Public Policy - Economics - Government - Strategy

The right policy path for superannuation default funds and governance

YOUR CLUB FOR GOOD

Club Plus Superannuation Submission to the Financial System Inquiry Final Report

Prepared by
Aegis Consulting Group

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Contact

For more information about this report contact:

Vishal Beri
Managing Director
Aegis Consulting Group
PO Box 243 Pyrmont NSW 2009 Australia
T +61 2 9660 1706 E vberi@aegisconsultgroup.com

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EXECUTIVE SUMMARY

This submission from Club Plus Superannuation (CPS) is in response to the Final Report of the Financial System Inquiry (FSI Report) released in December 2014.

CPS welcomes the consultation process and the opportunity to participate. The focus of this submission is on two recommendations in the FSI Report:

- Recommendation 10 concerning competition in the default super system; and
- Recommendation 13 concerning governance by equal representation Boards.

About CPS

Key points about CPS are that:

- it is the superannuation provider for the registered club, hospitality and related industries and has over $1.9 billion in assets;
- in 2014, the membership of the fund was just over 92,000 people and 17,737 employers participated in the fund;
- its MySuper product has delivered returns of an average of 6.8 per cent over the previous 10 years (it is ranked 34 out of 108 funds surveyed);
- in 2014 it had delivered returns above the industry average calculated by the Australian Prudential Regulatory Authority (APRA);
- it has implemented measures to improve member services and benefits and lifted member satisfaction over the last 6 years from below 45 to 80 per cent;
- it is recognised by independent rating agencies as one of Australia's lowest cost and best value funds; and
- it received the Canstar Award as the best value superannuation fund in 2014.

Response to Recommendation 10 – Competition

The FSI Report seems to consider that competition is an end in itself, rather than a means to an end. This is inconsistent with the principles of National Competition Policy. The FSI Report applies the orthodox economic notion that efficiency and proper outcomes are efficiently achieved in a market where people freely make trade-offs. However, it does not properly consider the limits to this notion in the super system.

Previous more comprehensive assessments of the default fund market by the Super System Review (2010) and Productivity Commission (2012) and Regulatory Impact Statement accompanying the Stronger Super reforms (2012) concluded that the appropriate balance between competition and a consumer safety net was best served by the involvement of an expert panel within the Fair Work Commission (FWC) to determine entry to the default fund market. Full contestability was firmly ruled out as an appropriate option to achieve this balance.

These reviews recognised that the full application of contestability will and should always be restricted in the super system, and particularly for default super because:

- Superannuation represents social policy. It exists to safeguard and deliver a dignified retirement income for working Australians. Any consideration of competition should first be tested against this fundamental purpose. The FSI Report does not do this.

- Superannuation contributions are deferred wages and inherently an industrial matter, and therefore the FWC is the most appropriate body to list default funds in modern awards.

- The compulsory nature of super means that employees have limited incentive to engage with it until they are closer to retirement. The introduction of MySuper was based on this recognition and designed to lift engagement, and at least ensure that disengaged fund members were not made worse off.

  The level of disengagement affects how employees choose funds, and investment options within funds, and is reflected in the fact that about 70 percent of workers are in the default fund of their employer or award. Disengaged consumers will not drive fee based competition in the way the FSI Report assumes.

- The overwhelming evidence from employers offered to previous reviews and the FSI is that they prefer the current default super model and inclusion of 2-15 funds in awards, and do not have the capacity or interest to select funds for employees in a contestable market. They consider that a contestable model will unnecessarily add costs to their business for no discernible benefit to them or their employees.

  The low level of capacity and interest of employers to select funds increases the risks to employees in industries like the club industry where there are a diverse range of small and medium employers and high level of casual and part time employment. These factors can combine to make employees worse off in their retirement unless there is strong industry based default fund that has the knowledge and background to manage employees' super lifecycle with these conditions and factors in mind.

- For-profit funds that are vertically integrated within a financial institution with business and residential banking, insurance and other products needed by small, medium and large business have the capacity and incentive to leverage this package of services and offer inducements to employers to choose their super product.

  Where employers make choices in their interests instead of their employees' interests, workers can be worse off. While the Stronger Super Reforms ban the use of inducements, enforcement practices may not completely dissuade or address the use of them, and in the case of employee retirement benefits prevention is likely to be better than cure.

- For smaller industry funds, like CPS, full competition in the award based default fund market may decrease revenue opportunities, and therefore reduce their capacity to fund continuous improvement in consumer service and benefits. This may lower the competitiveness of smaller industry funds, and over time result in a market dominated by large retail and industry funds only, thereby reducing consumer choice.

  The level of market concentration in the superannuation industry is much less than that for the banking and insurance sectors and this is of benefit to fund members because it offers diversity of products and services.

- Where full competition forces a 'one size fits all' approach to super fund services and products, employees are likely to be worse off, particularly those in non-traditional employment arrangements or those who work casually or part time whose lifecycle engagement with super may be even less than the normal degree of participation.

  Preserving and encouraging diversity in funds so that safety nets are tailored to differing kinds of employment, employment lifecycles and industry demographics is especially important to help employees deal with two major risks - involuntary retirement and retirement income sequencing. Managing involuntary and sequencing risks is particularly important in industries with low skills and education and where weekly wages are less than $1000.

  The accommodation and food industry (which includes clubs) has the highest incidence of involuntary retirement. These risks can be effectively identified and managed by a specialist industry fund, such as

CPS, but are unlikely to be reflected in pricing models of for-profit funds bidding for default fund management to the extent necessary to benefit employees.

- The level of fees in the super system are driven by regulatory and compliance issues and average costs are similar for industry, retail and public sectors funds. Accordingly, fees are not as important as net returns to members when choosing default funds. Tendering on price alone is likely to affect product design and features, as well as a trustee's ability to provide a product that appropriately discharges their fiduciary duty to act in the best interests of members.

Full contestability should only be entertained if there is widespread support for this and evidence that legislative intervention to promote competition is necessary to address market failure. The previous assessments by the Super System Review and Productivity Commission establish that neither of these conditions are present. The FSI Report ignores this fact and also the detailed assessment of the strengths and weaknesses of current arrangements which led these previous assessments to conclude that existing arrangements struck the appropriate balance between system stability and competition.

Prior to the current FWC model being introduced, retail funds faced higher barriers to entry in relation to default funds in modern awards. However this has not led to any evidence of market failure, such as competitive disadvantages for retail funds or reducing benefits to employees, which requires regulatory intervention. Some key points to note are as follows.

- The default fund in modern award market is small and represents only 6 per cent of total superannuation assets and between 6 and 9 per cent of all superannuation contributions for APRA regulated entities. This means that activities within it are unlikely to have any adverse effect on the total superannuation market.

- The current distribution of assets across fund types indicates healthy competition between retail funds (39 per cent of assets) and industry funds (31 per cent of assets).

- In 2013, retail funds maintained the highest number of members in every age group except for those under 35.

- Over the last ten years industry funds have on average performed considerably better than retail funds to the benefit of fund members, including employees in default funds in modern awards. Industry funds have performed better than the average of all superannuation entities regulated by APRA.

Response to Recommendation 13 – Governance

In the view of CPS, legislation or regulations that mandate the appointment of independent directors to superannuation trustee Boards is <u>not</u> consistent with the need to ensure an appropriate balance between standard rules of governance and the need for organisations to have flexibility to meet their own needs.

Recommendation 13 is not in CPS's view a sensible proposal because:

- Current legislation governing directors' duties in the superannuation industry is the most effective instrument for good corporate governance. The *Superannuation Industry (Supervision) Act 1993* (SIS Act) creates and regulates the obligations for Boards of superannuation funds. These requirements include that directors must perform their powers and functions in the best interests of beneficiaries. The Stronger Super Reforms strengthened these obligations. The APRA considers that these current arrangements are effective in managing the specific purpose of superannuation and cannot be compared to the purposes of general companies regulated under the Corporations law.

- There is no credible case for a mandated one size fits all approach to corporate governance. While the Organisation of Economic Cooperation and Development (OECD) and Australian Securities Exchange (ASX) recommend the inclusion of independent directors on Boards, neither organisation support a mandated approach to this in legislation. The ASX corporate governance principles relied on in the FSI Report specifically support the capacity of entities to choose their own arrangements.

- There is no evidence from previous reviews of superannuation corporate governance of the need for a mandated approach. The previous assessments by the Super System Review and Productivity Commission demonstrate that there is no majority support within the superannuation industry for this approach, and there is no strong evidence that this step is necessary to improve the governance and performance of superannuation funds.

  The Super System Review recommended that the SIS Act be amended to enable equal representation Boards to appoint independent directors, not that it should be changed to require those Boards to include a majority of independent directors.

