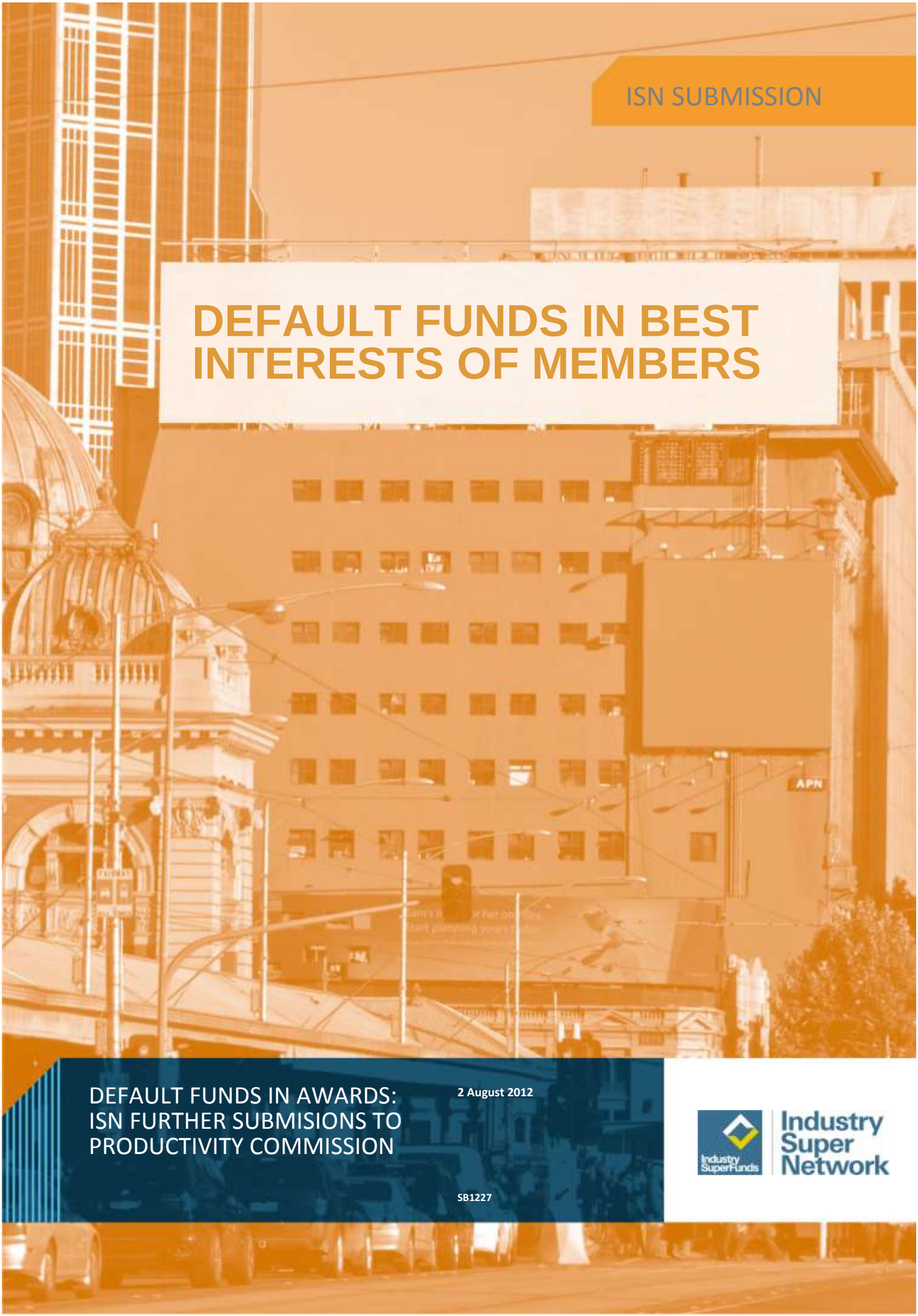

ISN SUBMISSION

DEFAULT FUNDS IN BEST INTERESTS OF MEMBERS

DEFAULT FUNDS IN AWARDS: ISN FURTHER SUBMISIONS TO PRODUCTIVITY COMMISSION

2 August 2012

SB1227

Industry SuperFunds

Industry Super Network

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About Industry Super Network

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

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SUMMARY

ISN welcomes the draft report of the Productivity Commission. In particular the recognition by the Commission that whilst the existing arrangements have served workers and employers well, there is a need for a formal process to consider a range of factors to ensure modern awards provide high quality default fund options for employers.

These brief submissions in large measure support the conceptual framework adopted by the Commission and the proposed factors to be considered when determining is a superannuation fund should be listed in a modern award.

ISN notes and endorses the Commission's overarching principle reflected in draft recommendation 4.1 that "The selection and ongoing assessment of superannuation funds for listing as default funds in modern awards should have the best interests of members as the primary objective."

ISN also supports the Commission's conclusion that "… when considering the best interests of default fund members, there is a case to consider factors over and above the disclosure criteria required for authorisation of MySuper products."[1] ISN agrees with the Commission when it states that "Hence, there is a need for a 'quality filter' to distinguish between funds seeking listing in modern awards."[2]

ISN stands by its earlier submissions that at the very least key performance and behavioural criteria should be met to enable funds to be considered for selection as a default fund in a modern award.

ISN makes further submissions regarding these matters and provides new evidence regarding persistence in superannuation fund returns undertaken by Deloitte Access Economics. ISN further explores options to ensure that long-term poor performing funds are not selected to be named as default funds in modern awards.

ISN notes the four options for selection processes noted by the Commission. ISN supports Option three which is an open and transparent selection process undertaken by Fair Work Australia (FWA).

Option one, under which employers chose a default fund from any MySuper authorised product, is clearly not supported by the Commission's own analysis, which recognises that employers are not necessarily incentivised or qualified to select an optimal fund for workers.

Similarly, ISN considers the Commission's recommendation that employers should be entitled to opt-out of award obligations as inconsistent with the analysis and recommendations contained within the report.

[1] Draft report page 174.

[2] Draft report page 9.

1. Conceptual framework and principles

ISN welcomes the Commission's conceptual framework detailed in section three of the draft report. The framework considers a number of challenges in the market for default funds also identified in work undertaken by ISN and others.[3] The framework recognises that the low number of employees who exercise choice necessitates a strong default system that has the best interests of employees as an overarching objective and assists employers to make a quality choice when selecting a default fund.

ISN concurs that the lack of demand-side competition and principal-agent issues need to be recognised in the design of any process for the selection of default funds in modern awards.

On page 8 of the draft report the Commission articulates the principles that it believes should direct the process of selection of default funds in modern awards:

> Place the best interests of members as the explicit overarching objective in any criteria for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.
>
> - Promote contestability.
> - Promote transparency.
> - Be procedurally fair.
> - Impose a minimum regulatory burden.
> - Promote stability in the superannuation system as a whole and hence confidence among all stakeholders.
> - Be consistent with other policies.
> - Have scope for regular assessment

ISN has no issues with the principles driving the Commission's decision making; however, we would recommend *adding* some recognition of the overarching social policy behind superannuation, namely delivery of improved retirement outcomes to an ageing population in a fiscally responsible manner. In places the draft report exhibits a focus on secondary objectives over primary objectives, such as when efforts to promote contestability based on idealised expectations actually result in weaker outcomes.

Notwithstanding the level of agreement on the principles, there are a number of comments and inferences made by the Commission throughout its draft report which we believe are unwarranted and contradict the Commission's findings.

The Commission makes reference on a number of occasions to the existing process of selection of default funds by Fair Work Australia (FWA) which presumably apply also to its predecessor the Australian Industrial Relations Commission (AIRC).

In particular, the Commission expresses a view that the current system for selection of default funds in awards lacks procedural fairness and has been tainted by self-interest and conflict. It further suggests that selection is driven by precedent rather than merit, inferring bias.

These assertions are in our opinion wrong. 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.

