# 7 Performance of the default superannuation fund selection system

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

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

Finding

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

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

* The Stronger Super and related reforms provide an effective foundation to promote disclosure and comparability of default superannuation products and funds but, given the uncertainty surrounding the likely number, mix and quality of MySuper products, there needs to be a ‘quality filter’ to distinguish among them.
* There is an administrative burden for employers in being required to choose from the potentially very large number of MySuper products.

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

* The appropriateness of the MySuper product’s long‑term investment return target and risk profile for employees who derive their superannuation products in accordance with a given modern award (as a primary factor).
* The fund’s expected ability to deliver on the MySuper product’s long‑term investment return target, given its risk profile (as a primary factor).
* The appropriateness of the fees and costs associated with the MySuper product, given:
* its stated long‑term investment return target and risk profile
* the quality and timeliness of services provided.
* Whether governance practices are consistent with meeting the best interests of members, with particular focus on the mechanisms put in place by fund trustees to deal with conflicts of interest, and the transparency involved with disclosing those conflicts.
* The appropriateness of the MySuper product’s insurance offerings for employees who derive their default superannuation product in accordance with a given modern award.
* The quality of intra-fund advice.
* The administrative efficiency of the fund.

Given that the overriding objective of the default selection system should be the best interests of employees who derive their default superannuation product in accordance with a modern award, the Commission considers that its proposed factors for consideration represent the most relevant factors that apply across all default products, while also taking into account the interests of employers.

In some specific cases, there may be other factors, in addition to the seven factors above, that are relevant to the needs of employees who derive their default superannuation product in accordance with a modern award. Where such factors are present, the decision maker should be permitted to take them into account.

The factors for consideration are of sufficient importance to the best interests of employees who derive their default superannuation product in accordance with a modern award that decision makers should be required by law to consider them. As such, they will need to be enshrined in legislation.

Recommendation

The factors for consideration should be enshrined in legislation. The legislation should also allow the decision maker to consider other factors that may be relevant, provided it clearly and publicly states its reasons for considering those factors.

Some of the factors for consideration are specific to each default product (such as fees, investment return objective and risk profile). As noted in previous chapters, funds will be able to offer tailored MySuper products for large employers and may, in some cases, be permitted to offer more than one MySuper product on a public‑offer basis. The performance of each of these products against the product-specific factors for consideration could vary, perhaps substantially. Other factors for consideration (including administrative efficiency and governance processes) relate to the fund as a whole, or might, depending on the fund and its products, have to be considered on either a product or a fund basis (such as intra-fund advice).

It will therefore be important that:

* the characteristics of each product and of the fund are considered by the default decision maker
* both fund and product details are listed in awards (chapter 9).

### Process for considering the factors

The process by which these factors are taken into consideration will be the ultimate determinant of whether the best interests of employees who derive their default superannuation fund in accordance with modern awards are met if their superannuation contributions are allocated to a default product fund under a modern award. Importantly, the factors are subjective rather than prescriptive. To properly consider them will require a decision maker to analyse a wide range of complex information and exercise considerable judgement (the identity of the decision maker is considered in chapter 8). Judgement will be required on such matters as:

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

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

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

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

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

Judgements required of a decision maker include consideration of the factors identified by the Commission, their relative importance and the appropriate fit for employees who derive their default superannuation product in accordance with the relevant modern award. Given the need for a decision maker (at least in the medium term — see chapter 8), the Commission has also considered the extent to which the current system, and its decision makers, conform with relevant principles of good process.

Given the primary objective of the process is to meet the best interests of employees who derive their default superannuation product in accordance with modern awards, the Commission considers that the following principles should guide the assessment of the current process used to select default products. These same principles are used to assess the merits of reforms to the process (chapter 8).

Recommendation 2

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

* Best interests — there is an explicit focus on meeting the best interests of employees who derive their default superannuation product in accordance with a modern award.
* Contestability and competition — all default products have an equal opportunity to be assessed for listing in awards, and competition provides the incentive for the ongoing innovation, efficiency, performance and consumer focus of superannuation funds.
* Transparency — relevant information is made publicly available and potential conflicts of interest are declared.
* Procedural fairness — all parties have the right to put forward their case for consideration by an unbiased umpire.
* Minimum regulatory burden — each party involved incurs the minimum cost and inconvenience compatible with achieving the aims of the process.
* Market stability — the superannuation market is not destabilised.
* Consistency with other policies — alignment with other relevant policy directions, including the Stronger Super and Future of Financial Advice reforms.
* Regular assessment — all default products must earn their listing in an award on a regular basis.

There was broad support from inquiry participants for these principles (including from Ai Group, sub. DR79; AMP, sub. DR85; Business SA, sub. DR55; Cbus, sub. DR81; FPA, sub. DR76; Suncorp, sub. DR64).