  There is ample and diverse empirical evidence that the representation model is the most effective corporate governance approach to align the interests of Boards and shareholders. Studies show that where Boards do not have a stake in the share price of companies or funds they manage the performance of their organisations can be worse. The representation model is completely consistent with the purpose of trustees in the superannuation system and industry funds with this model have consistently outperformed retail funds across key indicators.

  For smaller industry based funds, like CPS, it is the affinity of the equal representation Board with the employees in its industry that adds, not detracts, to the sense of responsibility that directors have to fulfil their statutory obligations and also ensure that fund members have the maximum opportunities for a dignified retirement income

  In the case of CPS, it is involvement of a majority of employee and employer representatives on the Board that enables it to inherently understand the specific risks facing employees in the accommodation and food industry (which includes clubs) which can affect their retirement incomes. This includes the risks of involuntary retirement and sequencing. A Board consisting of a majority of independent directors is unlikely to experience the same affinity with and understanding of these issues.

- Current Board structures demonstrate that self-regulation has been and can continue to be a success in improving corporate governance. It is clear that the current self-regulatory approach which APRA supports is working effectively in relation to the use of independent Directors. For example, of the not for profit entities (industry funds) with equal representation which can offer products to the general public, 21 or about 54 per cent have Boards with an independent Director.

  The CPS experience is a good example of the success of self-regulation. Between 2006 and 2013 the number of Board members has reduced from 16 to 8, and there have been five changes of directors over the last four years. The Board chair is rotated annually between employer and employee representatives. CPS now has 21 full time staff who have greatly enhanced the fund in terms of services to members and governance without changing the fund’s low fee structure. CPS has successfully maintained its low fee structure due to the Board policy of Board reduction, low Director fees and an effective and robust budgetary process.

  The Board has also appointed an independent investment consultant who attends meetings of the Board and investment committee. This adds further rigour to the fund’s investment decision making.

1. INTRODUCTION

1.1 Focus of this Submission

This submission responds to the following recommended actions in the Financial System Inquiry Final Report (the FSI Report).

- **Recommendation 10** – "*Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system*"[1].

Club Plus Super (CPS) considers that this recommendation puts at risk the retirement incomes of hundreds of thousands of low paid workers in the clubs and other industries, particularly workers employed on a casual and part-time basis. It is concerning to CPS that this recommendation is completely at odds with the conclusions of previous assessments of competition and default funds in awards conducted by the Super System Review and Productivity Commission[2].

Those assessments were significantly more comprehensive and detailed than the FSI Report's consideration of the super system, and recommended that in the interests of maintaining the appropriate balance between competition and stability, the current process of nominating default funds in awards should be maintained. It is troubling to CPS that the FSI Report contains no substantial evidence to support such a significant departure from the recommendations of these previous assessments.

Of equal concern is that the FSI Report makes this recommendation despite support for the current arrangements from stakeholders across the spectrum.

- **Recommendation 13** – "*Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair*"[3].

CPS considers that this proposal is not consistent with the market approach to corporate governance and is also not supported in the FSI Report by any substantial evidence of the benefits. This approach is not supported by the previous assessments by the Super System Review and Productivity Commission[4]. Neither is it supported by the Australian Prudential Regulation Authority (APRA)[5].

Despite the FSI Report's attempt to argue otherwise, this approach is also not supported by the Organisation of Economic Co-operation and Development (OECD) or Australian Securities Exchange (ASX) which firmly recommend in favour of organisations having the flexibility to choose their own arrangements guided by agreed standards and principles[6].

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[1] Australian Government, Financial System Inquiry Final Report, December 2014; p101

[2] Australian Government, Review into the governance, efficiency, structure and operation of Australia's superannuation system, 2010 and Productivity Commission, Default superannuation funds in modern awards 2012

[3] Ibid; p133

[4] Ibid

[5] Australian Prudential Regulation Authority, Response to interim FSI Report, 2014

[6] Australian Securities Exchange Corporate Governance Council, Corporate governance principles and recommendations, 3rd Ed, 2014 and Organisation of Economic Co-operation and Development, Principles of corporate governance, 2004

1.2 About Club Plus Super

1.2.1 Coverage[7]

Club Plus Super (CPS) has been a superannuation provider for the registered club, hospitality and related industries for over 25 years. In 2014, the membership of the fund was just over 92,000 people and 17,737 employers participated in the fund.

The popularity of and participation in the fund has grown steadily over time and in 2012/13 about 24 per cent of CPS contribution revenue consisted of transfers from other funds, an increase in this income source of about 4 per cent from 2011/12.

Employees and employers in the club industry rely heavily on CPS to fulfil their obligations and rights under the superannuation system. For example, around 80 per cent of all employees of clubs are members of CPS.

1.2.2 Products and Performance

In 2013 total CPS revenue was over $411 million and before tax its accrued benefits were over $384 million. Its total assets in 2013 totalled over $1.9 billion[8].

CPS has two main products, Club Plus Super and Club Plus Pension. Within these main products there are a range of investment options ranging from cash to high growth. The balanced investment option is also the MySuper option.

In 2013 CPS was one of the first funds to become MySuper authorised by the Australian Prudential Regulatory Authority (APRA) following superannuation reforms introduced by the former Federal Government.

CPS has a normal rating with APRA and is platinum rated[9] for all its accumulation and pension products. In 2014 it was awarded the Canstar Award for the best value fund.

According to independent market rating instruments, CPS is amongst the five lowest cost funds in Australia[10] and its directors' fees are 30 per cent lower than the industry average[11].

The CPS MySuper product has delivered returns of an average of 6.8 per cent over the previous 10 years. In 2012/13 CPS delivered a 13 per cent return on its MySuper/Balanced option and a 14.4 per cent return on its Club Plus Pension Balanced option[12].

These results compare favourably with annual average industry-wide rates of return for funds with more than four members of 13.7 per cent for the year ending 30 June 2013 and 6 per cent for the 10 years to 30 June 2013[13].

[7] CPS Annual Report 2013
[8] Ibid
[9] Rating by independent rating agency, SuperRatings
[10] Ibid
[11] McGuirk survey
[12] CPS Annual Report 2013
[13] Australian Prudential Regulation Authority, Annual Superannuation Bulletin for the Year to 30 June 2013, 8 January 2014

1.2.3 Default Fund

The industrial award system is an important, but not the only source of revenue for CPS. About 50 per cent of CPS members participate in the fund through their industrial awards and 50 per cent are non-award members[14].

However of the contributing members who are employees of clubs, almost all maintain CPS as their default fund[15].

1.2.4 Member Focus and Services

Like many industry smaller funds, CPS must continue to improve services and benefits for its members and participating employers in order to maintain its competitiveness. Over the last 5 years CPS has introduced or commenced the development of a myriad of service improvements including[16]:

- removed switching fees;
- expanded the range of investment options;
- introduced binding death benefit nominations;
- refreshed on-line services for members to improve access to information and fund portability;
- launched a clearing-house for participating employers, which enables them to pay all their employees in one transaction regardless of super fund;
- introduced a new Direct Investment Option (DIO), an online platform that enables super and pension members to invest in term deposits, S&P/ASX 300 listed shares and exchange traded funds (ETFs); and
- introduced its own financial planning arm (CPFP).

The long term commitment of CPS to continually improve member services and benefits has contributed to the increase in transfers from other funds and its consistent recognition as one of Australia's best value super funds[17].

As part of its commitment to member services, CPS conducts regular customer satisfaction surveys and annually reviews its approach to member services. In 2013 CPS achieved an 80 per cent customer satisfaction result. When surveys were first introduced six years ago, member satisfaction levels were less than 45 per cent. The substantial increase in member satisfaction over this time demonstrates the success of the commitment of CPS to focus on member services and benefits.

1.2.5 Board Composition

The Board of CPS comprises equal representation of four member representatives and four employer representatives. The chair of CPS rotates between the member and employer representatives each year.

An independent investment adviser attends meetings of the Board and investment committee.

[14] Advice from CPS
[15] Ibid
[16] CPS Annual Report 2013
[17] Chant West, an independent rating agency

2. RESPONSE TO RECOMMENDATION 10 IN FSI REPORT – COMPETITION FOR DEFAULT FUNDS IN AWARDS

2.1 Overview

To reach its conclusion that full contestability for default funds should be implemented in the future the FSI Report appears to rely primarily on the theoretical notions that[18]:

- increased competition in the default fund market may be needed to put downward pressure on fees in the system as a whole and thereby benefit members; and
- an auction or tendering process for all default funds may be more efficient than the current selection process.

