help members, so they've got a best in show to choose from and then they've got the MySuper authorised products, which are the good products, where's the risk of defaulting only once in that system?' (p. 187, Melbourne Transcript)

allocation mechanism that means their lack of understanding is very likely to be exploited by funds who exist primarily to maximise shareholder value for non-members.

The Draft Report acknowledges the risk of upselling to disengaged members (but not, it seems, that of cross-selling). However, the proposals to deal with upselling contained in the Draft Report are wholly inadequate. It is suggested that as part of the elevated MySuper standards trustees must report annually to APRA how many members switch to a choice product. The Draft Report states: “this information could be considered in future MySuper authorisation processes” (p. 436).

This recommendation lacks precision and substance. As the Draft Report notes, switching can be generated by marketing, or by member-initiated action. We suspect that marketing plays the dominant role, for reasons discussed above. If reporting of data to APRA is required, in theory it could attempt to distinguish between switching that resulted from contact being initiated *by the fund* and switching where the member initiated contact *with the fund*.

Having said this, policing the accuracy of switching data reported to APRA would be very difficult and time-consuming to undertake. The scope for manipulation and misreporting of figures by sales, counter and advice staff – responding to intense pressure from senior managers, and whose pay is strongly dependent on meeting targets – would be considerable.

For example, the Draft states that funds should be required to annually report switching ‘to a higher-fee choice product.’ It would be quite straightforward for a fund to discount the fee for the first 12 or 18 months, and then apply a higher fee thereafter. Under the proposed reporting requirement, the upselling would not be counted. Numerous other ways to game the requirement would be found as regulators constantly shifted the goalposts in vain attempts to capture the data they want.

In short, we doubt that retail funds can be trusted to provide accurate and meaningful data, and we doubt the willingness and capacity of APRA to check it.

But even if the accuracy and trust issues could be mitigated, and funds did accurately report to APRA how many default members had been actively sold into higher-fee choice products, the Draft Report is insufficiently clear about what should be done with the data. It is suggested that the information ‘could be considered’ in future MySuper authorisation processes.

That it ‘could be considered’ suggests that APRA should have discretion to maintain the MySuper authorisation of a fund even when it has evidence that the fund may be knowingly causing financial harm to some of its members. This would effectively mean tolerating the exploitation of disengaged members as a necessary or inevitable part of the default system.

This is a far cry from the Commission’s declared objective of ensuring that default members join the very best funds. Having acknowledged the risk of upselling, the proposed reporting obligation is insufficient.

As a minimum, any final package of reforms advocated by the Commission must include clear prohibitions on cross-selling and upselling – even though the difficulties of enforcing these prohibitions in the face of lobbying and regulatory gaming by retail funds will be considerable.

The dilemma the Commission faces is that by assigning a normative priority to consumer autonomy and choice, and so eliminating the protections afforded by the industrial safety net, the Commission is increasing the risk that disengaged members will be upsold into inappropriate products by retail funds – in a commercial and regulatory environment where such selling will be very difficult to detect and prevent.

### 3.4.1 ASIC's Product Intervention Powers

The Draft Report appears to offer two diametrically opposed views of the potential for AISC's proposed product intervention powers to protect members. In the context of upselling the Draft states:

> 'ASIC's new product intervention powers will strengthen its ability to guard against upselling.' (p. 29)

Later, the Draft states:

> 'The Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 proposes additional disclosure obligations on financial products and powers for ASIC to proactively intervene in relation to financial products by making orders prohibiting specified forms of conduct. These arrangements are yet to be implemented, so their impact on conduct in the superannuation industry it is not clear, particularly given that conduct is already regulated under the SIS Act. It is likely that the intervention powers would only be used in extreme cases where a product was of unequivocally no value to all consumers, not just where it was unsuitable given a particular individual's own circumstances.' (p. 344)

These positions seem contradictory. The Draft Report refers to the powers when seeking to deflect criticism of a recommendation, only to later acknowledge the powers are unlikely to be effective.

Setting aside the draft report's internal contradictions, the proposed intervention powers will be very unlikely to protect members from upselling, except in the most extreme circumstances. Providers will be accorded significant discretion in defining 'target markets' and the ill-defined notion of 'significant detriment' will very likely mean that only products that are 'of unequivocally no value to all consumers' will be subject to intervention. In this context the vast bulk of upselling that currently takes place will simply continue.

After many months of work the draft report's treatment of a well-known and critical risk to members is disappointing, and undermines the credibility of the recommendation.

## 3.5 Employer Influence

The Draft Report argues that the proposed AEC model no longer ascribes a role to employer choice in the default selection process. The online choice from the shortlist, or another listed product, means default selection becomes an employee-only exercise. It is argued that this is a positive feature of the AEC model because many employers do not have sufficient understanding of superannuation to make good choices on behalf of their employees from an award list. Also, some employers may face conflicted incentives when choosing a fund, perhaps responding to inducements from a provider.

While the proposed AEC model no longer ascribes a formal role to employer choice, it will not eliminate employer influence. There are times in the Draft Report when the Commission inadvertently points to circumstances that may lead some employers to exert influence over how employees interact with the proposed online system – but there is no discussion of the resulting risks to employees who use it.

The Draft states that under the proposed AEC model "Employers will still have scope to bargain with super funds on behalf of their employees to secure group discounts on fees or to develop tailored products or insurance" (Draft Report, p. 36).