The claims expressed in various forms that the selection of default funds in awards has been tainted by self-interest and conflict and is driven by precedent rather than merit, is in our opinion wrong. The strong

[3] Supernomics

Fear and Pace

inference within the draft report is that not only does the system not offer procedural fairness, but that the decision making process undertaken by the umpire is biased. We do not think that this view is proper or fair.

Reflecting its genesis from the wages system, the initial moves (in the 1970s and 1980s) to include superannuation clauses in awards were bitterly contested. However, there is now a general consensus that superannuation payments are a form of deferred wages and consequently part of the wages system, consistent with Australian common law.[4] There is also a level of consensus that the system should operate in the best interests of beneficiaries. This level of common agreement between the key parties within the system, those that pay, employers, and those that receive, employees, should not be confused with self-interest at the expense of those who seek to operate within the system for commercial gain. ISN continues to believe it is appropriate that the views of the representatives of the key stakeholders, employers and employees, whilst not being determinative, should have greater weight when considering these issues.

It is ISN's view that Fair Work Australia should be required to explicitly address the views of employer and employee representatives. Nor should it be assumed that there will be complete consensus between these representative bodies. In the event that Fair Work Australia rejects the submissions of the key stakeholder representatives it should be required to provide reasons why this is the case.

The Commission rightfully acknowledges that those funds that have been selected as default funds have outperformed other funds. This is the case over the long, medium and short term. ISN has proposed change to ensure the process will continue to operate in the best interests of fund members, on this important point we agree with the Commission. ISN's proposed process is transparent and uses objective criteria which avoids conflicts or perceived conflicts of interest.

1.1 Do the Stronger Super and MySuper reforms offer sufficient protection?

ISN concurs with the views of the Commission that whilst the Stronger Super and MySuper reforms provide additional protections for employees, there remains a need to provide a strong default system. Whilst MySuper adheres to a principle of 'value for money' it does not either limit cost nor have any explicit absolute or relative performance hurdle.

It is anticipated that the Stronger Super reforms and proposed APRA prudential standards will aid transparency and comparability between MySuper funds. However, these reforms will generally only assist those employers and employees who take an active interest and exercise choice of fund. Research shows that key issues such as net-performance and insurance cost and coverage are not factors that most employers consider when choosing a default fund. Survey work for the ATO found that 66 percent of employers did not compare funds.[5] Employers generally consider their relationship with the fund, either

[4] See, e.g,. The Manufacturing Grocers' Employees Federation of Australia and Another; Ex Parte the Australian Chamber of Manufacturers and Another, 160 cle 341, 355-356 (stating that "It may be observed generally that superannuation benefits are commonly regarded as being an aspect of the terms or conditions of employment, being in many circumstances in the interests of both employer and employee. ... As a matter of common understanding, entitlement to participate in a superannuation scheme and the means by which that scheme is to be funded are matters which pertain to the relations of employers and employees and fall within pars. (b) ["the privileges, rights and duties of employers and employees"], (c) ["the wages, allowances and remuneration of persons employed or to be employed"] and (h) ["the mode, terms and conditions of employment"] of the definition of industrial matters in s. 4 of the Act.").

[5] Colmar Brunton Social Research quantative survey Page 68-70

because it is easier to make contributions and otherwise interact with the fund or there is another direct or indirect benefit obtained from the fund to the employer.[6]

ISN agrees that additional factors beyond MySuper authorisation considerations should be applied to the default fund selection process. Whilst there is a best financial interest requirement within MySuper, the MySuper default arrangements will allow for a wide variety of products with a range of service delivery objectives and net returns to members. The level of service and returns under MySuper is not subject to any minimum standards or otherwise prescribed, hence the increased need to ensure MySuper default funds named in modern awards are appropriate and provide higher end net returns to members.

Where employees are not choosing their own super fund the system must ensure a higher duty of care is exercised. Whilst the Stronger Super reforms add further duties upon trustees, the Cooper Review's MySuper reform proposals were considerably more comprehensive than what has been adopted by the government. It is appropriate that additional elements proposed by the Cooper Review but rejected by the government be included in the criteria considered by industrial parties and FWA.

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

ISN does not agree with the Commission's draft recommendation 7.1 that there is no case for prescriptive criteria over and above that to be used by APRA in authoring MySuper products.

ISN is of the view that on balance there should be a minimum performance criteria applied to default funds in modern awards. In particular the use of long-term net-performance should be more than a consideration. ISN submits that applying a minimum performance criterion to the selection of default funds is good public policy that will ensure that poor performing funds are not listed in awards. ISN has also expressed a strong view that funds that flip their members should not be eligible to be listed in an award.

Both of these factors should be prescriptive criteria, not mere considerations. It is not in the best interests of employees or the system to allow a poorly performing fund that mistreats its members to be selected for inclusion, or even considered for inclusion in a modern award. ISN is of the view that there should be clear and objective criteria which will instil competition and higher standards beyond the MySuper requirements.

Best interests as primary objective

ISN welcomes recommendation 4.1 which establishes the best interests of members as the primary objective of the process.

Net-returns

The Commission's draft report is not sufficiently clear when it discusses investment performance, that the intention is to consider net investment returns, i.e. returns after, fees, charges and taxes. It is appropriate and consistent with the MySuper reporting arrangements that net-returns be the measure applied. A careful reading of the report indicates that this is the intention of the Commission. We suggest, that if this be the case, the final report should state that the clear and unambiguous focus should be on net return i.e. the funds placed in a members account after the deduction of taxes, fees and other charges.

ISN is aware of considerable industry debate regarding the definition of net returns and we support the definition in the Cooper Review and suggest the Commission explicitly adopt this definition.

[6] Ibid Page 28

1.3 The 9 minimum factors to be considered in selection process and ISN response

The Commission's draft report nominates 9 minimum factors for assessing if a fund should be listed in a modern award.

ISN believes that the factors are not inappropriate. However, in some instances they are redundant due to the requirements of MySuper. For example, it is a MySuper obligation that the fund's board makes decisions in the financial interests of its members and approves and maintains a risk, investment and insurance strategy that is appropriate to the fund demographic.

1. **Draft Recommendation 4.2.** The appropriateness of the MySuper product's investment return objectives and risk profile for employees to whom the superannuation provisions of that modern award apply (as a primary factor).

   ISN response

   Whilst welcome, the requirement that trustees develop and maintain an appropriate investment strategy considering the fund's demographic, is a MySuper requirement.

2. **Draft Recommendation 4.2.** The fund's expected ability to deliver on the investment objectives of its MySuper product (as a primary factor).

   ISN response

   It is recognised that the Commission has accepted at page 68 that : "…a fund's expected ability to deliver on its objectives, which will relate in part to its performance record, is a valid factor to consider, and should be given primary consideration among a range of factors."[7]

   We agree that past performance data "…presents an opportunity for decision makers to assess a fund's expected ability to deliver on its investment objectives."[8] An emphasis on long term returns is likely to reduce short term 'herding' among funds and rather place emphasis on long term asset allocation and the skill of the trustee.

3. **Draft Recommendation 4.3.** The appropriateness of the fees charged on the fund's MySuper product, given its stated risk and return profile.

   ISN response

   ISN welcomes this consideration. A proper consideration will see fees (read fees and charges) considered together with investment returns to be a net-return consideration.

4. **Draft Recommendation 5.1**. Whether governance structures are, as far as legislative requirements allow, consistent with meeting the best interests of members.

   ISN response

   ISN welcomes this consideration and has long argued that the equal representative governance structure has delivered appropriate products that have acted in the best interests of members. The Commission appropriately recognises that the equal representation model was generally operated well to date. It should be noted that there are considerable governance changes, including a duty to act in the financial interests of beneficiaries, being imposed as a part of the Stronger Super and APRA prudential standard reform process.

[7] Draft report Page 68.

[8] ibid

ISN later raises some questions regarding recommendation 5.2 which calls for a Government inquiry into the governance structures applying to industry and corporate funds. ISN suggests this recommendation is not even handed and fails to consider other recent regulatory developments.