It is concerning to CPS that the FSI Report relies on these theories to recommend a significant change to default funds given that:

- the FSI Report also agrees with many stakeholders that it is too early to judge the full effects of MySuper on default funds[19];
- there is clear evidence that MySuper has delivered early positive results in terms of fee reductions and an improved focus on member benefits[20];
- submissions to the FSI across the full spectrum of stakeholders urged that competition in the super system should not be assessed on fees alone, and that net returns to members were more important[21];
- there is clear evidence in submissions to the FSI that levels of fees and efficiencies in the super system are influenced by a range of issues, such as regulatory costs, not the current process of nominating default funds[22];
- there is clear evidence that the compulsory nature of the super system means that consumer engagement and behaviour is not as readily linked to price elasticity that may occur in other markets[23]; and
- member surveys indicate that they are comfortable with the current system[24].

The concerns of CPS about this are amplified given that the FSI Report does not seem to have considered:

- the findings of more comprehensive assessments of the super system already undertaken since 2010 which support current arrangements[25];
- the rationale for the limits on competition reforms to date[26];
- the actual impact of the default fund market on competition in the super system as a whole; or
- the detrimental impact of full contestability on smaller industry based funds, like CPS, and their members.

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[18] FSI Report 2014; p108
[19] Ibid; p106
[20] The Australian Institute of Superannuation Trustees, Second submission to the financial services inquiry, 2014; p15 and Centre for International Finance and Regulation, MySuper: A stage in an evolutionary process; 2014
[21] Australian Council of Trade Unions, Australian Institute of Superannuation Trustees, Corporate Super Association, Association of Superannuation Funds Australia, and Independent Fund Administrators & Advisers Pty Ltd
[22] Ibid
[23] Australian Government, Review into the governance, efficiency, structure and operation of Australia's superannuation system, 2010; Productivity Commission, Default superannuation funds in modern awards 2012; and Australian Department of Education, Employment and Workplace Relations, Regulatory Impact Statement: Default Superannuation Funds in Modern Awards, 2012
[24] ClubPlusSuper, member surveys
[25] Australian Government, Review into the governance, efficiency, structure and operation of Australia's superannuation system, 2010 and Productivity Commission, Default superannuation funds in modern awards 2012
[26] Australian Department of Education, Employment and Workplace Relations, Regulatory Impact Statement: Default Superannuation Funds in Modern Awards, 2012

By concluding that full contestability is preferable without consideration of all the proper evidence and countervailing views, the FSI Report:

- appears to have been unfortunately captured by only one set of self-interested opinions – that of the for-profit financial service providers who are strong advocates of full competition in the default market;
- puts at risk the balance between stability and competition in the super system favoured by the Super System Review and Productivity Commission in their previous assessments of competition in the default market; and
- at worst increases the likelihood that workers in specific industries, and particularly low skilled workers at risk of sudden and early retirement, will be detrimentally financially worse off.

2.2 FSI Report Misunderstands the Application and Impact of Full Competition in the Super System

The FSI Report considers that fees remain high and are not subject to competitive pressure. It believes that a major reason for this is "*the absence of strong consumer-driven competition, particularly in the default fund market*"[27]. The FSI Report suggests recommendation 10 to address this perceived problem.

Unlike the previous assessments of default funds undertaken since 2010[28], the FSI report has succumbed its analysis to traditional notions that price based competition is the ultimate influencer of consumer led behaviour. In doing so it has ignored the natural limits on competition in the superannuation market, and particularly the default fund market.

2.2.1 Limits on Competition in the Default Super System

(a) Super exists to fulfil a social policy purpose

It is widely acknowledged that the original intent of the Australian Parliament and the legislation it enacted to support compulsory superannuation is that the super system should operate as part of workplace relations arrangements and deliver financial security for workers in their retirement[29].

It is the legislated compulsion on employees to save and employers to support employee saving for their retirement that provides both for-profit and not-for-profit super fund providers with the basis of their business models. Accordingly policy recommendations that seek to apply market principles to the super system must prioritise the interests of employees first. This is especially the case for those employees who do not engage with their super until closer to their retirement.

The Regulatory Impact Statement (RIS)[30] that accompanied the Stronger Super reforms in 2012 is an important guide when considering one of the key limits to competition in the super system, and particularly default funds. It concluded that, unlike other markets, funds cannot be traded freely because superannuation forms a key part of the Australian safety net and workplace relations system and members are relatively inactive in managing their funds. In proposing full contestability for default funds, the FSI Report unfortunately does not appear to have considered the RIS and this clear limit on the application of competition theory.

[27] FSI Report 2014; p102

[28] Australian Government, Review into the governance, efficiency, structure and operation of Australia's superannuation system, 2010 and Productivity Commission, Default superannuation funds in modern awards 2012

[29] Superannuation Guarantee (Administration) Act 1992

[30] Australian Department of Education, Employment and Workplace Relations, Regulatory Impact Statement: Default Superannuation Funds in Modern Awards, 2012

(b) Compulsory saving reduces member engagement with super

Existing data varies and demonstrates that the compulsory nature of saving encourages employees to engage less with making choices in relation to their super.

Choosing funds: The Productivity Commission has estimated that about 70 per cent of employees are in a default fund offered by their employer or award[31]. It is also estimated that since the introduction of legislation enabling employees to choose between a variety of retail and industry funds, switching rates between funds have actually declined from about 5 per cent in 2005 to about 2 per cent in 2010[32]. Of those who do switch between funds, it is estimated that about 50 percent do so because they change employers[33].

Choosing investment options in funds: The Super System Review estimated that 60 per cent of default fund members are in the default investment option, but did not actively choose this[34]. It is also estimated that more than 90 per cent of fund members do not choose to switch between investment options during the life of their fund and before retirement[35].

These estimates provide a clear signal that the natural disposition of members in funds and their rates of switching between funds or investment options is unlikely to change in any dramatic way in response to fee based competition amongst default funds.

While the FSI report purports that recommendation 10 is designed to generate additional benefits for members, it has not discussed or recognised this natural limit on competition, and any associated impacts on assumed advantages for employees from competition.

(c) Agency issues which cause detriment to employees can be exacerbated in a fully competitive market

One of the most important set of inherent restrictions on the capacity of a fully contestable model to deliver optimal outcomes for employees, includes:

- the ability of employers to make choices from a range of funds that properly benefit their employees;
- the risk that employers, particularly small and medium businesses (SMEs), may be induced to select for-profit funds on the basis of the financial incentives, such as banking and insurance packages, that for-profit funds can and will offer them; and
- the risk that full competition may reduce service innovation, product diversity and safety nets for members.

Unfortunately, the FSI Report appears to have given these critical issues cursory or no consideration.

(i) Capacity and desire of employers to select default funds

It has been legitimately established and agreed for some time that individual employers are not always the best agents to determine appropriate default funds for their employees, outside of an industry fund arrangement.
The RIS that accompanied the Stronger Super reforms in 2012 concluded that there is a risk that where employers are choosing default funds for employees as part of a competitive process, the choices of employers

[31] Productivity Commission, Default superannuation funds in modern awards 2012; p29
[32] Ibid
[33] Australian Council of Trade Unions, Submission to the FSI, 2014; p5
[34] Australian Government, Review into the governance, efficiency, structure and operation of Australia's superannuation system, Final Report: Part One: Overview and Recommendations, 2010; p9
[35] Australian Council of Trade Unions, Submission to the FSI, 2014; p5

may not always necessarily align with the best interests of their employees[36]. This was one of the key reasons that the previous Federal Government did not choose full contestability for the selection of default funds.

In its 2012 assessment of default funds in modern awards, the Productivity Commission also rejected full contestability for default funds because it had similar concerns about the limits on employer capacity as those expressed in the RIS. Specifically the Commission concluded that "*while the MySuper legislation seeks to provide information that will better enable superannuation products to be compared, employers are not best placed to make this comparison from the expected full suite of products that will be available in the medium term. This is due to the inherent principal–agent issues that exist between employers and employees, and the stated lack of interest and expertise on the part of many employers when it comes to choosing a default product, particularly from a large number of available products*"[37].

The position taken by the previous Federal Government and Productivity Commission was and continues to be supported by employers. This is primarily because they recognise that a fully contestable model has two key consequences for their capacity.

- Firstly, it would significantly increase the complexity for employers in relation to selecting a default fund for their employees. This added complexity may be particularly acute for small and medium sized businesses which are unlikely to be well resourced in relation to superannuation administration. The Productivity Commission found that many smaller employers prefer the simplicity of selecting a fund specified in a modern award, rather than selecting from potentially hundreds of funds in the market.[38]

- Secondly, their search costs associated with comparing a wide range of funds would increase significantly. Search costs for employers include the administration time and activities needed to notify all relevant employees that their superannuation will be directed to a different fund, assessing and comparing available default funds, enrolling their employees in funds and facilitating the change in funds for employees[39]. The search costs would especially rise where employers were not fully informed or able to understand the choices and differences between available superannuation funds. Small to medium businesses may be particularly vulnerable to this.