The Queensland Nurses’ Union pointed out that trade‑offs between the principles may be required.

Some of the principles outlined in recommendation 7.1 for the selection and ongoing assessment for listing as default funds in modern awards may be contradictory. For example, promoting contestability could lead to increasing regulatory burden and instability of the broader superannuation system. (sub. DR61, p. 5)

The Commission acknowledges that different options for reform of the default superannuation selection system will meet each of these principles to a greater or lesser degree. To the extent that tradeoffs between the principles are required, these will be considered in assessing options for reform (chapter 8).

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

## The current fund selection process

### Selecting default funds in modern awards

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

#### During award modernisation

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

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

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

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

The financial outcomes for employees who derive their default superannuation fund in accordance with a modern award were not explicitly assessed by the AIRC.

We do not think it is appropriate that the [AIRC] conduct an independent appraisal of the investment performance of particular funds. Performance will vary from time to time and even long term historical averages may not be a reliable indicator of future performance. We are prepared to accept a fund or funds agreed by the parties, provided of course that the fund meets the relevant legislative requirements. (2008b, p. 6)

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

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

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

In accepting a fund or funds recommended by the parties, the AIRC was not required by the *Fair Work Act 2009* (Cwlth) to ensure that the parties had considered the relative merits of competing funds, or that they had necessarily proposed funds that would best meet the interests of employees who derive their default superannuation fund in accordance with the relevant modern award.

#### Since the commencement of modern awards

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

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

Between January 2010 and August 2012, 30 applications were made to vary the superannuation provisions of a modern award. A hearing was held for 22 of these applications. Over 70 per cent of the applications made during this period were successful.

##### Standing

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

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

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

|  |
| --- |
| Box 7.1 AMP application for inclusion as a default fund |
| In March 2010, AMP applied to Fair Work Australia (FWA) to vary the Professional Employees Award 2010. AMP’s application was supported by the Australian Information Industry Association (which is not a registered organisation and did not take part in industrial negotiations). However, the application was opposed by the Australian Industry Group and the Association of Professional Engineers, Scientists and Managers Australia (both registered organisations that were parties to the relevant pre-modern awards, and were involved in the negotiations that led to the development of the Professional Employees Award 2010). AMP was not listed as a default fund in any relevant pre-modern award or award-based transitional instrument that preceded the Professional Employees Award. (It is separately listed in other modern awards through historical precedent.)  FWA dismissed the application on the grounds that AMP did not have standing. FWA chose not to exercise its power to vary the award on its own initiative, “as it is clear that to include AMP Life Ltd would not be consistent with the approach taken in establishing default funds in modern awards.” (2010a, p. 2) |
| *Source*: FWA (2010a). |
|  |
|  |

##### Grounds

In decisions issued to date there have been three grounds on which variation applications have been granted. The first is whether the fund was listed in a pre‑modern instrument, such as a pre-modern federal award or a notional agreement preserving a state award, relevant to the modern award’s coverage. A pre-modern instrument will be relevant if it covered employees who are now covered by the modern award (FWA 2010f). The pre‑modern instrument will not be relevant if the employees for whom the contributions were being made are now covered by a different modern award (FWA 2010c).

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

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

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

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

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

January 2010−August 2012

|  |  |
| --- | --- |
| Ground | Number |
| Fund was included in a relevant pre-modern instrument | 14 |
| Consent of industrial parties | 4 |
| Contributions are already being made to the fund on behalf of employees covered by the award (as at 12 September 2008) | 11 |
| Fund merger or name change | 9 |
| Other grounds | 16 |

a Includes variation applications and applications brought in the 2012 Modern Award Review. Some applications have not yet been determined. Applications may be brought on more than one ground. FWA may base its decision on other grounds.

*Source*: Productivity Commission estimates.

#### Review

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

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

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

### Exceptions to the general award default arrangements

#### Awards without a default fund

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

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

Where awards do not list a default superannuation fund, employers are free to choose any complying fund as a default fund. There is little evidence about how these employers approach the task of selecting a default fund, though hypotheses can be made for several industries. For instance, because the Rail Industry Award 2010 and the Fire Fighting Industry Award 2010 cover industries that are (or have been) largely in the public sector, it is likely that most employers in these industries use the relevant public sector superannuation fund or its successor as their default fund.