An employer may negotiate a tailored superannuation package, perhaps as part of a broader package of financial services provided by the employer's bank. As part of this package an employer with poor understanding of superannuation may agree to a superannuation plan that is not in the best financial interests of their employees. Alternatively, they may knowingly agree to a poor quality plan because the range of other financial services is advantageous to them as the employer.

Either way, having signed-up to a particular superannuation product, it is very likely the employer will want new and existing employees to join it. And as the Draft acknowledges in a different context: "Pushing back on your employer's choice is hard" (Draft Report, p. 431). This is true – particularly for new and younger employees in non-union workplaces where there are often no formal mechanisms through which employees can challenge employer policy.

An important advantage of default selection via enterprise bargaining is that employee representatives have input into deciding which funds are used for default purposes. Under a strengthened Fair Work process, workers not covered by enterprise bargaining would be protected by having the choice-universe available to employers limited by the relevant award.

The Draft Report presents the AEC model as one involving only the employee and the online choice system, but in reality maintains the risks that involving employers can create, without the strengths and protections of the existing industrial approach.

## 3.6 Problems of Continuous Membership

Under the proposed AEC model there is an emphasis on employees remaining members of the default fund, or a fund they have previously chosen, until they actively choose otherwise. A new entrant to the workforce who does not make any choice will be allocated to a shortlisted fund on cab-rank basis. They will remain there until they select a different fund at a future date. An employee who changes jobs and who has an existing fund will also remain in that fund unless they choose otherwise.

When a new fund is chosen by the employee, the ATO will consolidate the previous account into the new one.

The Draft Report's rational for this approach is to reduce the account proliferation that can result when employees change jobs. Reducing proliferation is a key reason for the Commission wanting to break the link between the workplace and how members join particular funds.

We discuss a better approach to dealing with account proliferation in the context of a strengthened industrial safety net elsewhere in this submission. However, there are some important problems and risks associated with continuous membership that the Draft does not discuss.

Firstly, there is the risk that an employee is sold into a poor quality product by marketing or conflicted advice at a point in time, which then effectively becomes their life-long product if they do not make another choice. The proposed design of the online screen, with the employee's existing fund at the top, will likely have the effect of encouraging choice of that fund over others listed below.

Retail funds will be very likely to leverage their existing customer banking relationships, advice networks and marketing budgets to sell employees into their products, whether or not they appear on the shortlist. Given that many of these products have been found by the Inquiry to perform poorly, remaining in these products for any length of time will cause financial detriment.

The Draft Report acknowledges the risk that employees may be marketed into poor and inappropriate products, but offers no suggestions for dealing with this (Draft Report, p. 445). Instead, the Draft tends to present the AEC model as operating in a vacuum, with employees making choices only by reference to an online screen without any countervailing pressures from banks, sales teams, advisors, employers and advertising.

Secondly, the Draft proposes that as long as a fund retains its elevated MySuper authorisation, a fund that loses its place on the shortlist will retain the members it secured when on the shortlist. Continuous membership of a fund in the absence of an active choice means a member will remain a member of the de-listed fund until they act.

The view appears to be that if a fund retains its MySuper authorisation, even if it loses a place on the shortlist the member's interests will still be protected. We have discussed above why the ambiguities that surround assessing MySuper products by reference to 'promoting a member's financial interest' will very likely mean a wide dispersion in MySuper net return performance persists. If so, and assuming the shortlist comprises the best funds in terms of net returns, remaining a member of a de-listed fund may cause significant long-term financial detriment.

The idea that de-listed funds will seek to improve their performance in order to be re-listed in the future is not a sufficient protection.

It is quite possible that the cost to the fund of returning to the AEC shortlist, even if possible, would outweigh the benefits of holding onto legacy default members. This is likely to be the case for those funds who can secure membership by other channels such as direct sales, employer-deals, advice networks, branch offices and leveraging existing banking relationships.

The response of retail funds to the FOFA 'best interests' requirement is instructive. ISA has previously published analysis of Roy Morgan's Superannuation and Wealth Reports which indicates that in response to the ban on conflicted remuneration and the introduction of a best interest duty as a result of the FOFA reforms, bank-owned funds instead sought to grow their business by direct sales to individuals under general advice.[18]

It is entirely foreseeable that the same institutions, when faced with not being included on an AEC shortlist, will intensify their focus on other modes of distribution.

A further problem of continuous membership arises in the context of corporate funds. When employed by a corporation a member may be a member of a sub-plan provided by a retail fund with advantageous fee and insurance arrangements for corporate employees. However, when they leave employment by the corporation they will not be entitled to remain in the sub-plan for corporate employees and may be 'flipped' into another part of the retail plan that has higher fees and more expensive insurance.

Under the AEC model this will be their 'existing fund' in the online system, the proposed screen design will likely encourage continuity of membership, and they will remain in that fund until they act. They may engage and decide otherwise. Or they may assume that their prior fee and insurance arrangements, to the extent they are aware of them, will continue. Given the low levels

[18] http://www.industrysuperaustralia.com/assets/MediaRelease/160904-The-Hard-Sell.docx.pdf

of engagement and superannuation-related literacy noted by the Commission, we suspect the latter outcome will be more common.