For example, in its submission to the Commission, the Australian Hotels Association argued that *"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."*[40]

The Australian Industry Group (AIG) is a peak employer body[41] and has been a consistent supporter of the current selection process for default funds in awards and opponent of full contestability. In response to the Super System Review in 2010 it advised that the award default fund nomination process was preferable because it is simple and reduces costs and the complexity for employers associated with selecting default funds. It pointed

[36] Australian Department of Education, Employment and Workplace Relations, Regulatory Impact Statement: Default Superannuation Funds in Modern Awards, 2012;p44

[37] Productivity Commission, Default superannuation funds in modern awards 2012; p191-92

[38] Ibid; p143

[39] Australian Department of Education, Employment and Workplace Relations, Regulatory Impact Statement: Default Superannuation Funds in Modern Awards, 2012;p36

[40] Australian Hotels Association Submission in relation to Default Superannuation Funds in Modern Awards; p9

[41] The Australian Industry Group is a peak industry association in Australia which along with its affiliates represents the interests of more than 60,000 businesses in an expanding range of sectors including: manufacturing; engineering; construction; automotive; food; transport; information technology; telecommunications; call centres; labour hire; printing; defence; mining equipment and supplies; airlines; and other industries. The businesses it represents employ more than 1 million people and its members operate small, medium and large businesses across a range of industries

out that corporate nominated default funds (which the FSI Report has relied upon as a benchmark to support its recommendation for contestability) also lacked transparency and competition and therefore it was unreasonable to implement reform directed at award based default funds only. This important point was accepted by the Review[42].

In its recent response to the FSI, the AIG repeated this point stating that "*a large proportion of employers and employees use one of the default superannuation funds which are listed in relevant awards and, in Ai Group's experience, most employers support the simplicity of this system. Employees also appear to support the default superannuation system given that most do not exercise their right to choose another fund. Ai Group supports the concept of 2-15 default superannuation funds being listed in each modern award consistent with s.156H of the Fair Work Act 2009 (Cth)*[43].

There is good reason for employer groups like AIG to support current approaches to selecting default funds in awards. In the experience of CPS, participating employers in an industry fund are fully committed to the interests of their members and choose funds accordingly. This is partly because participating employers are all involved in the same industry and share experiences, lessons and approaches for the benefit of the industry as a whole. They also accept the merits of including default funds in awards consistently across the industries in which they operate.

Approaches that preserve the opportunities for employees to gain a dignified retirement income, without imposing additional fund search and selection costs on employers is particularly relevant in industries consisting of a high degree of small to medium businesses undertaking similar operations across the nation in urban and regional areas. The club industry is one example of this. The capacity of all employers within this industry to equally and effectively individually choose appropriate default funds for their employees through a competitive process is significantly limited. In a fully contestable model, this may seriously reduce the opportunities for employees to optimise their retirement incomes.

The risk of this to employees is made more acute where an industry, like the club or hotel sectors, rely heavily on using casual or part time employees. The nature of these employment arrangements may increase the likelihood that employees will not engage with their super until closer to retirement. These employees may be worse off in retirement where, in a fully contestable model, their individual employers do not have the capacity to select the most appropriate fund option that suited their actual employment arrangements and career lifecycle.

In these instances, smaller industry based funds, like CPS, play a critical role in providing employees in the club industry with equal opportunities for dignified retirement income regardless of their lifecycle employment arrangements.

(ii) The use of employer inducements by the for-profit sector

A key issue that the FSI Report fails to discuss is that the mix of for-profit and not-for-profit fund providers in the super system affects how fee based competition in a fully contestable default fund market will potentially operate.

While there is criticism of industry funds for being too aligned with industrial parties based on precedent in the industrial system, there are also concerns about the close relationships between retail funds and banks and

[42] Australian Government, Review into the governance, efficiency, structure and operation of Australia's superannuation system, Final Report: Part Two: Recommendation Packages, 2010; p10-11

[43] Australian Industry Group, Second submission to the financial system inquiry, 2014; p5

wealth management companies, with most retail funds being owned by and/or vertically integrated within these financial services providers.

In a fully competitive market it can be expected that retail funds would increase their promotion, marketing and other efforts to lift their participation in the default fund market. This would be part of the strategic business planning of financial services providers and banks that have relationships with or interests in retail funds.

Targeting employers across industries who are existing clients of financial services providers may be an integral part of this strategy. Retail funds would have natural economies and scale and competitive advantages because they could work together with the financial services companies which own to offer employers a range of financial services related incentives to choose a retail fund as the default funds in awards.

This can create risks that employers may be attracted to choose retail funds as default funds for reasons other than what is in the best interests of employees.

For example, research by the Australian Prudential Regulatory Authority suggests that "*whilst company boards and trustee boards of retail pension funds are distinct entities, their historical origins and their typical compositions with significant numbers of overlapping executive directors make the distinction more theoretical than real, particularly in many cases where the shareholders are related entities or a parent company. In practice, the conflicts are 'resolved' by the retail trustees treating fund members like clients or consumers in a pension product, thus possibly diluting the notion of trusteeship in favour of the notion of product manager. Unlike non-retail trustees who negotiate the best possible terms for investment management services for their funds, retail trustees who often have investment managers as executive directors on their boards have impaired incentive to negotiate best terms for investment management services*"[44].

While the Stronger Super reforms make inducements and decisions made because of them illegal, the enforcement of this will rely on the resources and capacities of regulators. Enforcement actions after the fact may not be sufficient to preserve the retirement benefits of employees. It is not appropriate that the retirement benefits of employees are subject in any way to the potential occurrence of inducements.

(iii) Full competition may reduce service innovation, product diversity and safety nets for members

The RIS that accompanied the Stronger Super reforms in 2012 concluded that "*under a fully contestable model there are limited incentives for superannuation funds to innovate and improve the quality of their product for employees…due to the absence of any specific criteria or assessment process, including that the fund meet the best interest of members covered by their particular award"*[45].

For smaller industry funds, like CPS, full competition in the award based default fund market may decrease revenue opportunities, and therefore reduce their capacity to fund continuous improvement in consumer service and benefits. This may lower the competitiveness of smaller industry funds, and over time result in a market dominated by large retail and industry funds only, thereby reducing consumer choice.

The FSI Report does not appear concerned about market rationalisation and believes it may drive efficiencies. However, in reality market concentration in the super system cannot be regarded in a similar way to banking, insurance or other markets.

[44] Wilson, S. Superannuation fund governance: an interpretation, Australian Prudential Regulatory Authority, 2008; p12
[45] Australian Department of Education, Employment and Workplace Relations, Regulatory Impact Statement: Default Superannuation Funds in Modern Awards, 2012;p43

Currently the superannuation sector is much less concentrated than the banking and insurance sectors in Australia. While the ten largest super funds have about 45 per cent market share, the top three insurance firms have about 70 per cent market share and the major four banks have more than 60 market share across product areas[46]. In normal competition theory where market concentration is accompanied by high barriers to entry it can encourage monopoly rents (higher prices for consumers). Market concentration and low barriers to entry can create the environment for the next cycle of new entrants offering lower prices and alternative products, which increases pressure on incumbents to offer more choice of services at lower cost.

The super sector exhibits certain features which may mean that market concentration has negative outcomes for consumers. Firstly, it is a compulsory not voluntary system of purchasing services and products. Given the high extent to which this makes consumers disengaged, price elasticity in a low barrier to entry environment is unlikely to drive consumer demand and produce incentives for service providers to be innovative or tailor products to suit members varying needs. However, the super sector is highly regulated and is not a low barrier to entry market, thereby increasing the risk that market concentration has the actual effect of restricting choice for consumers and elevating prices.

This means in practice for example that full competition may reduce the capacity of industry funds to offer the kind of consumer benefits, such as more comprehensive life and income protection insurance and lower fees for these products that by comparison are superior to retail funds.

Less choice is not an outcome that would not be in the interest of employees, particularly if it is assumed that the diversity of employment and employment arrangements demands similar variety in the super fund market. The Super System Review clearly found that "*the level of engagement of any individual member will depend on a range of factors, for example, the member's age, account balance, and broader financial and life circumstances. The key point from the Panel's perspective is that a compulsory system needs to be able to cater for these different degrees of engagement: the significant proportion of members who are not engaged with their super, or in a position to make the sorts of decisions required of them; and the informed, financially literate, or well-advised members*"[47].

Where full competition forces a 'one size fits all' approach to super fund services and products, employees are likely to be worse off, particularly those in employment arrangements that may increase the level of disengagement with super over their vocational lifecycle. These workers require careful attention.

There is strong view amongst independent stakeholders that "*smaller funds play a very valuable role in allowing greater levels of personalised member contact, resulting in outcomes more customised to the needs of the member, as well as delivering very competitive returns. In addition, consolidation of the industry detracts from the competition that the Government wants to achieve, which is likely to reduce pressure on remaining funds to reduce fees*"[48].