5. **Draft Recommendation 5.3**. The mechanisms put in place by fund trustees to deal with conflicts of interest and the transparency in disclosing those conflicts.

ISN response

ISN also welcomes this consideration. ISN and Industry Funds have encouraged debate regarding the avoidance and management of conflicts of interest. The proposed APRA prudential standards regarding conflict management and disclosure are supported by ISN.

6. **Draft Recommendation 5.4**. The likelihood of default members being switched to higher cost divisions of the fund, or facing significantly higher fees for features of their policies (such as insurance), upon exiting their current employment ('flipping').

ISN response

ISN has consistently argued for the abolition of the practice of flipping. ISN made detailed submissions to the Commission on this matter. It is an appropriate consideration that in ISN's opinion should be raised to an eligibility criterion.

At pages 92-93 of the draft report the Commission discusses flipping. The Commission states that it does not wish to discourage negotiated arrangements with employers to offer discounted fee rates and says that it has no issue with the removal of the discount when an employee laves the employer "…as long as the employee's fees become no higher than the standard rate for the relevant product, then consideration should be limited to whether the fees or other features remain comparable with other, similar MySuper products."

This will allow a continuation of current practice among retail funds, under which product providers will offer discounts to employers on a loss leader basis. When an employee leaves the employer there is nothing to stop their assets being transferred without approval to a more profitable product, with higher costs and/or lower service levels. As many members in default products are disengaged, the product the employee is transferred into need not be price competitive.

This business model is currently active in the market and with the ability of RSE licensee's to offer multiple MySuper products and negotiate administrative fee discounts with employers, the insidious practice of flipping may be expanded and entrenched.

Flipping is a significant issue in high turnover industries, many of which are heavily award dependent.

ISN believes that any fund that flips its members into a higher cost product should not be eligible to be selected as a default fund in a modern award. At 1.5.6 of ISN's original submissions ISN provides an example of the real impact of flipping on employees who have recently been made redundant. Annexure 1 of ISN's original submissions detail the data on flipping provided by Superratings Pty. Ltd, using data provided by the funds themselves.

7. **Draft Recommendation 6.1**. The compatibility of the fund's insurance offerings with the characteristics of employees to whom the superannuation provisions of that modern award apply.

ISN response

ISN highlighted this issue in its submissions and welcomes this consideration. Industry funds have been successful in tailoring their insurance to meet the needs of the funds members. At page 101 of the draft report the Commission correctly notes that; *"Employees in different occupations face different risks, and this require different types of insurance. The more that insurance can be tailored to a member's circumstances, the better will be the outcome for that member."*

8. **Draft Recommendation 6.2**. The quality of member- and fund-specific intra-fund advice.

   ISN response

   ISN welcomes this consideration as it recognises that quality intra-fund and fund specific advice is a significant service that funds can offer their members.

9. **Draft Recommendation 6.3.** The administrative efficiency of the fund, according to a set of benchmarks determined by APRA (or another appropriate body) in consultation with the industry.

   ISN response

   Whilst ISN has no objection to recommendation, it is considered more appropriate to have such matters dealt with as part of the Stronger Super, Superstream and small business clearing house initiatives. The Commission notes that administrative efficiency considerations (however judged) could be dealt with via a funds product dashboard which will be required by APRA in the future.

1.4 Scale considerations

Recommendation 4.4 of the draft report states that scale should not be a consideration over and above the MySuper scale test. This is appropriate. It remains ISN's view that a consideration should be the fund's ability to deliver services to the industry it seeks to service via listing in the relevant award. Scale is only one of these considerations. An example is the ability of a fund to provide workplace visits, seminars and direct assistance, including intra fund advice, across the demographic and geographic scope of the award.

2. Past Performance

At page 67 of the Draft report the Commission states:

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

ISN takes issue with the Commission's view that past performance is not a reliable indicator of future performance, including its reliance on the standard past performance disclaimer required by ASIC. The ASIC past performance disclaimer is appropriate as it has wide use outside of the superannuation industry. ISN also takes issue with the 'practical issues' which it claims would hinder the establishment of a performance standard for the selection of default funds.

2.1 Commission's concerns regarding establishment of performance targets and ISN response

The Commission has raised three issues to explain why, in its view, the use of minimum performance targets are problematic. We address each of these concerns**.**

1. That the "Minimum return targets or 'league table' approaches would require frequent updating, which could prove very disruptive to funds (and their members) that are around the cut-off point."

   ISN response
   We are unclear why – in the context of a 4 or possibly 8 year review process – comparative data would require updating. The Commission has accepted that there should be a process to review selected funds in awards to determine if it is appropriate that they continue to be listed as one of the 5-10 funds in the relevant award. Transitional and grandfathering arrangements could adequately deal with any genuine issues that arise where it could be argued that continued contributions to a poorly performing fund are in the best interests of the member.

   APRA itself releases net-performance data on an annual basis. It is this data that should be relied upon.

2. There is a likelihood that funds may be more conservative and less responsive to changing market conditions where a performance criterion was applied, to ensure that they did not stray 'too far from the pack'. This could be detrimental to system-wide performance.

   ISN response
   ISN believes that the establishment of a performance standard that funds must meet will instil competition into the process. ISN does not agree with the Commission's contention that high performing funds would deliberately reign in their investment performance to not "stray 'too far from the pack'". In any case, an analysis of past returns shows that volatility levels are very similar across the vast majority of funds, indicating herding is already a powerful driver of fund behaviour. Establishing a performance standard will be a driver for higher returns.

3. Deciding on how performance should be measured would be highly contentious, given the significance of the decision for stakeholders. It would be difficult to find a measure that would be seen by all as accurate, consistent and that allowed for full comparability between funds.

ISN response

There is absolutely no ambiguity as to what is the appropriate measure.
Superannuation is an investment. Investment represents a deferment of consumption by the investor. The investor is compensated for deferring consumption with investment return. The actual return *to the investor* is obviously that component to which the investor is entitled; that is, returns net of all taxes and fees.

ISN is proposing the use of official long-term APRA net-return data. The Commission's concerns regarding the treatment of different investment options is irrelevant to a MySuper product with a single diversified investment product. A key feature of the MySuper reforms is the enhancement of comparability via standardised measures and reporting systems. APRA data can and should be relied upon.

Whilst ISN welcomes the Commission's finding that **"**past performance may provide a useful guide of the ability of trustees to deliver on their stated investment objectives."[9], we believe past performance is a key factor for consideration. The reliable and key APRA data is the sum placed in an employees' superannuation account over a period of time. There is no factor more important than this and it should not be dismissed so readily by the Commission.

2.2 Persistence in returns

At table 4.1 of the Commission's draft report, the Commission produces a comparative performance table using APRA fund-level profiles and financial performance data. The table shows the top five ranking funds in 2004 and compares this to their ranking in 2011. The rankings in the later period are very different.

With respect, we suggest that both the methodology and the conclusion the Commission comes to is flawed. Of the 5 funds shown, 4 remained in the top quartile of performing funds over the relevant period. A period of historically high volatility due to the GFC event. The use of such a small sample is selective and inappropriate. It is clearly designed to mislead the reader by giving the impression of great instability in performance.

In fact, as has been established previously in APRA (2009)[10] and Sy and Liu (2009)[11], and is confirmed in new research commissioned by ISN (Deliotte Access Economics, 2012) discussed below, persistence in relative returns has been a feature of the Australian superannuation market. Most relatively strong performers in one period are relatively strong performers in subsequent periods.

The reason for this is obvious to any unbiased observer of the Australian superannuation market: returns are primarily a function of profit-orientation and governance structure, and these characteristics of funds are stable.