## 3.7 The Expert Panel

Central to the AEC model is the role of a new Expert Panel in selecting an AEC shortlist every four years. The Draft Report argues that the FWC is ill-suited to hosting such a panel because the AEC model no longer allows a place for workplace relations and industrial precedent in connecting members to funds, and that the FWC's strengths lie in arbitration in the context of securing the objectives of the industrial relations system – not in ensuring employees join the best funds.

The assessment of the FWC in the Draft Report is inaccurate. We discuss the role the FWC should play in the context of a strengthened industrial safety net in section 4.

The Draft proposes that the new Expert Panel be established as a statutory decision-making body, with members appointed for a fixed term after positions have been publically advertised and candidates have been interviewed by 'a high level selection panel (including a member capable of representing member interests) for Cabinet approval' (Draft Report, p. 448). Conflicts of interest would be disclosed prior to decisions being made. The relevant Minister would not have powers to change the decision of the Panel once made.

By these new means a shortlist of the alleged 'best' funds will be decided. However, there are good reasons to doubt this will be the case.

Firstly, the Expert Panel is very likely to comprise individuals mostly or entirely with a background in for-profit financial services. In previous submissions we have recounted the political science research which demonstrates the superior lobbying capacities of the financial sector and their ability to present their interests as being coterminous with the public interest.[19] The financial sector, because of the resources it can command, and because its profitability is highly sensitive to government regulation, has the means and motive to attempt to 'capture' the shortlist selection process via its extensive experience of lobbying at Ministerial and Cabinet levels.

A strength of the FWC-based process is that the final decisions are independent of Ministers and Cabinet, and the FWC is institutionally distant from the financial industry and the lobbying channels it utilizes. The Ministerial and Cabinet involvement proposed in the Draft Report will politicize the process, tempting some senior politicians to use it to signal their dislike of not-for-profit funds by appointing individuals associated with retail funds and their corporate parents.

Secondly, if an Expert Panel makes its decisions primarily by reference to net performance, on the basis of the analysis reported in the Draft the shortlist of 10 is very likely to comprise only not-for-profit funds. In anticipation of this the for-profit sector is very likely to lobby intensely for the list to be longer and for the selection criteria to be diluted – in the name of offering 'real choice' for employees and securing a 'fair go' for all parts of the industry. The policy settings surrounding the membership of the Expert Panel, the length of the shortlist and the criteria for selection will become highly politicized and unstable, with the risk that a government will succumb to pressure to revise them, either when they are first being legislated or after.

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[19] Section 2.4 in 'Risky Business: Why the proposed models would not protect members', 2017

The Draft Report indirectly acknowledges the capacity of the retail sector to block or amend reforms that would be in the public interest – but which have not been implemented. In relation to repeated delays to the introduction of choice dashboards the Draft notes:

> Dashboards already exist for MySuper products and have been slated for choice products, but the process of developing these has been beset by industry resistance, missed deadlines and an attempt by the Government to exempt some products from the rules (p. 38)

There is no reason to suppose that such blocking and amending of proposals will cease even if Government attempts to implement all parts of the AEC model envisaged by the Commission, including an enhanced set of MySuper standards that give a measurable priority to net returns.

Thirdly, in the absence of selection criteria that assigns clear and consistent priority to proven long-term net returns, there is a risk that some applicant funds will attempt to loss-lead their way onto the shortlist and remain there, using the promise of low fees to cross-sell and upsell to newly acquired cohorts of AEC members.

Fourthly, the proposed shortlist will effectively establish a set of national funds that do not take into account how many of the best performing not-for-profit funds offer services, products and member support that are tailored to specific industries and occupations. Unlike retail funds, many not-for-profit funds do not simply receive and manage contributions. They also offer forms of default insurance appropriate to particular high risk occupations, education and member-engagement programmes designed for specific workplaces, and pro-active employer-compliance activities that help to reduce unpaid SG, particularly in industries where non-payment is a significant risk to disengaged members.

# 4. A Stronger Industrial Safety Net

Around the world, the best way of connecting employees to good quality funds is via the systems of industrial relations. This is the case in Australia as well, via a quality filter applied by the Fair Work Commission (FWC) to modern awards and enterprise bargaining agreements. This method of low-cost workplace distribution in which the representatives of employees and employers have a role in selecting the best funds for their industry has a proven record of acting in the best interests of most default members.

The Draft Report acknowledges that the default segment has worked well for most employees within it. This confirms what ISA has been saying about the segment for many years. In addition, ISA has previously provided performance analysis to the Inquiry that shows it is the presence of retail products within modern awards that has dragged the average performance of award listed funds downward.[20]

Removing poor performing funds is one of the reasons the FWC default listing process was reformed in 2012. Central to this revised process is a 4-yearly review in which an Expert Panel will decide the universe of good funds that can be named in particular awards.

Unfortunately the Government, with the support of retail funds, has not allowed the new process to operate. A consequence has been that a number of underperforming funds remain listed in awards and have continued to receive default contributions from some employers.

Given that connecting members to default funds via the industrial system has been proven to be in most members' best interests, the focus of reform should be on how to improve the current system – not on scrapping it in favour of an untested AEC model that will increase the risk employees are marketed into poor quality products that may not be appropriate to their industry and occupation.

## 4.1 The Commission's Criticisms of the Fair Work Commission

The Commission has made its case for AEC partly on the basis of a set of criticisms of the FWC that are ill-informed and misplaced.