Because super is a product of the employment system and is compulsory, there is an obligation for the system to provide a safety net for consumers that does not exist in the completely voluntary banking and insurance markets. The Stronger Super reforms, including the introduction of MySuper products, are intended to improve the prudential regulation of superannuation and consumer protections, particularly for disengaged members.

What the Stronger Super reforms seek to embed, the FSI Report recommendation about full contestability would unwind. This is a system 'where employees have access to default superannuation arrangements which are most appropriate to them [and] consideration of what is in the best interests of members is best reflected through fund features including:

[46] Australian Centre for Financial Studies, Submission to the FSI, 2014; p85-87
[47] Australian Government, Review into the governance, efficiency, structure and operation of Australia's superannuation system, Final Report: Part One: Overview and Recommendations, 2010; p9
[48] Independent Fund Administrators & Advisers Pty Ltd (IFAA), Submission to FSI; 2014; p3

- Default investments which reflect the fact that different industries have different demographics and therefore varying super fund needs. For example, funds that support younger employees in the club or retail sector may not be appropriate for funds which serves older employees in the telecommunications industry.
- Insurance products that can cater to all workers including those in higher risk occupations.
- Customer facilities that support the varying financial literacy and capability of employees within specific industries. For example low skilled factory workers are likely to require a higher level of service and more tailored products to boost their engagement with super compared to financial service industry employees[49].

What the FSI Report fails to adequately consider and reflect is the fact that the previous more comprehensive assessments of the default fund market by the Super System Review and Productivity Commission and Regulatory Impact Statement accompanying the Stronger Super reforms all concluded that the appropriate balance between competition and a consumer safety net was best served by the involvement of an expert panel within the Fair Work Commission to determine entry to and diversity within the default fund market. Full contestability was firmly ruled out as an appropriate option to achieve this balance[50].

Preserving and encouraging diversity in funds so that safety nets are tailored to differing kinds of employment, employment lifecycles and industry demographics is especially important to help employees deal with two major risks - involuntary retirement and retirement income sequencing.

In considering its proposal for full contestability it appears that the FSI Report has relied on assumptions within traditional economic theory that every decision by a consumer is the result of a rational analysis of trade-offs. For example the FSI Report assumes that consumer driven fee competition will derive from full contestability because fund members will trade off stability for lower prices. A discussed above the inherent nature of superannuation imposes severe limits on these kinds of assumed traditional responses.

In opting for full contestability the FSI Report has similarly ignored the variety of normal circumstances that can affect an employee's capacity to make rational trade-offs about their security in retirement. When an employee is subjected to involuntary retirement for example, that person is no longer in a position to participate in a "*classical life-cycle model of retirement in which the age at which an individual retires is determined by the satisfaction derived from leisure relative to work compared to the potential increase in future consumption that would result from continued work*"[51].

This is not an uncommon event. Research shows that almost 75 percent of males and more than 40 per cent of females are subject to involuntary retirement before the age of 55. In general across the economy the primary reason for this is considered to be health, however retrenchment and the inability to find work because of economic circumstances, skill levels, education levels and/or age, as well as decisions to care for others are also factors[52]. In general, data from the ABS suggests that the rate of involuntary retirement is highest for employees in accommodation and food services, community and personal services, clerical, administrative and sales roles, labourers, and occupation types with average weekly salaries below $1,000 a week[53].

Of particular importance to CPS is the fact that statistics also show that within this broad group of occupations, "*the two industries with by far the greatest risk of early retirement are accommodation and food services and administrative and support services*"[54]. The majority of employees within the club industry fall within these occupations and may be particularly susceptible to involuntary retirement because of the combination of three

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[49] The Australian Institute of Superannuation Trustees, Second submission to the financial services inquiry, 2014; p22
[50] Ibid
[51] Australian Centre for Financial Studies, Involuntary retirement: characteristics and implications, 2014; p13. This paper was included in the ACFS submission to the FSI
[52] Ibid; p3
[53] Ibid; p4
[54] Ibid; p19

main factors – "a greater prevalence of poor health outcomes, a greater instance of retrenchment (and are less likely to hire older staff) and a greater proportion of females in the workforce".[55]

These risks to workers in the club industry mean that superannuation products need to be tailored to consider, accommodate and where possible minimise the impact of these risks on the ability of workers to enjoy a dignified retirement income. A specific default fund based on and designed for the industry and managed by employees and employers is the most effective option to achieve this. A fund selection process shaped only by price competition and employer selection will not be able to respect and respond to the importance of these risks to employees.

A related issue is that of sequencing risk, which is defined as "*the risk of experiencing returns in an unfavourable order during periods facing changes in invested capital, either through contributions or distributions*" [56].

This risk can arise in both the accumulation and de-accumulation phases of super "*when large negative returns are experienced during the period with the greatest portfolio balance (that is, the worst returns in their worst order)*"[57]. The primary factors influencing this risk are "*the size of the contributions (or withdrawals); the growth of the contributions (or withdrawals) through time; the timing of contributions (or withdrawals); and the portfolio balance and the return volatility*"[58].

It is generally regarded that the most effective way to manage this risk is via astute management taking into account asset diversification, the employment and other lifecycle circumstances of the fund member and early design of a portfolio to address the risk[59].

Given that employees in some sectors, like those in the club industry, are more prone to involuntary retirement it is essential that sequencing risk they may experience is managed effectively. Smaller industry funds, like CPS, that exist to serve specific employment sectors with employees who are more vulnerable to lifecycle issues affecting their super accumulation and de-accumulation, can be properly focussed on managing sequencing risk for fund members. This is particularly because default funds members are generally disengaged and focussed on retirement incomes and therefore fund design and management has an added responsibility to consider their sequencing risk.

A fully contestable market based on fee competition is unlikely to prioritise these issues within pricing models and default fund members would be worse off as a result.

2.2.2 Conclusions of Super System Review about Competition

To support its recommendation about full contestability the FSI Report seeks to rely on the Super System Review in 2010[60]. The FSI Report specifically states that the Super System Review noted that default funds were a major reason for lower fee competition[61]. However, this interpretation by the FSI Report is a serious over statement of the actual conclusions reached by the Super System Review, and is used by the FSI Report out of the correct context intended by the Super System Review report.

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[55] Ibid; p19
[56] Financial Services Institute of Australasia, Sequencing risk: research report, 2012: p6
[57] Ibid
[58] Ibid
[59] Ibid; p24
[60] Australian Government, Review into the governance, efficiency, structure and operation of Australia's superannuation system, 2010
[61] FSI Report 2014; p101

When considering why competition had not delivered optimal outcomes by 2010, the Super System Review concluded that there were 7 reasons why normal consumer demand led competition was made more difficult in the superannuation system. These were:

- "***Failure to exercise choice****: Often a member doesn't choose the fund to which they belong. New employees typically simply become a member of their employers default fund.*
- ***Lack of price awareness****: Compulsory contributions don't come directly out of member's pockets, nor do the fees and costs charged by the fund (at least until they retire). This makes people much less price aware and much less likely to make a decision based on price or cost.*
- ***Lack of interest****: Members are often not engaged with their super until closer to retirement and so will not be sufficiently interested to respond to competitive behaviour on the part of funds until that time (if at all).*
- ***Agency and structural issues****: There are limited opportunities for member vigilance, on the one hand, or incentives for agency vigilance, on the other, to reduce prices.*
- ***Complexity****: Super is inherently complex and many consumers do not feel confident making decisions about it.*
- ***Lack of comparability****: Even if members are engaged up to a point, there is a lack of contestability at consumer level because of product complexity and lack of information and transparency about fees and performance.*
- ***Frictions****: Lastly, even if someone is interested in switching funds, often the paperwork and other frictions in changing funds become too big a disincentive and they give up*"[62].

Six of these factors relate to general poor consumer engagement and overall super system complexity which occur for members of all funds, whether retail or industry based. None of these six factors are specific to default funds in modern awards. It is concerning that the FSI Report through the structure of its discussion seeks to suggest that weak member driven competition in the super system specifically arises or is more prevalent than it should be because of the current selection of default funds in awards[63].

The findings of the Super System Review clearly demonstrate that it is inaccurate for the FSI report to suggest that competition reform to the selection of default funds is a singly important factor to lift consumer engagement and put downward pressure of fees. This is particularly because it recommended the MySuper architecture to precisely address the major factors impeding the super system – poor member engagement and system complexity. The purpose of MySuper was also to encourage lower costs over time.

Critically, all of these outcomes were considered achievable without the need to introduce full contestability for default funds. In fact, the Super System Review concluded that "*there seems to be no logical reason why the default funds in modern awards should not continue for the time being*"[64].