[9] Draft Report Page 68

[10] APRA (Australian Prudential Regulatory Authority), 2009, *Response to Submissions – Fund level disclosure from the APRA superannuation statistics collection*, APRA. Available: http://www.apra.gov,au/statistics/

[11] Sy, W. & Liu, K., 2009, *Investment performance ranking of superannuation*, Australian Prudential Authority. Available: http://www.apra.gov.au/Research/working-papers.cfm

2.3 New Research

The underperformance of retail superannuation funds relative to not-for-profit funds has been discussed in published research now for almost a decade.[12]

Sectoral performance is the aggregate of individual funds within each sector. It is reasonable to investigate, therefore, whether persistent underperformance (or outperformance) is also evident at the individual fund level. New research by Deloitte Access Economics (DAE) demonstrates that that is in fact the case. This work is found at **Attachment 1.**

APRA's fund level rate of return series is available for eight financial years (2004 – 2011). DAE divided the eight-year period into two four-year periods, 2004-2007 and 2008-2011.

Funds were grouped into tertiles (three groups by ranking: highest, middle and lowest) based on geometric mean performance in both four year periods. A 'transition matrix' (Figure 4) is prepared tabulating the funds according to their rankings in both periods.

If past returns offered no guidance as to future performance, the funds would be distributed evenly across the matrix. In fact, the concentrations of funds in the corners at top left and bottom right (representing consistently high or consistently low performance), and the much lower numbers of funds in the opposite corners (representing a reversal of form), indicate there is persistence in performance.

A fund in the top third of the distribution in the first period has close to double the probability of being in the top third in the second period as it does of being in the bottom third. Econometric tests of this data establish that the level of prediction is statistically significant at the 95% confidence interval (p-value = 0.02).

Figure 1 Transition matrix - All 172 multi-asset class APRA-regulated funds with 8 years performance data (2004-2007 to 2008-2011)

		2008-2011			
		T3	T2	T1	
2004-2007	T3	25	21	12	58
	T2	19	16	23	58
	T1	14	20	22	56
		58	57	57	172

Note: T1 = bottom 1/3 funds, T2 = middle 1/3 of funds, T3 = top 1/3 of funds

[12] See Coleman et al (2003), Ellis et al (2008), APRA, (2009), Sy and Liu (2009).

Figure 2 Transition matrix – APRA-regulated funds with 8 years performance data with over $1b assets (2004-2007 to 2008-2011)

		2008-2011			
		T3	T2	T1	
2004-2007	T3	16	8	6	30
	T2	11	10	9	30
	T1	3	12	15	30
		30	30	30	90

Note: T1 = bottom 1/3 funds, T2 = middle 1/3 of funds, T3 = top 1/3 of funds

For the same test based on the 90 funds with over $1 billion in assets the result is more pronounced and statistically significant with a 99% confidence level. Of the 30 funds in the top third in the second period, 16 (over half) came from the top third in the first period and only three came from the bottom third. Of those in the bottom third in the second period, 15 (half) were bottom third previously, whereas only six were in the top third. The likelihood of getting this result by chance is less than 1/2000 (p-value = 0.00047).

The reason persistence is stronger among larger funds is that persistent differences in performance are due to differences in governance and profit orientation, and these differences *increase* with scale.

This new research, which has been based on official data, clearly shows that there a number of factors which do lead to consistent outperformance by super funds. It confirms the result in APRA (2009) which also used raw returns though for a different time period, and the result in Sy and Liu (2009) which analyses risk-adjusted returns for an overlapping time period.

Clearly, decisions makers selecting default funds to be listed in modern awards must take past performance into account as a first order issue. Evaluation must start with past performance, before asking why future performance might be better or worse than it was in the past, based on some change in other factors – such as scale, asset allocation or governance.

The findings by Sy and Liu, APRA and Deloitte Access Economics and others are consistent with a decade of research that shows that returns are directly influenced by profit orientation and governance – that is, whether a fund has representative trustees or not.

Since 2003 APRA has published research on numerous occasions showing that retail funds underperform not for profit funds.[13]

APRA researchers have also looked into why this is the case. Besides noting differences in fees and asset allocation, the researchers found that, on average, retail funds overpay suppliers who are related parties by a multiple of 2.6, whereas not for profit funds pay market rates to related party suppliers.[14]

[13] Coleman. A, Neil. E & Wong.M. APRA Working Paper 2003-01: *The Investment Performance of Australian Superannuation Funds*. February 2003; Ellis.K, Tobin.A & Tracey. B. APRA Working Paper: *Investment Performance, Asset Allocation, and Expenses of Large Superannuation Funds*. October 2008; APRA Insight Issue 2 2007; Dr Cummings. J.R. APRA Working Paper: *Effect of fund size on the performance of Australian superannuation funds*, March 2012

APRA's research have also found that despite the demonstrated existence of economies of scale in superannuation administration across sectors, retail funds do not pass on economies of scale in the form of improved net returns, whereas not for profit funds do.[15]

APRA also found that there are differences in the characteristics of trustee directors on super fund boards, according to the profit orientation of the fund.[16]

Firstly, a majority of retail fund trustee board members work for the fund or its suppliers (in the case of not for profit funds, the reverse is true). [17]Clearly, this has the potential to give rise to inherent conflicts for trustees, given that they are obliged to consider the requirements of the financial institution, its shareholders and members.

Secondly, only a small minority of retail fund directors have a personal stake in the fund they are invested in (whereas a majority of not for profit directors do).[18] This raises the question as to how committed a retail fund trustee may be to ensuring strong performance of the member fund when they have little 'skin in the game' themselves.

On the whole, it is clear that retail funds underperform; they underperform persistently; and they do so for reasons clearly related to their profit orientation and governance model.

The PC draft report identifies the risk of agency costs in superannuation: the risk that fund management will not work in the interests of members.

In a retail fund there are three sets of potentially competing interests – members, management and shareholders. The research suggests that the best interests of members often do not prevail.

APRA research also shows that members do better with not for profit funds. These findings are very clearly reflected in persistent differences in net performance.

ISN believes that it would be inappropriate for decision-makers determining workplace default funds to ignore this historical record.

ISN also believes that it would be inappropriate for those designing a structure in which those decision-makers will operate to not consider the very strong evidence now before them.

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[14] Liu. K & Arnold. B.R. APRA Working Paper: *Australian superannuation outsourcing – fees, related parties and concentrated markets.* July 2010.

[15] Dr. Cummings. op cit.

[16] Sy. W, Inman.C, Esho.N & Sane.R. APRA Working Paper: *Superannuation fund governance: trustee policies and practices*. July 2008

[17] Ibid

[18] Ibid

3. Reforming the selection process

The Commission has identified and assessed four options for reform to the process for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. Of these four options the Commission has rejected two, options 1&2, and is seeking the views of interested parties on the merits of options 3&4.

3.1 Option one

ISN cannot discern any significant practical difference between option one, which would allow an employer to choose any MySuper or other approved default product from recommendation 8.2 which effectively allows this to also occur, with unspecified challenge rights for employees against the employer's choice of fund.

The Commission rightly rejected option one on the grounds that it "does not, by itself, sufficiently protect the best interests of employees and would result in high search costs for employers." It is not possible to align recommendation 8.2 with the Commission's own finding that option one is not consistent with the primary principle of establishing a process that works in the best interests of members. This inconsistency is perplexing.

3.2 Option two

Option two has been described as the status quo option. In fact it is not. The current system is not one where the industrial parties select a group of funds and present them to Fair Work Australia as a *fait accompli*.

The report describes with some sympathy the failed attempt of a retail fund to have its products inserted into awards. The system should not be condemned for the failure of any particular fund to obtain support. The lack of support may be due not to a conflict of interest, but rather to consistently lower net returns. Such an example would appear to provide evidence of a functional system.

In fact, a superannuation fund, for-profit, or not-for-profit, need only obtain the support of a single employer or employee representative body with standing before the tribunal in relation to the relevant award, or an employer.

Nonetheless, ISN has long argued for a transparent process based on explicit criteria and believes option three best achieves this goal.

3.3 Option three

Recommendation 8.1 states:
All funds that are authorised to offer a MySuper product (and exempt public sector superannuation schemes) should be able to apply to be listed in an award and have the application considered on its merits. An applicant's case should be outlined and assessed against the factors for consideration identified by the Commission. Other factors could be taken into account for individual awards at the decision maker's discretion.