### 4.1.1 Evidence-Based Decision Making

The Draft Report argues that the FWC is not suited to making merit-based assessments of superannuation products because it is a dispute solving body whose primary concern is with the regulation of industrial relations, with a heavy emphasis on precedent, standing and history.

This characterisation of the FWC ignores the role it plays in setting minimum wages. Every year the FWC conducts an annual wage review that involves considering submissions from the Commonwealth, employer and employee representatives, and other interested organisations and individuals. It also commissions new research to help inform its conclusions.

An Expert Panel reporting to the President assists the FWC in its deliberations regarding the setting of new minimum rates and their potential economic impact. The Expert Panel includes

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[20] Letter submission to the Commission dated 3 August 2017.

three part-time members, the selection of which is not limited to those with expertise and experience in the field of industrial relations. Expert Panel members are appointed for a set period of no more than 5 years, and on a part-time basis to ensure relevant working experience is added to the decision-making process.

The decisions made by the FWC in relation to setting minimum wages are not a function of precedent, standing and history. Nor are they determined by reference to 'the objectives of the industrial relations system' (Draft Report, p. 488).

Minimum wage decisions are the result of thorough evaluations of complex economic evidence contained in submissions and in original research commissioned by the Expert Panel. Where the Panel believes it needs more expert input and advice on particular issues before reaching a decision, it obtains it. The process is not rushed – it takes place over a number of months to allow full consideration of the relevant evidence and the making of a decision on the basis of that evidence.

The FWC fulfils its duties in respect of minimum wages in a diligent, professional and evidence-based manner. There is no reason to assume that it would fail to act similarly when deciding which superannuation funds should be eligible to be named in modern awards.

Just as the Expert Panel commissions independent research relevant to wage setting, so it would be expected to commission research relevant to superannuation from bodies such as the Australian Government Actuary, research organisations, and academic institutes.

The Draft Report undermines its credibility by presenting a simplistic and inaccurate caricature of what the FWC does, speculating that it is somehow incapable of making evidence-based policy decisions that are not grounded in industrial precedent.

### 4.1.2 Removing Underperforming Funds

In support of its argument that the FWC is an unsuitable venue to decide fund selection, the Commission states that 'the FWC has never shown any preparedness to remove underperforming funds from awards.' (Draft Report, p. 291).

This is an inaccurate characterisation of the work and priorities of the FWC since it began operating as Fair Work Australia in July 2009, and conveys a false impression. In 2009 the then government directed that the priority for the new tribunal was to complete a comprehensive modernisation of the award system. The new system would then be subject to review every 4 years. The modernisation process was completed in 2010 with a timetable to undertake the first review in 2014. This was to be the first opportunity for a comprehensive review of award provisions, including the application of the new default selection process legislated in 2012.

To suggest that poor performing funds have not been removed by the FWC because of a lack of 'preparedness' to do so is simply wrong.

The new selection process requires the Expert Panel to consider a number of factors when deciding the Default Superannuation List, including net returns, fees and costs. The implication of the Commission's statement is that it is reasonable to assume the FWC will disregard its duties in respect of making the List, and let underperforming funds remain.

The FWC is a tribunal with judges. Judges must regularly deal with changes in law and faithfully apply those changes to the facts. However, the Draft Report suggests that when it comes to

applying the 2012 default selection legislation, judges at the FWC cannot be relied upon to act appropriately.

Not only is there no evidence to support this speculation, it is insulting to the professionalism of a trusted public body.

The only way to know how well the stalled selection process will operate in the interests of members is for it to be allowed to operate, and for its performance to be assessed after an appropriate period of time.

A very simple and near-term recommendation that the Final Report should include is to promptly run the FWC process, even if the long term process of legislating the AEC is undertaken. It would take at least 4 years.

### 4.1.3 Accountability and Bias

The Draft Report criticises the FWC for lack of accountability to government. This is odd given that the Draft then ascribes considerable importance to ensuring the selection panel it wishes to establish outside the FWC is sufficiently independent from political and industry bias to command public confidence.

We agree that any panel that has the power to shape how the contributions of millions of employees are distributed between funds must command public confidence and function in a manner that justifies this confidence. However, where Ministers in any government are involved in selecting such a panel the risk of politicisation and bias (real or perceived) will always be present. It cannot be eliminated completely – but it can be managed.

The independence of the FWC from government is therefore an asset, not a liability. Research indicates that in terms of whose views can be trusted in ensuring 'the superannuation system works in the best interests of ordinary Australians', the FWC is the most trusted institution in the sample, at 65 per cent of the public – significantly higher than the financial regulators and almost 30% higher than the Federal Government.[21]

The independence of the FWC, and the high level of public trust in it, provides an existing basis for a default selection process that works in the best interests of members and commands public confidence. We don't need to re-invent the wheel. And most of the elements of such a process already exist in law.

A key risk for any panel responsible for superannuation fund selection, within the FWC or as part of the proposed AEC model, is that it comprises individuals who may no longer have formal connections with the industry (and so may be considered 'independent') but who nevertheless share a worldview and set of assumptions that in practice affect their decision making.

For example, a panel member with a long prior career in retail finance may regard upselling and cross-selling by funds to be an inevitable and desirable feature of 'good business' and delivering for shareholders. Therefore, funds who practice cross-selling and upselling should not have that counted against them when being considered for inclusion on a shortlist.