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

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

#### Awards that allow contributions to be made to ‘grandfathered’ funds

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

Very little information is available on the use of the grandfathering provision. The Association of Superannuation Funds of Australia suggested that ‘the funds benefitting from the grandfathering provisions in the main are relatively small funds and/or regionally based although there are exceptions’ (sub. 31, p. 7). Asset Super considered that ‘grandfathering clauses are a safety net for small employers who do not have access to professional advice and who do not belong to industrial associations’ (sub. 32, p. 2). Ai Group said that grandfathering arrangements:

… have been common in awards since the late 1980s. For example, an employer who was using a particular complying superannuation fund prior to the making of the *Metal Industry (Superannuation) Award* in 1989 was entitled to continue to use that fund after the award was made. The employer is still entitled to use that fund as a default fund because the pre-modern award exemptions have been preserved through the grandfathering provision in modern awards. (sub. DR79, p. 11)

Grandfathering may also be used for many payments to corporate superannuation funds, as only a small number of corporate funds are listed as default funds in modern awards (for instance, the BHP Billiton Super Fund is listed as a default fund in the Coal Export Terminals Award 2010 while the **Rio Tinto Staff Superannuation Fund is not**).

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

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

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

### Employers make the final selection

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

Though employers ‘have different resources, capabilities and interests with respect to how they select their default fund’ (ANZ Wealth, sub. DR82, p. 3), the ‘vast majority’ of employers have not actively selected their current default superannuation fund — they simply use the fund they have ‘inherited’ (Colmar Brunton 2010b, p. 27).

The initial selection decision is critical because what your employers do is select and forget. (Financial Services Council, trans., p. 65)

Those employers who have chosen a default fund tended not to conduct their own research into available funds, instead relying on advice from a range of sources (box 7.2).

Many inquiry participants submitted that employers would prefer to choose from a small number of funds rather than from the hundreds of funds in the market. For example, Eldercare submitted that:

… from an employer perspective, we would prefer not to be given the responsibility of choosing a default fund from an extensive list, and would favour choosing from a small number of proven funds in awards. (sub. DR57, p. 1)

Many also highlighted that the burden of choosing between a large number of funds can be costly for employers.

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

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

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

|  |
| --- |
| Box 7.2 How do employers choose a default superannuation fund? |
| Administrative convenience  [Employers] want to “get on and build” rather than be concerned with intimate and complex issues of superannuation administration. (Master Builders Australia, sub. 41, p. 4)  Generally, the primary concern of employers in this process is the ease of the transaction process with a fund and any employer costs involved. (Australian Hotels Association, sub. 10, p. 7)  Employers naturally evaluate funds based on the ease of contribution and processing … most employers look for ease of processing and online transactions in choosing their default funds. (Colmar Brunton 2010b, p. 27)  Industry norms and experience  [Employers] will most likely choose the fund that most of their employees are members of already. If it is a new business the employer will most likely choose the fund that he/she has some experience with … It is very rare for an employer to research the benefits (i.e. fees, etc) of a fund and base their choice on that data. (Tasplan, sub. 6, p. 1)  Historically, in the previous state based industrial system and currently in the federal modern award system employers have utilised a default fund already listed … this will continue as employers will have already established a system and relationship with the relevant fund and established relevant financial transaction processes to minimise delays and costs … Where more than one fund is nominated, the selection made by an employer is either ad-hoc or based on previous experience with the fund in question, with little to no investigation into the relative features of each fund. (Electrical Contractors Association, sub. 17, pp. 1−2)  Advice from financial advisers  Employers typically receive advice from consultants and/or financial advisers to assist them select an appropriate fund. As part of the selection process a number of criteria are generally considered including pricing (fees), selection of investment options, strength of brand, insurance premiums and coverage, education, member service and access to financial advice etc. (Colonial First State, sub. 42, p. 2)  Ordinarily, the assessment of a fund against factors such as the ones set out in the Draft Report is carried out for an employer or an employee by a qualified licensed financial adviser (who will be subject to statutory and general law duties). (Law Council of Australia, sub. DR67, p. 4)  A combination of these factors  Businesses will often choose a fund based on prior experience with a fund if they have such experience, or alternatively, based on the fund which suits the majority of their employees. In many cases they will seek guidance from their employer organisations, such as the state Real Estate Institutes, Real Estate Employer’s Federation, or Real Estate Institute of Australia. (REI Super, sub. 26, p. 1)  When they eventually understand that they have to choose a super fund (for themselves or a new employee) [small businesses] will seek advice from their accountant (when they finally choose one), a financial adviser, TV/magazine advertisements, business group mentors, their family or Google. (COSBOA, sub. 7, p. 2) |
|  |
|  |

To avoid the cost of comparing funds:

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

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

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

The Australian Chamber of Commerce and Industry (ACCI) noted that ‘increased fund “closure” also means that employers may need to select new defaults more often than in the past’ (sub. DR83, p. 5).

## Meeting the (relevant) employees’ best interests

### Participants’ views

Inquiry participants generally supported the principle that the selection of default funds should be conducted with the best interests of employees who derive their default superannuation product in accordance with modern awards in mind.