Options 3 and 4 are consistent with recommendation 8.1

ISN continues to support option three. We rely on our previous submissions. In our view options three and two are the only options proposed by the Commission that are consistent with the Commission's terms of reference.

ISN agrees with the Commission's finding that:
"Options 3 and 4 best adhere to the principles for an effective process for the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. In particular, Options 3 and 4 are most aligned with the best interests of members while also addressing the needs of employers when they are choosing a default fund."[19]

ISN stands by its position that the views of the key stakeholders, employers and employees and their representatives should be explicitly considered and if their submissions are not agreed with a "if not, why not" explanatory approach should be adopted by Fair Work Australia.

The use of FWA's knowledge, systems and resources in combination with outside expertise, is the most efficient, effective and fair means of selecting default funds for listing in modern awards.

3.4 Option Four

Option four is similar to option three, but decisions would be made by an expert body independent of FWA, with FWA playing a minimal role in administering the decision.

It is not clear how this option would work without significant change to the Fair Work Act to remove the ability of representative bodies and FWA to deal with these matters.

The proposal is clearly intended to remove industrial considerations from the determination of such matters. This proposal would add a further layer of regulation to the determination of minimum conditions of employment. Without establishing an additional tribunal like structure, it is difficult to see how the Commission's stated principles to be applied to a selection process e.g. right to be heard, transparency, appeal rights etc, can be applied.

Superannuation is part of the wages system and it is appropriate that the selection process is under the auspices of FWA, albeit with additional expert assistance.

A consideration by the Commission appears to be a concern that members of Fair Work Australia may be biased or that there is a perception that they are biased "towards the views of any party that they were, or remain affiliated with." What the Commission means by 'remain affiliated with' is unknown. Fair Work Australia appointees are required by section 640 of the Fair Work Act to disclose and avoid any conflict or potential conflict of interest that may interfere with the proper performance of the FWA member's duties. ISN considers these concerns to be unfounded and unfair.

It should be remembered that FWA appointments are made by the Governor-General and must have knowledge or experience in one or more of fields of workplace relations, economics, social policy, business, industry or commerce.[20] Appointments are permanent and with the exception of employment in the defence forces, prohibits paid employment outside the duties within FWA without the Presidents prior approval.[21]

It is also unclear how option 4 involving an "expert body" would not suffer from greater conflicts, particularly if the appointments are limited in tenure or part-time. It would be difficult to construct an 'expert body' that is comprises independent persons with no conflicts or perceived conflicts of interest, including paid employment or arrangements with related bodies operating in the industry.

[19] Draft report Page 176

[20] Section 627(4) *Australian Fair Work Act 2009*

[21] Section 633 *Australian Fair Work Act 2009*

It is suggested that an 'expert-body' with no recent or current experience or activity in the industry would be lacking.

Option 4 involves the establishment of another legalistic, if not judicial body that would be empowered to receive applications, hold hearings, take evidence, publish reasons for decision and have an established appeal process. In addition such a body would be required to have at the very least a permanent secretariat, offices, web site and records section. To be effective and provide protections to the appointees and procedural fairness to applicants would require the passage of legislation.

It is not appropriate that Fair Work Australia be empowered to implement and hear appeals relating to a decision made by another body, relating to matters it has limited institutional expertise in.

ISN does not believe there are any benefits associated with the establishment of an expert body. It is suggested that any on any proper and fair assessment option 4 would be result in an inappropriate expense and duplication of resources. A cost that is likely to be sourced via an industry levy and ultimately borne by superannuation fund members. ISN does not believe that the establishment of a separate 'expert body' to select default funds to be included in modern awards is justified.

The purpose of the system should be to ensure that poor performing funds are not selected. The process should not result in the perverse outcome of poor performing funds being nominated to demonstrate an even handed approach. ISN supports the inclusion in awards of funds that can demonstrate high net returns over the long-term.

4. Employer discretion to choose a fund not listed in a modern award

ISN finds the proposal by the Commission to allow employers to choose a fund not listed in an award as a default fund unworkable and inconsistent with the draft recommendations and findings elsewhere in the Commission's report.

In particular, this proposal appears very similar to option one – which was not supported by the Commission. Besides appearing directly contradictory, the addition of this feature makes the structure of the report around consideration of those four options seem redundant. In less than two pages the Commission's draft proposal sets aside the considered reasoning contained in over 200 pages of the report. The four reasons the Commission provides for proposing employers have ultimate flexibility in these matters are not supported by evidence or reference to submissions made to the Commission.

Given the significance of the proposal, ISN is surprised at the lack of analysis supporting it. It is a further concern that the proposal is outside the Commission's terms of reference. ISN believes the limited reasoning provided is flawed. We do not believe it is appropriate for the Commission to make such a recommendation without addressing how such a proposal would work alongside a safety net award system, the risks involved, and what processes and systems would be applied when an employer's choice is challenged. Even the most basic of questions of who could challenge; how they would challenge; where the challenge would be heard; and what rights, including restitution rights and remedies would be available in the event of a successful challenge are not considered.

The only issue that appears to be considered is compliance monitoring and only to the extent that the Commission is seeking the views of interested parties via an information request.

4.1 Addressing the 4 reasons for allowing employers to opt out of the system.

Reason one

It is claimed that 45 percent of pre-modern federal awards did not list a default fund and a further 12 percent allowed employers to choose "any other fund" and half the modern awards allowed employers to choose a different fund by application to the Australian Industrial Relations Commission (AIRC) or by agreement with employees. It is further said that the AIRC was not aware of any problems with these arrangements.

Response

This reasoning shows a misunderstanding of the transition from former state based awards to the consolidated safety-net federal modern awards. Whilst it is recognised that many former state awards (transitional) and smaller or workplace specific federal awards did not nominate a default, in most instances default superannuation arrangements were found elsewhere; either by reference to another award or decision; provided by statute or by agreement.

It is unclear if the Commission's analysis refers to pre-reform awards, transitional awards, national agreements preserving state awards; referred awards, section 170MX Awards or Division 2B Awards. In any event ISN questions the assertion that 45 percent of pre-modern awards did not list a default fund.

It is suggested that the vast majority of employers and employees under the pre modern award regime were subject to awards that named one or more default funds.

Whilst it is recognised that Clause 19 of the Luv-A-Duck Pty Ltd Poultry Farm Workers Award 1999[22] stated: "The employer will pay superannuation contributions in accordance with the Federal Superannuation Guarantee legislation, into a complying fund nominated by the company in respect of each eligible employee."

The weight to be given to this and other small enterprise awards is insignificant when considering the arrangements within large federal awards covering tens of thousands of employers and hundreds of thousands of employees. The key awards such as those setting default arrangements in the manufacturing, retail, hospitality, health and community services, transport and other key industries named default funds. The vast majority of employers were covered by these arrangements, except where enterprise agreements were in place. The Commission acknowledges that the available evidence is that the majority of enterprise agreements reflected the arrangements found in the underpinning award.

Nor is it accepted that the previous arrangements were without issue. The evidence is that the past arrangements have resulted in significant compliance issues. In 2010 the Inspector General of Taxation estimated that there were significant compliance issues surrounding superannuation obligations and that $600.8 million in superannuation payments remained owing to employees after enforcement proceedings.[23] It is not surprising that the AIRC stated to the Productivity Commission that it was not aware of any issues as it was not the role of the AIRC to monitor or enforce compliance with superannuation obligations.

It is suggested that reason one is flawed and should not be relied upon.

Reason two

That allowing employers to use their discretion would help alleviate the problems associated with contestability, (bias towards fund the industrial parties are associated with to the exclusion of retail funds and the restriction of employers to select the funds named in the award) and giving employers the ability to choose a default fund, other than one listed in a modern award will induce a threat of competition for listed funds.