A panel that comprises members who share such views seems likely to decide a shortlist that looks very different to one that doesn't.

[21] UMR Omnibus research for ISA, February 2018.

The existing Expert Panel system within FWC guards against domination by any particular set of perspectives and interests.

Under the 2012 legislation, the Expert Panel responsible for deciding the Default Superannuation List must comprise seven members. It must be chaired by the FWC President (or Vice President). Three of the seven members must comprise part-time Expert Panel members who have been appointed because they have a background in finance, investment or superannuation. The remaining three members may comprise part-time members of the Panel responsible for minimum wage decisions and/or other full-time members of the Commission.

This composition of the Expert Panel helps protect against informal biases that may be shared by the three finance experts. In the process of assessing applications, considering submissions and commissioning research, the views of the finance experts will be challenged and checked by the majority of Panel members. This will also militate against the risk that a Minister stacks the Panel in favour of a particular set of interests.

The Panel must have input from appropriate experts, but will not be hostage to their world views.

Rather than speculate that this selection system will not work in the interests of members, it should be allowed to operate and then assessed on the basis of how it actually performs.

## 4.2 Reforms to Strengthen the Industrial Safety Net

For reasons discussed throughout this submission, ISA supports connecting members to good products via an industrial safety net in which funds are subject to a quality filter applied by the FWC. This method has served most default members well. Instead of scrapping it in favour of an untested high-risk alternative, the focus for policymakers should be on how to make the existing system better.

There are a number of reforms that would help to achieve this – in relation to the FWC Expert Panel, the coverage of industrial instruments, and protecting those members who leave the default system.

### 4.2.1 The FWC Expert Panel

The present Expert Panel system within the FWC would be improved by clarifying the process by which part-time experts should be appointed. The current legislation provides for appointments by the Governor-General on the basis of recommendations made by the responsible Minister following ‘a merit-based selection process.’

While the selection of part-time finance experts conducted in 2014 was an open and public process, it would assist public confidence if a more detailed process was prescribed.

The process should commence with the public advertising of positions. This should then be followed by formal interviews conducted by a panel comprising senior public servants who have experience of selecting candidates for senior public positions.

The interview panel could include a nominee by each of the social partners, as would be the case in those jurisdictions with highly regarded retirement income systems. A nominee by a consumer advocacy body (e.g. CHOICE) also may be appropriate.

On this basis the panel should agree a shortlist of candidates from which the relevant Minister must choose before securing final Cabinet approval.

As with current FWC practice, appointments of part-time experts should be for fixed terms of up to 5 years.

### 4.2.2 Coverage and Fund Selection

Not every employee is protected by a modern award. As a result, the workplace default super fund for a proportion of the workforce is only subject to MySuper regulation. In practice, this has allowed some funds to market poor quality default products directly to employers, sometimes offering inducements along the way.

This can be fixed to the advantage of millions of fund members.

There are two main categories of employees who are not currently covered by the default fund provisions in modern awards.

Firstly, there are employees in workplaces that are award-exempt because a registered agreement means the award that would otherwise apply no longer does.

In this context, the law can be amended to require that where an award does not apply because of a registered agreement, the agreement must specify a default fund set out in the relevant award, or if a broader approach is desired, the agreement must specify a default fund on the shortlist created by the Expert Panel.

Secondly, there are employees that are protected neither by an award nor an agreement.

In this context, as part of its 4 yearly reviews the FWC full bench should decide a list of 'general default funds.' The National Employment Standards should be amended to require the use of a fund from this list where awards and agreements do not apply.

To better protect members in workplaces covered by agreements, all agreements must name the fund or funds used for default purposes, and those funds must be selected only from those listed in the relevant award.

### 4.2.3 Protecting Members Who Leave the Industrial Safety Net

ISA has previously presented evidence to the Inquiry that the greatest source of inefficiency in the superannuation system and member harm is the movement of members from high performing default funds into lower performing bank-owned retail funds and SMSFs.

The findings in the Draft Report confirm this.

The default system must address this serious problem. A default system cannot adequately protect members unless there are safeguards to ensure members who leave the default are better off.

There are two kinds of policies that can protect members from self-harm upon exiting the default system: policies that make it harder for providers to exploit members, and policies that ensure members have sufficient capability to exit the system.

We have previously suggested the Inquiry give careful consideration to both kinds.

Focusing just on regulatory options that may apply to providers, options we have suggested include:[22]

(i) A *Better off test:* a requirement that providers do not provide advice or solicit a member acquisition unless the provider has reasonably determined that the member would be better off from a financial point of view.

(ii) An *Earned profits requirement:* this would seek to better align the interests of fund members and providers. It would require a superannuation fund (or the average member of that fund) to achieve above-median net returns for a specified period before profits from the superannuation business of which the fund is a part to pay profits to the fund's shareholders. In this way, shareholder profits would have been "earned" through outperformance.

Unfortunately the Draft Report has not given consideration to these potential measures (or to any others) to better protect members, preferring instead to rely on dashboards and disclosure – tools that have not worked to date and for which there is no evidence to suggest that they will.

In light of the Commission's repeated assertions that the superannuation system should serve the interests of members over those of funds, the Inquiry should give explicit consideration to these options in its Final Report. If it does not agree they should be implemented, then it should explain why.