2.2.3 Fees, Costs and Net Returns

To justify its recommendation about full contestability the FSI Report focusses predominately on the notion that fees are too high, particularly when compared to international pension funds.

In adopting this position the FSI Report seems to have largely ignored the credible and independent advice of a wide spectrum of stakeholders about fees, costs and net returns. CPS agrees with the views of these stakeholders.

[62] Australian Government, Review into the governance, efficiency, structure and operation of Australia's superannuation system, Final Report: Part One: Overview and Recommendations, 2010; p7-8
[63] See page 105 of the FSI Report
[64] Australian Government, Review into the governance, efficiency, structure and operation of Australia's superannuation system, Final Report: Part Two: Recommendation Packages, 2010; p10-11

There is a strongly held view amongst fund based and independent stakeholders that the level of fees are largely a result of regulatory burdens in the super system, particularly with recent regulatory reforms aimed at improving consumer protection and prioritising member interests.

For example, it is independently considered that "*if fees in the superannuation industry are perceived to be high, this is significantly due to the highly intensive and evolving regulatory landscape. This requires very significant investment of resources in analysing requirements, upgrading IT systems, staffing to give effect to the requirements, upgrading disclosure documents and audit costs to review compliance*"[65].

This view is echoed by peak super industry bodies which suggest that "*there are significant costs in implementing Stronger Super and it will take time for this cost burden to flow through*"[66].

It is also suggested that in relation to retail funds there are "*other factors affecting costs which include the requirement for a return to shareholders in for-profit management structure, particularly in a vertically integrated structure*"[67].

Recent research indicates that for industry, public sector and retail funds the average operating expenses per member have increased from around $140 a year in 2010 to around $190 a year in 2013, with an annual average rate of increase in costs of 11 per cent a year over three years[68].

Nevertheless analysis shows that "*the great bulk of MySuper products and practically all products that are being considered for inclusion as a default fund in awards have fees under 100 basis point*"[69]. It is claimed that this compares favourably with international experiences for similar products. For example, "*in a range of developed and developing countries fees for defined contribution funds mostly invested in equities and open to multiple employers typically are in the range to 70 to 100 basis points per year. In a number of countries, including the United States (US), Canada and Hong Kong, costs and fees are in excess of 100 basis points, sometimes substantially more*"[70].

For smaller funds, like CPS, regulatory costs can be a more significant burden and put added pressure on fund outcomes. However the solution to this is not the introduction of full contestability. It is rather a case of appropriate regulatory management by government to accommodate the different capacities of funds in the market.

There is also a widespread view that the interim FSI Report was too focussed on the level of fees and not net returns when judging competition in the market. This is a problem that the final FSI Report seems to have repeated, but which is a trap that the Super System Review and Productivity Commission successfully avoided in their previous assessments of the super system.

Independent stakeholders argue that while keeping fees competitive is important, "*the focus on fees should be balanced against the net returns and the services received by members. Lowest cost does not necessarily deliver on either of these objectives. If there is an exclusive focus on fees, there is a risk that net outcomes and provision of quality services will be overlooked, when in fact these factors should be of equal or greater importance*"[71].

[65] Independent Fund Administrators & Advisers Pty Ltd (IFAA), Submission to FSI; 2014; p2
[66] Association of Superannuation Funds Australia, submission to FSI; 2014; p82
[67] Corporate Super Association, submission to FSI; 2014; p2
[68] Rice Warner research referred to in Association of Superannuation Funds Australia, submission to FSI; 2014; p17
[69] Ibid; p39
[70] Ibid; p17
[71] Independent Fund Administrators & Advisers Pty Ltd (IFAA), Submission to FSI; 2014; p2

This view is strongly endorsed by CPS, and it also shares the following concerns about the actual impact of full contestability on fee competition through tendering as proposed by the FSI Report.

- "*Tendering on price alone would necessarily impact on the product design and features, and would impede a trustee's ability to provide a product that appropriately discharges their fiduciary duty to act in the best interests of members. ASFA considers this duty to be of paramount importance, especially when dealing with default (disengaged) members who have made no active decision to acquire that product*"[72].

- There is unlikely to be any downward pressure on fees from a tendering model because "*most providers do not have any (or any substantial) profit margin that could be reduced in order to obtain default business; any reduction in costs and fees resulting from a tender process is unlikely to be at the levels claimed by proponents, given that international fee comparisons show that MySuper products are already relatively competitive in terms of fee levels in international terms; the MySuper authorisation process already involves an implicit tender process, where trustees put forward their cost competitive proposal; a focus on costs and fees, rather than net member benefit, is likely to lead to development of passively managed products with a heavy investment weighting toward bonds. This is not an approach that will maximise long-term investment returns and deliver the most benefit for fund members*"[73].

Recent research based on a survey of 28 executives across 20 Australian superannuation fund providers also suggests that the FSI Report's focus on fees is misplaced. That research indicates that funds are prioritising member interests above performance and fees. Member interests are considered to include the need to engage default fund members, and aligning portfolio management with lifecycle issues[74]. The research also directly challenges the need for the FSI Report recommendation about contestability because it found that:

- the alignment of fund management with members is improving, *"with providers aiming to deliver better outcomes for default members under the combined influence of a sense of fiduciary duty and business incentives*"; and
- "*there is member heterogeneity both within and across funds, of which [funds] are well aware and aiming to cater for*"[75].

2.3 FSI Report Ignores Productivity Commission Findings about Default Funds

As a result of a recommendation by the Super System Review the Productivity Commission conducted a comprehensive examination in 2012 of the transparency and competition issues in the nomination of default funds in modern awards.

The FSI Report discusses only one limited aspect of the Productivity Commission's assessment in relation to agency and structural issues. It suggests that the Commission found that "*employers might have little incentive to invest time and effort into making choices that are in the best interests of their employees*" and that employers "*face high search costs, may lack information and expertise to make an appropriate choice for their employees and may choose a fund based on auxiliary benefits specific to the employer, such as low administrative requirements*"[76].

It is not clear why the FSI Report only raises this issue and not others in the Commission's report or fails to acknowledge the actual overall findings and recommendations made by the Commission.

[72] Association of Superannuation Funds Australia, submission to FSI; 2014; p47
[73] Ibid
[74] Centre for International Finance and Regulation, MySuper: A stage in an evolutionary process; 2014; p2-3
[75] Ibid; p4
[76] FSI Report 2014; p106

In doing so the FSI significantly ignores the actual findings and recommendations of the Productivity Commission. After a comprehensive review of the transparency and competition issues associated with default fund selection and the views expressed in hundreds of stakeholder submissions, the Commission found that the process used for listing default funds in modern awards had several strengths and weaknesses.

In terms of strengths the Commission found that the nomination of default funds in awards:

- "*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*"[77].

With respect to weaknesses the Commission found that the system:

- "*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; and*
- *has inadequate mechanisms for the ongoing assessment of funds*[78].

The mix of strengths and weaknesses required the Commission to consider a sensible approach to any policy reform so that weaknesses might be addressed without retarding existing strengths. In essence this approach was guided by the need to balance the need for competition and system stability[79].

The Commission recognised that the competitiveness of any market relies on both demand and supply side competition. Demand side competition is optimal when consumers are fully empowered and interested to take the time to examine and choose between offered products and services. Supply side competition relies on the range of organisations offering goods and services and the extent to which these organisations have incentives to compete on price, quality and innovation. Incentives for suppliers to be competitive usually rely on the extent and nature of consumer demand[80].

Unlike the Productivity Commission, the FSI Report appears to ignore that while competition is an important objective it should not be regarded as an end in itself[81]. Consideration of options to facilitate competition should be fundamentally guided by the following key principle:

"Competition policy is not about the pursuit of competition per se. Rather it seeks to facilitate effective competition to promote efficiency and economic growth while accommodating situations where competition does not achieve efficiency or conflicts with other social objectives. These accommodations are reflected in the

[77] Productivity Commission, Default superannuation funds in modern awards 2012; p 164
[78] Ibid
[79] Ibid; p163
[80] Ibid; p148
[81] This is the fundamental principle underpinning the recommendations in the Hilmer Reforms which led to the development and implementation of national competition policy in 1996. Those reforms were instrumental in restructuring the Australian economy and boosting productivity. But at no time did the Council of Australian Governments consider that NCP was an end in itself.

content and breadth of application of pro-competitive policies, as well as the sanctioning of anti-competitive arrangements on public benefit grounds"[82]

This principle is very relevant to the policy treatment of superannuation default funds. The social and workplace relations policy purpose of the superannuation system means that it as a whole, and in particular superannuation default funds, are very different from other goods and services traded in financial services and other markets.

While some companies in the superannuation market may advocate for greater competition, it is critical to note that their existence and activities are a by-product of this social policy intention, not the reason the superannuation system exists. Thus consideration of appropriate policy options should prioritise public benefit, not the commercial agendas of some market competitors.