Response

The Commissions allegations of systemic bias and procedural unfairness are not supported by any evidence. ISN's proposed process, being open and transparent, should address any perceived conflict issues. In fact the available evidence apparently accepted by the Commission is that employers do not seek to be burdened with the responsibility of choice of fund.

Whilst accepting that few employers are likely to take up the option, the Commission is of the view that there mere threat of competition will "… strengthen the incentive for listed funds to produce outcomes that are in the best interests of members." It is suggested that it is far more likely that insofar as any competitive pressure is to be generated, the "incentives" are likely to be directed at the decision maker, employers, not employees.

The Commission's proposal is likely to result in the structuring of products and services that are primarily designed to work in the financial interests of employers. ISN's original submissions referred extensively to the survey work undertaken by Colmar Brunton Social Research on behalf of the Australian Taxation Office in 2010. This survey is the largest survey undertaken of employer attitudes to superannuation. At page 32 of our earlier submissions we highlight that the survey found that 13 percent of employers admitted to receiving a direct or indirect benefit from a superannuation provider. This included a number of large employers.

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[22] AP787314 Luv-A-Duck Pty Ltd Poultry Farm Workers Award 1999

[23] Inspector-General of Taxation. *Review into the ATO's administration of the Superannuation Guarantee Charge – A report to the Assistant Treasurer*, March 2010

The Commission's proposal will do nothing to alleviate this issue or the perception that some employer's choice of default fund is influenced by financial discounts and services offered by banks.

We believe that reason two will not instil competition that delivers outcomes in the best interests of members, will encourage inappropriate behaviour and will undermine confidence in the industry.

Reason three

Those employers that have the interest and expertise for making and informed decision should be allowed to exercise choice in the way they exercise their legal obligation.

Response

The single paragraph providing grounds for reason three is surprising and it is suggested at odds with the Commission's expressed views elsewhere. Elsewhere the Commission has formed the considered view that the Stronger Super reforms, including MySuper will be insufficient in themselves to ensure adequate protections regarding the selection of default funds within modern awards and has recognised that MySuper products will vary.[24] However at this point the Commission adopts a contrary view that the reforms will provide "… employers with the ability to exercise choice in a way that does not disadvantage their employees is likely to increase."

There is no evidence or further exploration of this reason by the Commission. In particular there is no reasoning given for the view expressed that the reforms are more likely will allow an employer to make a choice that does not disadvantage employees.

ISN suggests that following the MySuper reforms there will continue to be significant differences between MySuper products. This recognition is reflected in the Commissions proposed considerations for a body charged with selecting between 5-10 default fund choices between what is likely to be many hundreds of choices.

The Commission should clarify which view it is taking on this important matter. The Commission either believes that following the MySuper reforms it doesn't matter which available MySuper fund is chosen by an employer or that further processes are required regarding the selection and that selection considerations should be applied. It is suggested that the system can't properly accommodate both views.

Furthermore the Commission extensively cites the need for procedural fairness and transparency in decision making (which ISN strongly supports) but then proposes a side-process which offers little or no transparency or procedural fairness.

Reason Four

That employer discretion allows for closer tailoring to the needs of a particular workplace than can a system based upon awards. It therefore has the potential to provide superior outcomes for those members.

Response

One presumes that this point is suggesting that it will be possible for an individual employer to negotiate changes to a MySuper product in the market to the benefit of their staff. It is suggested that the tailoring options available to individual employers within an existing product is limited.

Where an employer may have sufficient scale to negotiate the 'tailoring' of a MySuper product it is suggested that there are few impediments to an engaged and appropriately motivated that employer coming to an alternative arrangement regarding default fund selection which involves reaching an enterprise agreement with staff which deals with superannuation.

[24] Draft report Page 174.

Flipping

Elsewhere in these submissions ISN discusses the issue of flipping, which was also extensively discussed in ISN's original submissions. It is open to an employer within the MySuper arrangements to 'negotiate' 'tailored' superannuation arrangements at a workplace which could potentially benefit an employee whilst they are employed at the workplace. However, these arrangements can, and in the case of commercial funds, usually do subsequently change when the employee leaves the employ of the employer, to the employee's significant detriment.

The Commission's proviso that "employees are at least no worse off" should be a test that applies to the employee's interest in the fund as beneficiaries, not employees. If the limited test suggested by the Commission is to be applied, the Commission will inadvertently adding the insidious practice of flipping employees. Any test should be an outcomes based test and not one limited to a period of employment with a single employer. See ISN's original submissions at 1.5.6 and Annexure 1.

4.2 Enterprise Agreements

It is open to any employer who is sufficiently engaged to seek to reach an Enterprise Agreement with their staff that deals with superannuation, including the nomination of a fund or choice of default fund. At pages 36-38 of ISN's original submissions we provided an analysis of the operation and coverage of enterprise agreements in the Australian workforce. It is entirely appropriate that an employer who seeks to change a fundamental condition of employment should be required to seek the approval of staff and have imposed a requirement that the employees are 'overall better off'. The Commission's proposal provides a unilateral right to an employer to impose a change to a basic employment condition on the condition that the employee is no worse off. It is not appropriate that a minimum wage employee would be denied the protections of the existing minimum wages system and be required to challenge their employer's choice and possibly motives. This suggestion fails to recognise the power imbalance present between employers and minimum wage employees.

The Commission's proposal requires an employer to undertake their own analysis of the respective merits of superannuation products by applying the 9 criteria or considerations adopted by the Commission. It is suggested that an employer sufficiently motivated, informed and resourced, should find no issue with reaching an enterprise agreement with their staff. It could be argued that such a course of action would be easier.

ISN does not propose that the 9 considerations be applied by employers and employees when negotiating an enterprise agreement or FWA when applying the "better off overall' test as this test is a holistic one that considers the totality of the agreement.

It should be noted that the "better off overall" test only applies to the period of employment with the relevant employer whilst employed under the terms of the enterprise agreement. The issue of future superannuation costs and entitlements post employment are not considered.

4.3 Process

The Commission has suggested that an employer's choice of default fund must be justifiable and made with reference to the factors identified by the Commission and ultimately, be capable of demonstrating that the employees are no worse off than if an employer had chosen a fund listed in the relevant award.

ISN suggests this process, such that it can be called one, is unworkable and is likely to cause serious compliance and other problems.

Modern awards cover the most vulnerable workers. The Commission has accepted that the process for selection of default funds is important as the vast majority of workers do not chose a fund. Surely the Commission must also accept that the vast majority of employees will not challenge their employer's unilateral choice of superannuation fund and the motivation of the employer and the outcomes for employees will never be investigated.

The Commission's proposal undermines the minimum award safety net system that uses modern awards to determine the minimum and appropriate terms and conditions for Australia's lowest paid and most vulnerable employees. The only means by which these minimum conditions can be altered is via an enterprise agreement agreed with the workforce and on terms that the employees are 'better off overall'.

The Commission's 'self-assessment regime' is a backward step that seriously undermines the protections provided by an open and contestable selection process and is likely to undermine confidence in the system.