[22] See ISA 'Risky Business', p. 15

# 5. Governance

Industry super funds support strong and effective governance arrangements that promote a robust culture of ethical behaviour, accountability, risk management and transparency.

That is why industry super funds were strong supporters of the enhanced governance requirements introduced through the Stronger Super reforms dealing with directors' fitness, skill and expertise, and enhancing policies around the management of conflicts of interest, transparency, risk management and board renewal.

While good governance is about much more than who sits at the board table, boards do matter.

Getting the right people on a board – properly motivated and with the right mix of courage, curiosity, scepticism, skills, experience and values – is integral to good governance.

The representative trustee model of governance that is found in the not-for-profit superannuation sector has a strong record of getting this right. Not-for-profit funds have a strong record of being governed by boards comprised of people from diverse backgrounds united by their strong belief that superannuation funds should be run only to benefit members and have a single focus on advancing members' best interest.

The proof is in the pudding, with industry funds outperforming retail funds by 1.8 per cent over the 10 years to June 2016,[23] while avoiding the scandals that have plagued the for-profit financial services sector.

However, despite the proven success of the representative trustee model of governance, on a number of occasions since 2015 the Government has sought to dismantle it. One of the arguments they have used in an attempt to justify this dismantling is that of 'best practice.' In previous submissions to the Productivity Commission and the Senate, ISA and others have shown this argument to be deeply flawed.

Unfortunately, this view is repeated in the Draft Report.

## 5.1 Mandating Independent Directors

The Draft Report's Finding 9.2 includes the statement that:

> 'Best practice governance for superannuation trustee boards would involve a 'critical mass' (at least one third) of independent directors.'

The Draft cites 'best practice' rather than evidence. The 'best practice' argument was also used by the Cooper Review in 2010 and the Financial System Inquiry in 2014 in support of mandating minimum proportions of independent directors to not-for-profit boards.

But neither inquiry cited evidence.

This is because there isn't any.

There is no evidence that the absence of a 'critical mass' of independent directors from the boards of nearly every not-for-profit fund is damaging the interests of members.

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[23] ISA analysis of APRA fund level net-return data, published March 2018.

Further, the absence of evidence has been previously acknowledged by the Productivity Commission in a different context.

As part of its inquiry into the selection of default funds to be listed in modern awards in 2012, the Commission considered the issue of fund governance and the composition of boards. However, rather than engage in the kind of evidence-free assertion that characterised Cooper and Murray on this issue, the Commission preferred to form a view based on what the available evidence indicated:

> '…there is a lack of compelling evidence to suggest that any one model of board structure should be viewed as clearly preferable in all cases. Therefore, the Commission does not consider it appropriate at this time for a particular structure to be mandated. Further, the Commission would not want to see restrictions placed on board structures without such restrictions having a sufficient evidentiary basis.'[24]

Since the Commission reached this conclusion no 'sufficient evidentiary basis' has emerged to support mandating independent directors on not-for-profit funds. If anything, experience points in the other direction.

This is why advocates of mandating independent directors have had to rely on abstract 'best practice' assertions in attempts to support their case.

While the Draft Report does not formally recommend mandating minimum proportions of independent directors, it is not clear on what basis it should be considered best practice.

The notion that boards of companies should comprise significant proportions of independent directors had acquired the status of policy orthodoxy among some governments and regulators around the time of the Enron and Worldcom failures. It was believed by some that imposing a majority of independent directors on companies would safeguard shareholders and the public from poor corporate behaviour.

However, these governance changes (as alternatives to stronger conduct-based reforms) were thrown into deep doubt by the events of 2008.

Nearly all the financial institutions responsible for excessive risk-taking, deceiving regulators and miss-selling to customers were governed by boards that comprised a majority of independent directors. Dr Wolf-Georg Ringe, Professor of International Commercial Law at Oxford University, has reflected on the impact of the 2008 financial crisis on what he calls 'the system' of corporate governance that had assumed the superiority of requiring independent directors:

> 'The 2007-08 global financial crisis has highlighted serious shortcomings in the system. Independent directors have in no way prevented firms' excessive risk taking; further, they have sometimes shown serious deficits in understanding the business they were supposed to control, and have remained very passive in addressing structural problems – in short, it is clear now that there were severe shortcomings and that boards can have 'too much' independence. A closer look reveals that under the surface of seemingly unanimous consensus about independence in Western jurisdictions, a surprising disharmony prevails about the justification, extent and purpose of independence requirements.'[25]

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[24] Productivity Commission, Default Superannuation Funds in Modern Awards Inquiry Report, No. 60, p. 102

[25] Ringe, W.G. (2013) 'Independent Directors: After the Crisis', European Business Organisation Law Review, Vol. 14.

In addition to the global events of 2008, the scandals that have engulfed parts of the Australian financial system in recent years should also cause policymakers to question the assumption that independent directors make for better corporate governance and better outcomes for consumers.