These issues influenced the Productivity Commission to conclude that continued stability in the superannuation system should not be sacrificed for the sake of increased competition. For example it found that "*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*."[83]

The recognised importance of reaching the proper balance between competition and stability led the Productivity Commission to recommend options for reform of default funds that could achieve this. The recommended options retained the traditional role of employees and employers in the industrial relations system in selecting default funds with some new processes to improve transparency and opportunities for new entrants in the default fund market[84].

In the view of the Productivity Commission its recommended options were "*designed primarily to benefit employees who derive their default superannuation product in accordance with modern awards. The proposals aim to ensure that employees who are placed into a default fund listed in an award will have their best interests served by that placement. The reforms are likely to also benefit employees who choose one of the products listed in an award. The proposed reforms will be clearly beneficial for employees who are entering the labour market for the first time and who do not exercise their right to choose a fund, as there will be a greater chance that these employees become members of a fund that meets their best interests. In addition to benefiting new employees, the proposed reforms will also benefit existing employees who are moved to a fund that in net terms better meets their interests*"[85].

The current legislation aligns with one of the options recommended by the Productivity Commission, but includes some additional regulatory management to ensure the interests of employees and employers are appropriately managed. The current legislative approach recognises that historical precedent in the industrial system may have inequitably favoured some funds and created barriers for other funds seeking entry as default funds in modern awards. The process in the existing legislation is designed to address this.

The legislation enables any authorised MySuper fund to apply to be a default fund in a modern award under a two-step process. Under this process:

[82] Australian Government, The Hilmer review of national competition policy, final report, 1993; pxvi
[83] Productivity Commission, Default superannuation funds in modern awards 2012; p 163
[84] Ibid
[85] Ibid; p226

- an Expert Panel created within the Fair Work Commission (FWC) will consider applications from MySuper funds seeking listing as a default fund in a modern award against legislated criteria and make recommendations to a FWC Full Bench on the MySuper funds to be included as default funds. The Expert Panel will consider applications in conjunction with the FWC review of modern awards which is to occur every 4 years commencing on 1 January 2014; and

- the FWC Full Bench will determine and select the funds to be listed as default considering the Expert Panel's report, the views of the industrial parties and the overarching objective of best meeting the interests of the relevant employees in that award.

A wide range of employer and employee representatives, such as the Australian Industry Group and Australian Council of Trade Unions supported the then Government's approach and particularly the creation of an Expert Panel within the FWC. This was because of their general agreement that superannuation contributions are deferred wages and inherently an industrial matter and therefore the FWC is the most appropriate body to list default funds in modern awards.

While some funds objected to the restriction of standing at the FWC hearings to industrial parties, the reforms enabled any party to gain standing if they won the support of an industrial party. This was considered appropriate given the social and workplace relations policy intention of the superannuation system. The capacity of any party to seek standing before the FWC full bench is consistent with the recommendation of the Productivity Commission that any party have standing before the Expert Panel.

Although the reforms increased the capacity of funds to compete, the Fair Work Act 2009 was not amended to lift the number of default funds listed in awards above 15. This was because of the need to reduce costs to employers associated with having to choose between default funds. In submissions to the FSI, peak employer groups have continued to express their support for the concept of between two and fifteen default superannuation funds being listed in each modern award consistent with s.156H of the Fair Work Act 2009[86].

In the view of CPS, the current FWC based model to promote competition is sufficient and meets the objectives for a contestable superannuation system for awards and appropriate balance of employee and employer benefit.

2.4 FSI Report Misunderstands the Impact of Default Funds on Competition

As discussed above, the current model of selecting default funds in modern awards is based on the fundamental need to ensure that the superannuation system is benefiting employees foremost, and also enabling employers to easily understand and make choices about default funds for their employees without unnecessary administrative cost. This approach is consistent with the original legislative intention of the superannuation system which is to operate as part of workplace relations arrangements and deliver financial security for workers in their retirement.

The superannuation system does not exist for the benefit of fund providers and therefore it is inappropriate for government to intervene in the system to improve competition to an extent that may benefit some providers, such as retail funds, but not deliver any discernible benefits or reduce benefits for employees and employers.

Any case for government intervention in markets beyond regulatory arrangements to deliver legislative intention, such as is the case with the current default fund model, should be determined on the evidence based need to address market failure.

[86] Australian Industry Group, Second submission to the financial system inquiry, 2014; p5

In relation to default funds market failure may occur if the inability of some funds, such as retail funds, to be listed as default funds in awards was distorting the market to an extent that:

- provided industry funds with an unfair advantage in terms of overall market share over time compared to retail funds; and/or
- reduced the benefits to employees.

Evidence from APRA and the Productivity Commission examined in this section indicate that these outcomes are not present in the market.

It should be noted that this section relies on data from APRA at June 2013 (the last date when comprehensive statistics were reported) and data from APRA at December 2014 (interim statistics available). At the time of this submission APRA had not yet released an update of its June 2013 comprehensive data. This is because it is revising its reporting frameworks to take into account changes to the superannuation system since 2013.

2.4.1 Size of Default Fund Market

(a) Total assets

Currently the total assets under management in the superannuation industry is $1.93 trillion, of which $1.18 trillion is held by APRA regulated entities. Of this $395.7 billion or 34 per cent of assets are in MySuper products. The share of MySuper assets increased by 7 per cent between December 2013 and December 2014[87].

Of the total superannuation assets, $72.7 billion or 6 per cent are held in accrued default funds[88]. Between December 2013 and December 2014 the proportion of total superannuation assets in accrued default funds decreased from 12 per cent to 6 per cent[89].

There are three key issues raised by this data:

- default fund assets represent a small share of total superannuation assets and the absence of a fully contestable market for the selection of default funds in modern awards is unlikely to have a significantly distorting effect on competition and consumer choice in the superannuation system overall;
- the share of default fund assets within total superannuation assets has decreased by 50 per cent in 12 months, which reinforces how marginal it is to the state of competition in the superannuation industry; and
- the introduction of MySuper has, and is likely to have, a greater impact on asset distribution in the superannuation system compared to accrued default funds.

(b) Annual contributions

In 2012, the Productivity Commission estimated that about $6 billion and maybe more than $9 billion in superannuation contributions are made to default funds annually, but there is no accurate data on how many employees covered by awards actually choose a default fund[90].

[87] Australian Prudential Regulation Authority, Quarterly Superannuation Performance (interim edition), 19 February 2015; p10
[88] Ibid
[89] Ibid
[90] Productivity Commission, Default superannuation funds in modern awards 2012; p33-36

In 2014 total contributions in the superannuation system for APRA regulated entities was $100.6 billion[91]. Based on the Productivity Commission assessment of contributions to default funds each year, default funds may represent between 6 and 9 per cent of total superannuation contributions for APRA regulated entities.

This is consistent with current data that shows that default funds make up 6 per cent of superannuation assets.

As estimated default fund contributions represent a small share of overall superannuation contributions for APRA regulated entities, it is unlikely that the prevailing system to select default funds in modern awards could have a significantly distorting effect on competition and consumer choice in the superannuation system overall.

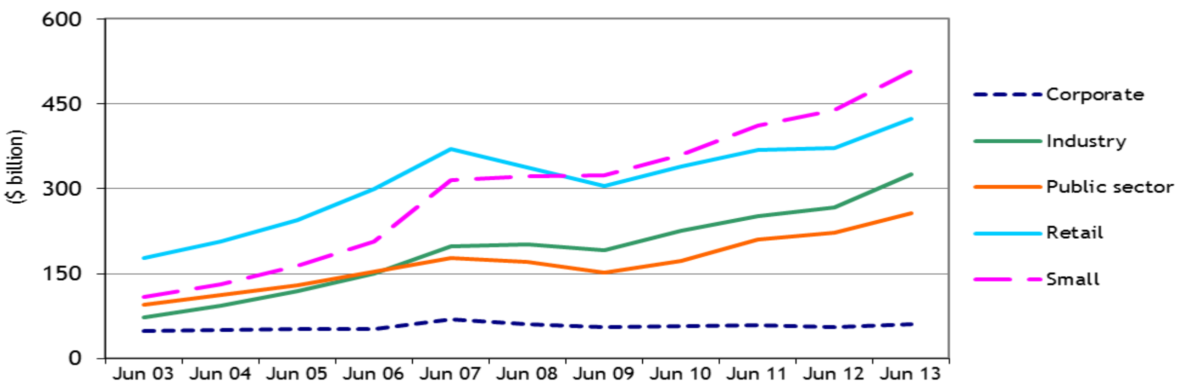
(c) Number of awards and funds

In 2013 there are 122 modern awards of which 109 list a default superannuation fund or funds. There were 66 distinct funds listed by APRA that participate in these awards. Of these 46 were industry funds, 11 were retail funds, 6 were public sector funds and 3 were corporate funds[92]. The number of industry funds reflects the fact that many default funds are provided for employees in particular industries. The CPS is one such example.