Whilst some employers may believe they have the resources, knowledge and proper motives to effectively replicate and better the work of Fair Work Australia and or a panel of industry experts, it is more likely that few employers will be in this position. It is likely that a greater number of employers will have an inappropriate motive for the selection of an alternative default fund. [25]

4.4 Process Flawed

We suggest the proposed process is seriously flawed for the flowing reasons:

1. The proposal sets a precedent whereby an employer which believes or states they are acting in the best interests of their employees can step outside the minimum statutory legal protections offered to employees. The process does not allow employees or their representatives any ability to act prior to a decision being made by an employer;

2. The evidence is that individual employers generally do not have the interest, skills or resources (including search costs), to select a default fund. It is less likely that they will be in a position to do so when required to apply the selection 'considerations' discussed by the Commission and applying a no worse off test, which requires an assessment of alternative funds named in the relevant award;

3. The process is open to abuse as only those employers with significant incentives are likely to exercise the right to opt-out of the obligations contained in the relevant award, the process is likely to encourage inappropriate incentives directed at the employer;

4. The proposed process will encourage arrangements which lead to the flipping of employees into high fee paying and profitable funds at their expense;

5. With the vast majority of employees not exercising the basic right of nominating a superannuation fund; it is even less likely that an individual employee will challenge their employer's choice of

[25] This is supported by the Colmar Brunton employer survey work undertaken by the ATO. See Colmar Brunton Social Research Investigating Superannuation: *Quantative Investigation with Employers*, 20 January 2010 and Understanding Superannuation: Preliminary Report: *Qualitative Investigation with Employers, Consumers and Industry*, 25 March 2010.

fund;

6. In any event there are serious questions regarding an individual employee's ability to pursue what is essentially a compliance matter before either Fair Work Australia or another body, presumably provided with tribunal style decision making powers, including appeal rights. Fair Work Australia is properly not empowered to enforce its own awards;

7. Any appeal against an employer's choice of fund will be constrained by the fact that there is no requirement for an employer to document the process that they have followed and the means by which they have applied the relevant 'considerations' during their decision making process;

8. The' no worse off' test is vague and lower than the 'better off overall' required by the *Australian Fair Work Act 2009* used when analysing enterprise agreements. One presumes that the test of the employer's choice of fund would include net returns and would need to be judged against the lowest performing fund named in the award. This 'not as bad or as bad as the worst test' is insufficient to protect the interests of employees. Further, it is unclear if the no worse off test is to be applied for every individual, classes of worker or the workforce as a whole;

9. Superannuation is a long-term investment and it may not be possible to properly assess the performance of an employer selected default fund in the short-term. Nor is there a limit on the employer's ability to change the default fund on a regular basis;

10. It is not immediately evident where an employee would challenge the employer's choice of default fund, if they would have standing to challenge the employer's choice and what restitution would be available to them;

11. There are further standing difficulties when an ex-employee wishes to challenge the employers past choice of default fund or the non-employee beneficiaries seek to do so;

12. It is suggested that it may only be in circumstances where an employer has acted consciously against the financial interests of employee's, where a tangible and clear long-term loss has occurred and the decisions made by the employer were demonstrably driven by self-interest, that a civil remedy may be open to an employee. It is highly unlikely that an individual employee would be in a position to take such an action and the Commission should not impose a system where the safe guard relied upon is the challenge of an individual; and

13. The proposed opt-out process will result in compliance confusion, a lack of comparability in the industry, and generally undermine confidence in the industry.

The Commission's proposal to allow employers to opt out of the selection system is a backwards step and is highly likely to reduce the protections currently available to employees.

ISN suggests that the Commission needs to take a single and consistent view on these matters within its final report. At page 52 in section 3.1 of the draft report the Commission discussed principal-agent relationship issues, these included a finding that employers:

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

These informed views by the Commission are discussed within the Conceptual Framework chapter which recognises that "…there is an overall net benefit to introducing criteria beyond those required of funds to be authorised to offer a MySuper product."[26] It is submitted that this is the correct view. The employer opt-out proposal is inconsistent with the conceptual framework suggested by the Commission and should be set aside.

4.5 Compliance issues

The employer opt-out process suggested by the Commission will severely inhibit any orderly process of superannuation compliance.

The proposal is also inconsistent with the Superstream superannuation initiatives that are designed to provide back of office administrative benefits and will greatly assist the compliance arrangements in the industry by the matching of data from employers, employees via TFNs and fund data.

In 2010 a review by the Inspector-General of Taxation[27] found significant levels of superannuation non-compliance by employers. It is suggested that those seeking to ensure compliance with superannuation obligations will have their effectiveness reduced as the current compliance regime relies heavily on employer and employer representative compliant, and fund follow up either directly or via organisations such as the industry funds credit control which pursues non-or under paying employers.

Information request from the Commission

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

One of the reasons ISN opposes the ability of employer's to select a fund themselves is the difficulties associated with compliance. The ATO currently estimates that hundreds of millions of dollars of superannuation payments are uncollected. This proposal will dramatically add to this significant problem.

It is unclear what the term 'monitor' means in this context and it is presumed the Commission is asking for views on who would be responsible for compliance. Not being a court, it would be inappropriate and not possible for the default fund naming decision making body, be it FWA or another body, to make and

[26] Draft Report Page 49.

[27] Inspector-General of Taxation. *Review into the ATO's Administration of the Superannuation Guarantee Charge: A report to the Assistant Treasurer*, March 2010 Page 4.

enforce its decisions. Nor is immediately clear which existing body would have the power to hear a challenge to an employer's fund decision.

The only possible way in which such a proposal could be subject to any serious compliance effort would be a requirement that employers who exercise the freedom to choose a fund other than one listed in a modern award, to provide details to the ATO of the fund, the TFN's of the affected employees covered by the relevant award. This information would need to be integrated into the Superstream data collection process and there should be a requirement to inform APRA.

A system that could have an employer paying into any complying fund and one that does not restrict an employer from utilising a number of default funds and/or changing those funds from time to time will add complexity and reduce enforcement.

4.6 Grandfathering arrangements

It continues to be ISN's view that the existing grandfathering arrangements found in modern awards should be removed regardless of the granting or otherwise of employer opt-out rights. The existing arrangements were explored on pages 39-40 of the original ISN submission. The continued use of grandfathering arrangements is incompatible with the introduction of MySuper which will require the identification of all funds.

In the event that the MySuper successor of a current fund named in a modern award or a fund selected in the future, on further examination, fails a selection process, it would be appropriate to provide limited grandfathering arrangements. The exact nature of the grandfathering arrangements would depend on the selection process adopted.

As a matter of principle the grandfathering arrangements should be designed to minimise disruption and benefit the employee. Grandfathering arrangements should apply to the individual not the workplace. An employer should not be entitled to continue to make contributions to a fund that has failed the selection process for future employees. It would be reasonable to have processes in place that inform any employees who are members of the fund that the fund, although remaining MySuper authorised, is no longer listed in the relevant award and informing the employee that choice is available to them and that they should in the circumstances seek independent financial advice.

4.7 Number of default funds named in awards

Draft recommendation 8.4 suggests that no fewer than 5 and no more than 10 default funds should be listed in modern awards. Whilst ISN believes a range between 2 and 6 would be more workable, there is no strong objection with this recommendation. It is suggested that Fair Work Australia be provided with the discretion to increase or decrease the range of funds named in a modern award if the circumstances permit. We are aware that some awards operate within a limited geographic or occupational sphere and it may be more efficient to reduce the number of options to a relevant number.

ISN does not oppose the recommendation that where a modern award does not list a default fund [28] that there be no requirement that this situation change. ISN believes that it is likely that future applications will

[28] The draft report on page 158 states that "currently around 10 percent of awards" do not list a default fund. Whilst it is true that 13 of the 122 Modern Awards do not list a default fund, the figure of 10 percent can be misleading. Generally the modern awards which do not list a default fund cover industries that have significant, in some cases almost blanket coverage of enterprise agreements and have few employers. In addition public sector and service superannuation arrangements can be determined by other statutory arrangements.

be made to have MySuper funds listed in those modern awards which currently do not list a default fund. These applications may come from the traditional industrial parties, but are more likely to come from commercial funds as part of a wider application process.

It is suggested that in circumstances where there is an application or applications to list a default fund in a modern award for the first time, it would be appropriate that the views of the industrial parties regarding the desirability of listing be given significant weight.

4.8 Regular Assessment of listed funds

ISN's original submissions argued that it would be appropriate for a full review of the listed default funds within modern awards during the award review process that takes place every four years. We believe a period of 8 years is too long a period. It is recognised that superannuation is a long-term investment. However, the Commission's draft recommendation 8.5 could potentially allow for the continued listing for up to 8 years of a fund that has grossly underperformed or otherwise had changed circumstances to the detriment of beneficiaries covered by the relevant award. Such a circumstance could cause significant harm to the retirement incomes of significant sections of the workforce and would undermine confidence in the superannuation system.