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

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

However, differing views were expressed about the extent to which the current process takes employees’ best interests into account. Many participants focused on the above-average returns received by members of default funds chosen under the current process, and considered that these returns demonstrate that the best interests of employees who derive their default superannuation product in accordance with modern awards have been well served (chapter 4). In contrast, others considered that the default selection system needs to change.

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

[In its draft report] the Commission proposes changes to the current system to better align the default superannuation arrangements with the important principle that the arrangements must meet superannuation fund members’ best interests. Ai Group supports this principle and agrees that changes are needed to the existing system. (sub. DR79, p. 2)

Participants also expressed concern about the conflicts of interest that can arise in the absence of a requirement to make a decision in the best interests of employees. As noted in chapter 3, various agents acting on behalf of employees can have conflicts of interest, including industrial representatives, employers and fund managers. eo Financial Services suggested that employees’ interests can sometimes diverge from those of their industrial representatives.

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

Similarly, the Financial Services Council said:

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

Vincent Mahon noted that:

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

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

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

The Industry Funds Forum was of the view that:

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

In contrast:

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

### The Commission’s view

The Commission notes the relatively strong returns received by members of default funds chosen under the current process (chapter 4). It also recognises that the size, complexity and tight timeframes of the award modernisation process may have explained the AIRC’s decision not to assess financial outcomes for employees who derive their default superannuation product in accordance with modern awards during the award modernisation process (see above). However, the Commission is concerned by the ongoing absence of an explicit requirement to give primacy to the interests of employees who derive their default superannuation product in accordance with modern awards. This is particularly problematic given that principal–agent issues are present.

As outlined in chapters 3 and 5, these problems arise because an agent making decisions on behalf of a principal may not always act in the latter’s best interests, and the principal does not always have the information, resources or inclination to monitor the actions of the agent. Generally, employees whose superannuation is paid into a product because it is the default product do not take an active interest in their superannuation and are unlikely to ensure that their agents faithfully represent their interests.

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

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

Principal–agent problems are also likely to arise where the employer chooses from a relatively large number of listed funds. In such cases, employers have little incentive to investigate the relative merits of different default funds and to select a fund that best meets their employees’ needs. Indeed, they are likely to have an interest in maintaining existing superannuation arrangements because this minimises their administrative costs. They are also likely to face an incentive to use funds that are easy for them to deal with, or funds that offer benefits to employers in exchange for default fund status (though the scope to offer such benefits is limited by the *Superannuation Industry (Supervision) Act 1993*). These incentives may lead some employers to choose a default fund that is less suited to their employees than other available funds.

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

In order to counteract possible conflicts of interest, the Commission considers that where default superannuation products are listed in awards, the process for the selection and ongoing assessment of default products should include explicit requirements for all parties involved in default listing — employee representatives, employers, employer representatives and default decision makers — to make decisions in the best interests of employees who derive their default superannuation product in accordance with modern awards.

## Contestability and competition

In considering the appropriate degree of competition in the default superannuation market, it is important to understand the economic concept of contestability, which can be defined as:

The degree of ease with which firms can enter or leave a market reflecting the level of potential competition. In a contestable market the threat of new entrants causes the incumbent firms to operate at levels approaching that expected in a competitive market. (Industry Commission 1996, p. xix).

In a competitive market, firms have an incentive to innovate, and this leads to greater efficiency and improved outcomes for consumers and/or firms. Though contestability is a necessary condition for competition, it is not by itself sufficient to gain the advantages of competition. For reasons discussed in chapter 3, measures to strengthen demand-side competition will also be required to achieve a competitive outcome.

### Participants’ views

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

#### Are contestability and competition important?

Several union groups suggested that it would not be desirable to increase the contestability of the default fund market.

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

United Voice does not support any recommendations by the Productivity Commission that would result in the opening-up of default arrangements to greater contestability or wider choice of fund. (sub. DR88, p. 7)

Similar views were expressed by some other industry and public sector funds.

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

Cbus takes issue with the findings in the Draft Report that underpin the conclusion that that current system displays … insufficient contestability. It is worth remembering that the primary place for contestability is the market, not the setting of the safety net. (sub. DR81, p. 4)

The existing superannuation fund environment already has adequate competition built into it through the choice provisions under the Superannuation Guarantee legislation and the portability provisions in Superannuation Industry (Supervision) legislation (LGsuper, sub. DR59, p. 2)

In contrast, some participants emphasised the potential benefits of increasing contestability and competition.

ACCI supports the view that funds should be exposed to appropriately channelled competition, or at least the threat of it, and that this is necessary to help offset the significant market advantage of award nomination. (sub. DR83, p. 6)

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

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

Transparency and contestability are critical elements in any marketplace, including default superannuation. Contestability is more important than transparency because if there is restricted choice transparency does not assist in getting the best outcomes. (CSSA, sub. 35, appendix C, p. 1)

#### Is the current process contestable and competitive?

Many inquiry participants considered that, under current arrangements, the default superannuation market is not contestable, and that the absence of competitive pressure has negative effects on the quality and value of superannuation products.