When government legislation mandating a minimum proportion of independent directors to the boards of superannuation funds came before the Senate in 2017, following an earlier failed attempt to pass similar legislation in 2015, ISA made the following observation:

> 'In the two years since the Government last wasted Commonwealth resources attacking industry super funds by introducing its heavy-handed governance legislation, the six largest financial institutions in Australia (and their subsidiaries, related entities and aligned advisors) have paid approximately $480,000,000 in refunds and compensation to customers as a result of admitted or alleged misconduct. They are all overseen by boards with a majority of independent directors – the kind of directors that the Bill seeks to impose on not-for-profit superannuation funds.'[26]

Since we made that observation in September 2017 the new Royal Commission has uncovered numerous examples of consumers being treated poorly by for-profit financial institutions, many of whom are governed by boards dominated by independent directors.

This is because mandating a 'critical mass' of independent directors (however defined) is a distraction from the real sources of poor corporate behaviour in the financial sector: a for-profit business model that drives companies to exploit low financial literacy and engagement across large swathes of the population.[27] In this context, and in light of recent evidence, few would now doubt that the presence of independent directors on the boards of such companies is an inadequate means of protecting and advancing the interests of consumers.

On a global level there is no one model of 'best practice' in the governance of pension funds. Practice varies. However, as we have previously informed the Inquiry, a number of the most highly regarded pension systems in the world – such as those in Demark and the Netherlands – are dominated by not-for-profit funds governed by boards that are mostly or entirely composed of representatives of employers and employees.[28]

In summary, there is no evidential basis for the Draft Report's finding that 'best practice governance for superannuation trustee boards would involve a 'critical mass' (at least one third) of independent directors.' The Commission recognised this in 2012. In fact, the best performing funds in Australia and in other countries utilise equal representation governance. If the Final Report insists on making recommendations about 'best practice' governance, equal representation governance is the only possible model to elevate.

The Inquiry's Final Report should acknowledge the lack of evidence on this issue and withdraw the draft finding.

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[26] ISA submission to the Senate inquiry into The Trustee Arrangements Bill, 29 September 2017.

[27] The role of the return-on-equity business model as a key driver of miss-selling, confusion marketing and excessive charging in retail finance is discussed in Bowman, A., et al (2014) The End of the Experiment? From competition to the foundational economy, Manchester University Press.

[28] Further detail on these governance issues was provided in our 2017 submission, 'Risky Business.' The Melbourne-Mercer Global Pension Index has repeatedly ranked the Dutch and Danish pension systems as the best in the world.

## 5.2 Regulation of Trustee Board Directors

Draft Recommendation 5 states that the Government should legislate a set of requirements on superannuation funds to:

- Use and disclose a process to assess, at least annually, their board's performance relative to its objectives and the performance of individual directors.
- Maintain a skills matrix for trustee boards and annually publish a consolidated summary of it, along with the skills of each trustee director.
- Have and disclose a process to seek external third party evaluation of the performance of the board (including its committees and individual trustee directors) and capability (against the skills matrix) at least every three years.

The Draft Recommendation also states that the Government should remove legislative restrictions on the ability of superannuation funds to appoint independent directors to trustee boards (with or without explicit approval from APRA).

ISA supports the Draft Recommendation.

However, on the matter of director skills the Draft Report states:

> 'Good outcomes are most likely when sponsoring entities recognise that recruitment of appropriately skilled directors is of critical importance' (p. 360)

This could be read to suggest that the Inquiry believes only individuals with already-existing skills and board experience should be recruited to fund boards. This approach would be bad policy.

A strength of the governance of not-for-profit superannuation funds is that many directors come from a variety of industrial and occupational backgrounds. Many of the most effective directors, some of whom have since become leaders in the superannuation industry, did not begin their time on boards with a fully developed set of formally accredited skills in topics such as investment and risk management. They acquired these skills through subsequent training and experience.

New requirements in relation to director capabilities must not inadvertently act to deter funds from cultivating the skills and experience of new directors who do not come from backgrounds in finance.

# 6. The Draft Recommendations

This section summarises our views on the Draft Recommendations already discussed in this submission, and outlines our views on the others.

**Draft Recommendations 1 to 4: Assisted Employee Choice**

ISA supports connecting members to good funds via a strengthened industrial safety net in which a quality filter applied by the Fair Work Commission (FWC) decides which funds can be named in awards, enterprise agreements and the National Employment Standards for default purposes.

Members within the industrial safety net should be protected from being sold-out of that net by requiring funds to meet a 'better-off test' or an 'earned profits requirement.'

The Assisted Employee Choice model, including the shortlist and elevated MySuper standards, will not ensure members are connected to good and industrially appropriate funds that deliver strong returns and in which trustees can be trusted to put the interests of members first.

While the recommended elevated MySuper standards are stronger in some respects than those currently being proposed by the Government, they do not give a sufficient measurable priority to net returns, and will not offer sufficient protections against upselling, cross-selling and behavioural risks.

The FWC is the appropriate forum for the selection of short listed funds because: (i) superannuation is deferred wages and an employment-related benefit, (ii) the FWC is an already trusted and respected public institution, and (iii) the FWC Expert Panel system provides for a combination of submissions from interested parties with commissioning new research to help inform final decisions.

The FWC is a tribunal that is independent of government with extensive experience of applying law to fact, and reaching evidence-based decisions that are not determined by precedent.

The Draft Recommendations in respect of Assisted Employee Choice, if implemented, will increase the risk that members are connected to poor quality funds that underperform and attempt to upsell them into poor quality choice products as a result of marketing, advice and deals with employers.