It is ISN's views that the Commission's administrative light touch cleansing exercise to be undertaken every four years does not offer adequate protection to the workforce.

The Commission at page 159 of the draft report raises a number of valid practical and cost issues regarding a full review every four years.

We suggest that an alternative option may be a full-review every eight years during which new entrants could apply to be listed and a general review in the intervening period which both ensures that issues regarding fund and award consolidation; name changes; fund MySuper compliance and serious performance issues are dealt with.

ISN's modified proposal captures the reasoning behind draft recommendation 8.5 whilst addressing the concern that a long-term under-performing fund would be removed from the listing.

4.9 Removal of underperforming funds – an ISN alternative position

ISN believes it would be appropriate that long-term fund net-performance be assessed every eight years as one of the criteria to determine which funds are listed as default funds in modern awards.

It is also appropriate that every four years an assessment be made to determine if a listed fund remains eligible to continue to be listed in the relevant award or awards. The primary eligibility criteria should be that the relevant fund continues to be MySuper authorised.

ISN's original submissions at page 6 proposed that a long-term net-performance precondition be met for a product to be eligible for listing as a default fund in a modern award. ISN reiterates its earlier submissions. Elsewhere in these submissions we disagree with the Commission's belief that there is no relationship between past and future returns and provide new research to support our case. We also continue to believe that net performance-based criteria will help to drive better performance.

Notwithstanding our preferred position, in the alternative we offer an alternative process that we believe would offer a level of protection that we believe is lacking in the Commission's current proposal.

A second eligibility criteria for a product to continue to be listed as a default fund in an award is a requirement that the product not be one of the worst performing funds over the previous four years. ISN's proposes that in the event that a product's net investment return be continuously in the bottom quartile of

MySuper net investment returns over the previously four years, the fund would no longer be eligible to be listed as a default fund and would be removed from the award.

We suggest that this proposal addresses the Commission's expressed concerns and adds a level of protection to employees and employers and builds confidence in the system by ensuring long-term funds with poor performance are not included in modern awards for extended periods.

4.10 Appeal process

ISN has proposed a process which is open and transparent where reasons for decision are provided. We agree with the Commission when it states that; "Hence, there is a need for a 'quality filter' to distinguish between funds seeking listing in modern awards."[29] Any appeal process must balance the rights of applicants, other parties and consider the needs of the system. Importantly, it must also recognise that many of the considerations that will necessarily be made will have a substantial element of subjectivity.

Whilst ISN has no objection to the Commission's recommended two stage selection process to be applied by Fair Work Australia[30]. The first being the draft decision of the Commission and its expert panel, followed by a period allowing for further submissions and hearing if required, to be completed by a published decision.

A right of appeal may be created, limited or abolished by statute. ISN agrees with recommendation 8.6 and suggests that the only means of achieving the appropriate balance is to clearly limit an applicant's grounds for appeal to significant errors of law or fact. In addition appeals should not be provided as an automatic right; an application to a higher Court for leave to appeal would be the appropriate process.

ISN is of the view that the first process which involves the release of draft decisions by the Commission and the expert panel assisting, should not be open to challenge as the process is not determinative and to allow challenges at that stage would result in unreasonable delay and cost.

[29] Draft report page 9.

[30] See page 13 of Draft report.

5. Additional points

5.1 Superstream

On page 159 of the Commission' draft report it is said that a four year light-touch or 'watching brief' if required to amongst other things to ensure employers do not continue to make contributions towards non-compliant or non-existent funds. It is suggested that the Superstream back of office reforms would make these scenarios unlikely, particularly contributions to non-existent funds.

Fund identifier numbers

The Commission has recommended at 9.2 that it believes that default funds named in awards should be accompanied by a fund identifier used by APRA. ISN supports this and suggests that the Superannuation Product Identification (SPIN) code or other industry accepted unique identifier be used. This will aid employers and reduce the incidence of contributions being forwarded to different products with like sounding names. Such a practice will also ensure that poor performing MySuper products can not readily be replaced by the RSE licensee with a different product with no performance history.

5.2 Exempt public sector schemes and non-public offer funds

ISN notes the views of the Commission on page 189 of the draft report. In relation to EPSSS's ISN recognises that EPSSS's have unique characteristics, however we are of the view that it is appropriate that these funds also be subject to a regular performance review as proposed by ISN.

5.3 Review of the process of selection

ISN questions the utility of proposing a specific date and broad terms of reference for a review in eleven years time. It is likely that there will be considerable change within the industry and its regulatory environment in the intervening period. ISN has no fundamental objection to recommendation 9.3, however, we propose a less prescriptive approach which simply recognises that there should be a future review of the arrangements for the selection of default funds. This could be a stand-alone review, or be part of a future wider superannuation review.

5.4 Transitional issues

ISN is of the view that the process would be more effective if it was undertaken as a single exercise during the 2014 Fair Work Australia review of modern awards. The best means of achieving this, which may involve a staggered approach, should remain in the hands of the decision maker.

6. Governance issues

6.1 Government review of governance of default funds

It is difficult to establish the reasoning behind the Commission's recommendation 5.2 which states:

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

It is not clear why an inquiry should address the governance structures of funds named as default funds in awards – where all large fund model types are currently represented. The 'limitations' referred to in the recommendation related to the equal representation rules in the SIS Act.

The Commission's treatment of the governance considerations in the draft report are neither even handed nor evidence-based. The Commission expresses the view that the arguments for a greater role for independent directors apply to both the not-for-profit and retail sections of the industry. It is therefore surprising and inappropriate that the recommendation is aimed directly at industry and corporate funds. ISN suggests this recommendation is not even handed and fails to consider other recent regulatory developments.

APRA is currently undertaking an extensive industry consultation process regarding a dozen prudential standards which will apply to the superannuation industry. These include governance, investment governance, fit and proper, risk management and conflicts of interest standards. It is anticipated that most of these standards will apply from 1 July 2013 which will coincide with the commencement of MySuper default fund requirements. These new standards are highly relevant and are not adequately discussed by the Commission.

In addition APRA in 2012 APRA will be releasing guidance materials relating to independent directors/trustees on superannuation boards.

With respect to the Commission, it is suggested that the final report should take a more even handed and informed view on these matters. We do not support draft recommendation 5.2 and in light of the other initiatives in this area we believe it should be removed from the final report.

Industry SuperFunds believe that the equal representation model has delivered superior performance and relevant products that meet the needs of both employers and employees. This view is supported by a significant body of independent research. We do not accept the views expressed in the draft report that representative arrangements become inappropriate when a fund accepts members from the public at large.

6.2 Conflicts of interest

ISN supports draft recommendation 5.3 which requires a consideration of the mechanisms put in place by trustees to deal with conflicts of interest and the transparency in disclosing those conflicts. These considerations apply to all large fund types and are addressed in detail within the proposed APRA prudential standard SPS 521 Conflicts of Interest.

7. Conclusion

ISN welcomes the Commission's draft report and concurs with many of the recommendations. Where ISN takes issue with findings or recommendations, it hopes to do so with vigour, but respect and with some confidence that the Commission will keep an open and informed mind on the outstanding issues.

With few exceptions, ISN supports the general framework adopted by the Commission, including the principles to be applied to the process and the considerations when determining selection. ISN supports option three which is one of the two options supported by the Commission.

ISN continues to argue that past performance is a reliable indicator of future performance and attached to these submissions is new research from Deloitte Access Economics that supports ISN's claims. For the system to properly work in the best interests of employees, it must include a past performance standard. ISN continues to propose its position detailed in its original submissions. In the event that the Commission does not accept the performance standard proposed, an alternative position is put to the Commission in these submissions.

ISN believes that recommendation 8.2 to allow employers to opt-out of the relevant award requirement to allow them the discretion to select a fund of the employer's choice, is unworkable, unfair and inconsistent with other findings and recommendations in the draft report.

ISN welcomes the opportunity to further address the Commission on the matters contained in these submissions.

Attachment 1.

Deloitte Access Economics: Persistence in Superannuation Fund Returns