CPA Australia’s primary concern with the current process for nominating default superannuation funds in modern awards is … the “closed shop” nature of the arrangements (sub. 39, p. 1)

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

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

The lack of necessary competition in this area is an important issue that needs to be solved quickly … (Association of Financial Advisers, sub. DR73, p. 2)

… contestability is a necessary element in maximising member value; but is a missing feature of the current system (FSC, sub. DR80, p. 3)

In contrast, United Voice did not see the need for greater contestability, saying that ‘the current model of regulated award distribution of default super funds is established on transparent and objective merit‑based criteria’ (sub. DR88, p. 13). Tasplan (sub. 6) considered that there is a level playing field between industry and retail funds, and ISN considered that ‘… the current process is more open and transparent than has been suggested by some’(sub. 27, p. 48).

Several participants suggested that it is easy for a superannuation fund to find an industrial party to bring a case before FWA to include that fund in an award (Cbus, sub. DR81; Unions NSW, sub. 13). The Australian Council of Trade Unions (ACTU) therefore considered that:

The fact that very few retail funds seek award inclusion via this route speaks volumes about their inability to convince a relatively informed group of potential sponsors of the value of their products. (sub. DR77, p. 9)

The Transport Industry Superannuation Fund — one of the few funds not previously listed in awards that has sought to obtain listing — spoke of the substantial barriers it encountered in doing so (box 7.3).

|  |
| --- |
| Box 7.3 The experience of the Transport Industry Superannuation Fund in applying for listing as a default fund in awards |
| During public hearings, the Transport Industry Superannuation Fund described its experience in attempting to obtain listing in the Road Transport and Distribution Award 2010 and the Road Transport (Long Distance Operations) Award 2010. The fund had not previously been listed in awards and so:  Since September 2008 it has been operating via a system of choice by members or through grandfathered arrangements with an excess of 3800 employers. (trans., p. 147)  In applying to be listed, it claimed that it faced considerable barriers.  It is a very tight closed little shop … to be able to get the thin end of the wedge in there to be able to argue your case. Then once you're in there and you can actually argue your case, all of the incumbents are actually making the decisions …  The quality of the fund counts for nought, because you have all these incumbents in there who have many different vested interests …[When considering our fund for listing they] are not looking at it going, “Well, gee, you’ve got a better definition of total and permanent disability and arson, that will be good for a whole bunch of drivers,” … “Wow, how did you do that?” That’s not the discussion. [Instead], it’s, “No, well, that will encroach on what we're doing and we’re trying to stitch up some sort of [enterprise agreement] over here with some other larger group” …  So when you ask about [our] experience, it’s all these things going on in the background which are, it is strongly arguable, not in the best interests of the members. These decisions that are being made are not in the best interests of the members, they’re in the interests of these other incumbent organisations trying to keep competition out and that is … probably the biggest single thing, it's not in the spirit of transparency, it’s not open, it’s not contestable. Many of the principles that you’re talking about are just simply not at work. (Transport Industry Superannuation Fund, trans., pp. 155–6) |
|  |
|  |

United Voice expressed concern about potential negative consequences of contestability, and suggested that:

Wider choice of default fund would simply lead to the addition of a distribution cost, which would outweigh any of the expected benefits of lower administrative costs … As a result of the proposed reforms, Rice Warner estimate that distribution costs will increase by $75 per member per annum. (sub. DR88, pp. 15–16)

Similarly, the ACTU suggested that:

… competition tends to generate additional distribution costs as funds invest more in marketing their products to sustain their revenue base. Research by Rice Warner estimates that such costs for the average industry fund member could increase by up to $45 per annum. (sub. DR77, p. 13)

In addition, as discussed in chapter 6, a range of participants also commented on industry connectedness.

### The Commission’s view

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

A limitation on contestability in terms of employers’ selection processes is that employers must generally choose one of the relatively small number of default funds listed in the award (though the grandfathering provisions allow some employers to continue to make payments to the fund to which they were contributing on 12 September 2008). This means that most employers of employees who derive their default superannuation product in accordance with modern awards have only a limited ability to switch to a fund that better meets their employees’ interests, or to a fund that has better administrative systems (but still meets employees’ interests).

The current processes of fund selection (both for listing in awards and by employers from those listed) therefore have the effect of reducing the contestability of the default fund market. This reduces competition, and reduces the likelihood that the fund ultimately chosen meets the best interests of employees who derive their default superannuation product in accordance with modern awards.