**Draft Recommendation 5: Regulation of Trustee Board Directors**

ISA supports the proposed measures to promote and disclose the assessment of director skills and capabilities. However, trustees should not be deterred from appointing individuals without prior experience in finance and supporting their professional development.

ISA supports the removal of legislative restrictions on funds to appoint independent directors when they believe it is in the best interests of members to do so.

There is no evidence that a 'critical mass' of independent directors represents best-practice in governance. If anything, and in light of experience globally and in Australia, the evidence suggests the opposite.

**Draft Recommendation 6: Reporting on Merger Activity**

ISA supports funds merging when it is in the best interests of affected members to do so. However, given that the Inquiry has found that many of the biggest retail funds are also among the poorest performers, promoting the merging of smaller funds will not by itself tackle poor performance in the system.

The Draft Recommendation states that trustees seeking to merge should disclose their intent to APRA when they enter a memorandum of understanding (MOU), and then disclose to APRA the reasons for any subsequent failure of the intended merger to proceed.

ISA supports.

**Draft Recommendation 7: Capital Gains Tax Relief for Mergers**

ISA supports.

**Draft Recommendation 8: Cleaning Up Lost Accounts**

ISA is responding to this issue in the context of the Government's Treasury Laws Amendment (Protecting Superannuation) Bill 2018.[29]

**Draft Recommendations 9 and 10: Dashboards**

ISA supports requiring funds to provide dashboards for all products. These dashboards must be useful to those members who wish to make use of them.

However, there is no evidence that dashboards will protect members against being sold, marketed and advised into poor quality products. Dashboards do not even approach being a sufficient response to the problems of underperformance that the Inquiry has found to be concentrated mostly in the retail and choice segments of the system.

The most effective way to connect members to good products is not by means of dashboards, but by implementing the strengthened industrial safety net discussed in Section 4 of this submission.

**Draft Recommendation 11: Guidance for Pre-Retirees**

ISA supports members joining a whole-of-life retirement income product while at work under the protections offered by a strengthened industrial safety net, with a member experience similar to a defined benefit pension plan. This means an income stream that commences automatically at retirement unless the member pro-actively chooses otherwise (together with a lump sum or commutation as determined by the member).

As a universal and compulsory system, superannuation when mature cannot be based on individual financial advice for each member to make product as well as benefit decisions. If individual financial advice is formally necessary, that is imminent proof of excessive complexity.

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[29] ISA's submission to Treasury on the Protecting Your Super package of measures, which deals with matters such as exit fees and insurance in greater detail, is here: https://static.treasury.gov.au/uploads/sites/1/2018/06/c2018-t286292-Industry-Super-Australia.pdf

ISA is engaging directly with the Government about these and other retirement-phase issues as part of the Government's proposed CIPRs framework.[30]

### Draft Recommendation 12: Exit Fees at Cost-Recovery Levels

ISA is responding to this issue in the context of the Government's Treasury Laws Amendment (Protecting Superannuation) Bill 2018.

### Draft Recommendation 13: Disclosure of Trailing Commissions

ISA does not support. All trailing financial adviser commissions should be banned with immediate effect. Requiring disclosure is an inadequate response when informed by the behavioural finance literature.

### Draft Recommendations 14 and 15: Opt-In and Cessation of Insurance

ISA is responding to these issues in the context of the Government's Treasury Laws Amendment (Protecting Superannuation) Bill 2018.

### Draft Recommendation 16: Insurance Balance Erosion Trade-Offs

ISA agrees there is a need for standardised and comparable disclosure of insurance costs and benefits that will be of use to those members who wish to make use of it.

However, we doubt that requiring funds to provide an insurance calculator on their websites will be broadly effective. The underlying variables are likely to be too complex to generate information that will be reliable for most members to make effective use of. A better approach may be to use a set of standardised assumptions against which the typical default insurance charge for the fund could be expressed.

### Draft Recommendation 17: Insurance Code to be a MySuper Condition

ISA supports.

### Draft Recommandation 18: Insurance Code Taskforce

ISA opposes the immediate establishment of the proposed Taskforce. Significant reforms to insurance in superannuation have recently been announced by the Government and their impact on the industry and members should be allowed to unfold and settle prior to a taskforce being established.

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[30] ISA's views on the proposed CIPRs framework and more details of our alternative approach are contained in our submission to Treasury here: https://consult.treasury.gov.au/retirement-income-policy-division/comprehensive-income-products-for-retirement/consultation/view_respondent?uuId=887952373

**Draft Recommendation 19: Independent Review of Insurance in Super**

ISA opposes. A significant degree of legislative and voluntary change is in the process of being implemented by the Government and the industry. The need for an Independent Review of Insurance in Super, and its parameters, should be a matter for decision in 4 years' time, not now.

**Draft Recommendation 20: Australian Prudential Regulation Authority**

ISA supports, subject to APRA undertaking prior consultation with the industry to ensure the information to be collected from across the industry is sufficient, comparable and consistent with advancing the interests of members.

**Draft Recommendation 21: Australian Securities and Investments Commission**

ISA supports.

**Draft Recommendation 22: Superannuation Data Working Group**

ISA supports. In addition, the Group should be required to issue papers on its work for the purposes of obtaining input from the public and interested parties.

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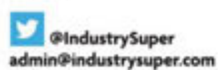

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Consider a fund's PDS and your objectives, financial situation and needs, which are not accounted for in this information before making an investment decision.