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

Allowing all funds to present the case for listing their default products in awards on an equal basis is likely to lead to improved outcomes for employees. Similarly, allowing employers to choose from a wider range of products listed in the relevant award would further enhance contestability and spur the benefits of competition. Importantly, it is not necessary that all, or even most, employers make active comparisons and decisions about default superannuation products in order to drive improved product and services offerings. The threat of competition is sufficient.

This does not imply, however, that the benefits of competition can be achieved without some costs. In particular, increasing competition may lead to increases in marketing and distribution costs. However, minimising these costs would only be possible if there was a single national default fund, and if that fund was efficient, low cost and innovative.

The objectives of reducing superannuation administrative costs and minimising complexity for workers can best be achieved by implementing a government-backed [universal default fund]. (Ingles and Fear 2009, p. 15)

For a range of historical reasons, Australia did not go down this path, instead adopting a model of competition between funds from different sectors (St Anne 2012). Given this framework, enhancing contestability and providing incentives for funds to deliver improved products are essential in ensuring that the interests of employees who derive their default superannuation product in accordance with modern awards are best served.

## Transparency

### Participants’ views

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

… it is essential that the listing of any superannuation funds be subject to a robust and transparent process. (Mercer, sub. 34, p. 6)

Transparency is important. (Unions NSW, sub. 13, p. 7)

Suncorp opposes any selection process for default superannuation funds. If, however, a selection process were to remain, this process must be transparent. Transparency can be achieved by requiring Fair Work Australia to provide written decision statements that are publicly reported. (sub. 38, p. 2)

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

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

A number of participants held the opposite view.

The present system is failing consumers and employers — it lacks transparency and is no longer appropriate following the introduction of MySuper. (FSC, sub. 30, p. 1)

The current model for the selection of default superannuation funds is not based on merit, is not transparent and … leads to an inequitable outcome that is very much biased in the favour of industry funds. (Association of Financial Advisers, sub. DR73, p. 2).

The existing FWA process surrounding the variation of Modern Awards to include a new nominated default fund is opaque. Without this transparency, the cost (through the need to employ expert resources) and effort of interacting with the system can often override any benefits. This leads to inertia in the system where employees are disadvantaged by a lack of competitive tension amongst superannuation providers. (AMP, sub. 52, p. 5)

ISN also indicated that there is scope to improve the transparency of the current process, in suggesting that ‘all relationships, including payments and commercial arrangements other than superannuation, between the fund and its related entities, on the one hand, and employers, employer organisations, and employee organisations relevant to the subject modern award, on the other hand’ (sub. 27, p. 5) should be disclosed as part of the fund selection process. Similarly, ‘AIST accepts that existing arrangements, while resulting in good, well-performing outcomes for millions of Australians, could be seen as having insufficient transparency [and] can *appear* opaque’ (sub. DR69, p. 5).

### The Commission’s view

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

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

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

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

## Procedural fairness

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

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

### Participants’ views

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

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

eo Financial Services considered that:

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

The Transport Industry Superannuation Fund said:

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

Other participants (including MLC Ltd–NAB Wealth, sub. DR87 and Suncorp, sub. 38) had similar views.

The Law Council of Australia considered that:

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

A number of participants, including DEEWR/Treasury (sub. DR89) and United Voice (sub. DR88) disagreed with the Commission’s assessment that the current selection process lacks procedural fairness. ISN considered that:

This view fails to properly appreciate the role of the industrial tribunal and the rights and obligations imposed by the Fair Work Act on FWA and those industrial organisations and others who have significant components of their activities controlled by the Fair Work Act. (sub. DR62, p. 4)

Australian Super focused on the ability of FWA to fairly consider the views of industrial parties, and stated:

We reaffirm the central relevance of FWA in determining all workplace conditions, including superannuation, in a manner which accords due process and properly includes the views of workplace participants. (sub. DR74, p. 4)

### The Commission’s view

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

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

Taken together, these shortcomings mean that the current process for selecting default superannuation funds does not provide procedural fairness. Funds that offer products that may serve employees’ best interests are unable to have the merits of those products considered and assessed in a fair and balanced way. Changes to the selection process are needed so that, before decisions are made, affected parties have a right to be heard by an impartial decision maker. In addition, as discussed in chapter 8, some mechanism for appeal or judicial review is an important component of fair process.

## Regular assessment

### Participants’ views

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

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

Master Builders Australia said:

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

The Financial Services Council considered that:

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

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

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

REST Industry Super said that it:

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

### The Commission’s view

The Commission considers that in the absence of an ongoing assessment process and a realistic likelihood that funds with unsuitable default products will no longer be listed in awards, listed funds are likely to face reduced incentives to act in the best interests of default fund members. Further, the presence of unsuitable funds and products in awards is not in the best interests of employees who derive their default superannuation product in accordance with modern awards. The creation of a process for the regular assessment of default funds or products listed in awards is therefore essential (at least in the medium term — chapter 8).

## Minimising regulatory burden

The process used to select default superannuation funds should impose the minimum possible cost and inconvenience on the parties involved, subject to achieving the aim of ensuring that the best interests of employees who derive their default superannuation product in accordance with modern awards are met.

Two aspects of regulatory burden merit specific consideration:

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

### Participants’ views

#### Overall burden of the selection process

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

legalsuper said:

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

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

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

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

ISN suggested that a more burdensome process would be justified.

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

#### Burden placed on employers

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

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

Others suggested that default funds can be difficult for employers to deal with (Adam Johnston, sub. 54). The Council of Small Business Organisations of Australia said that:

Due to the placement of a fund in an industrial award or instrument there is not motivation for a fund to be efficient in dealings with employers. (sub. 7, p. 5)

Similarly, the Financial Services Council was of the view that:

The captive market enjoyed by many large superannuation funds has failed to provide an incentive for the adoption of efficient and user‐friendly administration services. Employers, as major users of superannuation administration services have no choice but to utilise the fund regardless of its administrative capacity/functionality. (sub. 30, p. 9)

In contrast, ASFA considered that default funds do in fact have a strong incentive to be responsive to employers’ needs, and noted that:

Most awards have more than one default fund listed. As well most funds rely for most if not a substantial proportion of their contributions from employers not subject to an award. There is strong competition in regard to signing up employers for default arrangements. (sub. DR75, p. 5)

Many participants also commented on the way in which employers go about selecting a default fund (box 7.2), and on the potentially onerous nature of this choice.

Other participants suggested that the role of the selection process is to produce a small shortlist of funds, in order to make it easier for employers to choose a default fund.

The value of nominating eligible default funds is to assist employers in their selection process. (Australian Hotels Association, sub. 10, p. 2)

… the purpose of the award nomination is to give confidence to the employer that the nominated fund is a quality offering. (Tasplan, sub. 6, p. 9)

… providing employers with a large range of funds from which to choose undermines the purpose of the award default system, which is to ensure an employee voice in the choice of fund, and to control the risk of a poor choice. (Cbus, sub. 15, p. 8)

### The Commission’s view

#### Overall burden of the selection process

The process currently used to select default superannuation funds does not place an undue regulatory burden on any party. However, this is not the direct result of good design but rather a consequence of the current process falling short when measured against sound principles:

* Because there is no requirement to give primacy to the best interests of employees who derive their default superannuation product in accordance with modern awards when selecting default funds, industrial parties do not have to spend time establishing and articulating what those interests may be and how the nominated funds best meet those interests.
* Because the process is not contestable, funds incur few costs in attempting to obtain or retain listing as a default fund.
* Because transparency is lacking, little effort is devoted to preparing and publishing relevant information.
* Because there is no requirement for regular assessment, the costs of preparing for and conducting regular and ongoing assessments are minimised.

Correcting these shortcomings is likely to involve an increase in the overall regulatory burden imposed by the selection process. However, improving the selection process — in ways that increase the regulatory burden as efficiently as possible — will be worthwhile if, overall, it leads to substantially better outcomes for employees that outweigh the additional regulatory costs.

#### Burden placed on employers

The Commission considers that to simplify employer choice, there would be benefit in providing employers with a concise list of default products from which to choose. At the same time, the Commission shares the concern expressed by inquiry participants that superannuation funds listed as default funds in modern awards, in the absence of contestability or regular assessment, do not have strong incentives to be responsive to the needs of employers of workers who derive their default superannuation product in accordance with a modern award. This is particularly the case when only a small number of funds are listed in an award. These privileged funds remain listed and have almost guaranteed market share regardless of the costs or burdens they impose on the employers who must make payments to them.

Therefore, in order to promote greater efficiency in the default superannuation market, the Commission considers that there would be benefit in listing more funds in awards that currently list only one or two. (In chapter 8, the Commission recommends that modern awards that list default superannuation funds should, where possible, identify a small subset of products for each award that it judges best meets the interests of employees who derive their default superannuation product in accordance with a given modern award). In addition, in another measure to reduce inefficiency, the Commission is recommending that a fund’s administrative efficiency should be considered as a relevant factor in the default selection process (chapter 6).

## Market stability

There are a number of ways in which the default fund selection process could affect the stability of the superannuation market. The more the selection process promotes change in the list of funds in a given award, the more likely it is that employers will be required to change default funds, and the greater the potential for significant changes in the flow of contributions between funds. Such changes could have consequences for the level of liquidity needed by, and thus the investment opportunities available to, superannuation funds. In addition, funds that lose default members would potentially experience a loss of scale that could have detrimental consequences for all members of the fund. The combined impact of these factors could potentially lessen confidence in the superannuation market more broadly.

### Participants’ views

Few participants commented on the effect of the default fund selection process on the stability of the superannuation market. Those participants who did mention stability did so with reference to the potential for default fund selection to affect the investment opportunities available to funds, and the returns on those investments.

If industry funds are less certain about the stability of their members and assets and their future growth, this may reduce the willingness of funds to provide additional capital to finance infrastructure assets. (REST Industry Super, sub. 47, p. 41)

High participation rates and strong cash flows also help funds to provide stability and confidence in the superannuation system (Industry Funds Forum, sub. 51, p. 10)

Similarly, Infrastructure Partnerships Australia said:

The Productivity Commission must also be mindful of any changes to the regulatory structure that results in greater ‘churn’ and could work against the stability required to make illiquid and longer dated assets attractive. (sub. 9, p. 1)

Suncorp considered that the principle articulated in the draft report (which was expressed as ‘avoiding system instability’):

… appears to be targeted at avoiding the circumstances experienced in Chile, where significant competition in the Superannuation sector led to high churn rates that adversely affected the stability of member investments. It is important to avoid introduction of a similar instability to the Australian system, however, it is also important to improve competition.

Some level of “instability” is required to allow default contributions to move between funds and drive commercial competition. Suncorp proposes that this principle would be more effective if the emphasis was placed on *sustainability* as opposed to *instability*. (sub. DR64, p. 6)

### The Commission’s view

The process currently used to select default superannuation funds promotes stability. Because some funds do not have an equal chance to present their case to be listed as a default fund, and current default funds are unlikely to lose default status, there is little risk that the current process for the selection of default funds will provoke large movements of members from one fund to another. Were this to occur under future changes, it could have significant consequences (chapter 8).

However, as discussed above with reference to contestability, the small likelihood that funds may be challenged for their default fund status also leads to inefficiencies, which in turn can lead to the best interests of employees who derive their default superannuation product in accordance with modern awards not being met. There is therefore a need to find a balance between promoting contestability and ensuring the stability of the default superannuation market.

In addition, as explained in chapter 8, some employees could end up worse off due to the creation of multiple accounts in different funds, unless the new fund is significantly better than the employee’s existing fund. Therefore, to the extent that a stable system prevents the creation of multiple accounts, a selection system that promotes stability can have benefits for members.

## Consistency with other policies

As discussed in preceding chapters, this inquiry is occurring at the same time as other significant reforms to the superannuation and financial services industries are being implemented. In particular, the Stronger Super and the Future of Financial Advice (FOFA) reforms will change the way in which default superannuation products and financial advice are provided. Broadly, these reforms are intended to deliver better outcomes to superannuation fund members through simpler products, greater transparency and enhanced competition, and to ensure that financial advice is provided by professional advisers acting in the best interests of their clients.

### Participants’ views

Many inquiry participants commented on the way in which the introduction of MySuper will affect the default superannuation market. Some suggested that the additional requirement for funds to gain authorisation to offer a MySuper product should in turn allow any fund that offers a MySuper product to be listed in awards. Similarly, some participants considered that MySuper will make it unnecessary to continue to list funds in awards. Others noted that MySuper is primarily a disclosure rather than a quality regime, and that the most suitable funds for employees covered by different awards still need to be chosen and listed in the award. These differing views are discussed in more detail in chapter 8.

### The Commission’s view

The Commission considers that the process used to select superannuation products and funds to be listed as defaults in modern awards should be consistent with the direction of the Stronger Super reforms.

In one respect, this would require the selection process to be based on clear and simple information that was made available in a transparent fashion. And, as discussed above, there is scope to improve the transparency and other features of the current process.

Similarly, the FOFA reforms are designed to tackle conflicts of interest that have compromised the quality of financial advice. To be consistent with this policy, changes to the default fund selection process would need to be made, including:

* requiring decision makers to act in the best interests of employees who derive their default superannuation product in accordance with modern awards
* improving the disclosure and management of conflicts of interest.

In addition, there are existing requirements for financial advisers to be qualified and licenced — that is, to have expertise. Consistency with these requirements would require that default fund decision makers also have a certain level of expertise.

## Overall assessment of the current process

After considering the current process against the principles outlined in recommendation 7.1, it is apparent that it has both strengths and shortcomings.

Finding

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

* has generally led to the listing of funds that have delivered relatively strong average net returns when compared to the net returns of non-default funds
* has a measure of transparency
* imposes few regulatory burdens and fosters stability in the superannuation market.

The process has the following shortcomings. It:

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

In view of the nature of the shortcomings of the current selection process, the Commission considers that reform to the process is essential. In its view, this is the only way of ensuring that the factors that should be considered in selecting default superannuation products and funds, as summarised at the beginning of this chapter, will be systematically taken into account. The Commission has considered several options for building on the strengths of the current process, while addressing its shortcomings. The assessment of these options, and recommendation of a preferred option, is the subject of chapter 8.