2.4.2 Market Shares by Fund Type

Figure A below shows the comparative superannuation assets by fund type over the last 10 years[93].

Figure A: Superannuation assets by fund type



Source: Australian Prudential Regulation Authority

In 2014, of total superannuation assets, retail funds held 39 per cent, industry funds held 31 per cent, public sector funds held 26 per cent and corporate funds held 4 per cent[94].

In 2013, small funds accounted for 31.4 per cent of total assets[95].

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[91] Australian Prudential Regulation Authority, Quarterly Superannuation Performance (interim edition), 19 February 2015; p7

[92] Australian Government, Better regulation and governance, enhanced transparency and improved competition in superannuation discussion paper November 2013; p26

[93] Australian Prudential Regulation Authority, Annual superannuation bulletin for the Year to 30 June 2013, 5 February 2014; p6

[94] Australian Prudential Regulation Authority, Segmentation of superannuation entities, 19 February 2015; p4

[95] Australian Prudential Regulation Authority, Annual superannuation bulletin for the Year to 30 June 2013, 5 February 2014; p6

The distribution of total assets across various fund types appears to demonstrate a healthy level of competition between large and small funds and between retail and industry funds. Over the last ten years retail funds have maintained a higher share of total assets compared to industry funds and have grown their share in line with the overall market direction. For this entire period retail funds have grown their market share, despite being subject to the previous arrangements for default funds in awards which largely precluded them.

Accordingly there is not a strong case that the default fund market needs to be fully contestable to ensure that there is adequate competition between retail and industry funds.

2.4.3 Market Competition

Key indicators of market competitiveness suggest that the lack of full contestability for default fund superannuation has not reduced the competitiveness of retail funds in the overall superannuation market. The nature of the market suggests that full contestability in the default market would further improve the already leading market position of retail funds at the expense of industry funds and particularly smaller funds like CPS.

Over the last 10 years, the number of APRA regulated funds in the superannuation market has been rationalised, with retail funds experiencing a higher rate of rationalisation than industry funds. But as demonstrated by tables 2 and 3 below, this has not reduced the market share or competitiveness of retail funds.

In 2013, retail funds led the overall superannuation market of APRA regulated entities in terms of the number of funds and accounts as well as total assets.

Table 1: Distribution of APRA regulated superannuation entities at 30 June 2013[96]

Fund Type	Number of entities	Number of member accounts ('000)	Assets ($ billion)	Average account balance ('$000)
Corporate	108	512	61.3	119.7
Industry	52	11,524	324.7	28.2
Public sector	38	3,337	256.9	77.0
Retail	127	14,395	422.8	29.4
Small	512,375	968	508.0	524.9
Pooled superannuation trusts	61		99.4	
Balance of life office statutory funds			45.4	
Total	**512,761**	**30,736**	**1,619.0**	

In 2013 retail funds held the largest number of member accounts in every age group, except for those under 35, where industry funds led. Most significantly retail funds led in the age groups of 35-65 years.

While industry funds may be more popular with younger employees, the leading role that retail funds have with all other age groups indicates that this does not provide industry funds with an advantage with employees as they age. Thus a fully contestable model may reduce the market share of industry funds, and particularly smaller funds like CPS that are still industry based.

96 Ibid; p19

Table 2: Member accounts by age and fund type at 30 June 2013[97]

	Age groups (,000)					
Fund Type	**< 35 yrs**	**35 - 49 yrs**	**50 - 59 yrs**	**60 - 65 yrs**	**> 65 yrs**	**Total**
Corporate	163	207	94	28	19	512
Industry	5,756	3,490	1,540	489	249	11,523
Public sector	726	1,163	796	315	337	3,337
Retail	4,656	5,449	2,493	1,007	789	14,395
Total	**11,301**	**10,309**	**4,923**	**1,839**	**1,394**	**29,767**
	Age groups (percentages)					
Corporate	32%	40%	18%	5%	4%	100%
Industry	50%	30%	13%	4%	2%	100%
Public sector	22%	35%	24%	9%	10%	100%
Retail	32%	38%	17%	7%	5%	100%
Total	**38%**	**35%**	**17%**	**6%**	**5%**	**100%**

Table 3: Number of superannuation entities - trends[98]

Fund Type	**Jun 2004**	**Jun 2005**	**Jun 2006**	**Jun 2007**	**Jun 2008**	**Jun 2009**	**Jun 2010**	**Jun 2011**	**Jun 2012**	**Jun 2013**
Corporate	1,405	962	555	287	226	190	168	143	122	108
Industry	106	90	80	72	70	67	65	61	56	52
Public Sector	42	43	45	40	40	40	39	39	39	38
Retail	232	228	192	176	169	166	154	143	135	127
Small	279,584	296,813	315,924	356,309	381,332	403,899	418,431	444,587	479,091	512,375
Pooled superannuation trusts	143	130	123	101	90	82	79	77	67	61
Total	**281,512**	**298,266**	**316,919**	**356,985**	**381,927**	**404,444**	**418,936**	**445,050**	**479,510**	**512,761**

2.4.4 Benefits to Employees

If the dominance of industry funds as default funds in modern awards was resulting in a detriment to employees compared to investment returns they could receive from retail funds, then there may be a need for further government intervention to promote competition. In 2013 industry funds held 67.2 per cent of assets in their default investment strategy, whereas retail funds held 19.3 per cent of their assets in this category of investment[99]. Thus the implications for fund members could be significant if industry funds performed worse on average than retail funds.

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[97] Ibid; p23
[98] Ibid; 20
[99] Ibid; 8

However, this is not the case because over the last 10 years industry funds have on average performed considerably better than retail funds to the benefit of fund members, including employees in default funds in modern awards. Industry funds have performed better than the average of all superannuation entities regulated by APRA. It is estimated that industry funds have outperformed retail funds by 1.7 per cent each year in the 10 years to 30 June 2012, returning 7.5 per cent annually compared to 6.4 per cent for retail funds[100].

Table 4: Comparative superannuation rates of return 2004-2013[101]

	Jun 2004	Jun 2005	Jun 2006	Jun 2007	Jun 2008	Jun 2009	Jun 2010	Jun 2011	Jun 2012	Jun 2013	2004 - 2013	
											Average ROR	Volatility
All entities	12.2%	12.2%	13.3%	14.5%	-8.1%	-11.5%	8.9%	7.8%	0.6%	13.7%	6.0%	9.5%
Corporate	12.2%	12.8%	14.0%	15.3%	-9.3%	-8.2%	9.4%	8.0%	1.7%	12.3%	6.5%	9.0%
Industry	13.4%	13.2%	13.1%	16.0%	-6.0%	-11.7%	8.5%	9.0%	0.9%	14.4%	6.7%	9.5%
Public sector	13.9%	14.1%	14.9%	15.1%	-5.8%	-12.3%	9.8%	8.9%	1.7%	14.2%	7.0%	9.7%
Retail	10.8%	10.6%	12.4%	13.4%	-10.2%	-11.5%	8.7%	6.5%	-0.5%	13.1%	4.9%	9.4%

Based on the relative performance of industry and retail funds, it is not evident that full contestability would improve benefits for employees. In the case of CPS, its above average performance in 2013 and over the preceding 10 years suggests that employees are able to receive significant benefits from smaller industry based default funds.

[100] Research by Chant West as referred to in the Australian Financial Review, 'Industry supers urged to oppose boards plan'13 Jan 2013; p4
[101] Australian Prudential Regulation Authority, Annual Superannuation Bulletin for the Year to 30 June 2013, 5 February 2014; p33

3. RESPONSE TO RECOMMENDATION 13 IN FSI REPORT - GOVERNANCE

3.1 Overview

Recommendation 13 covers a number of issues. It proposes that the *Superannuation Industry (Supervision) Act 1993* should be amended to:

- require that Boards of public offer superannuation funds include a majority of independent directors and an independent chair;
- align the director penalty regime with managed investment schemes; and
- strengthen conflict of interest requirements.

This submission discusses the first of these proposals only.

However, CPS notes that APRA is not supportive of the proposal to re-align the regulation of superannuation with managed investment schemes. In its reasoning, APRA has highlighted some serious deficiencies in the thinking applied in the FSI Report. CPS considers that these same inadequacies are also present in the FSI Report view on the need for superannuation fund governance reform.

In its submission to the FSI Interim Report, APRA indicated its firm support for the status quo in relation to superannuation governance. It considered that "*there were sound reasons for establishing the current regulatory approach at the time of the Wallis Inquiry – including the compulsory nature of superannuation savings, the lack of effective choice for a large proportion of members, the long-term nature of superannuation and the contribution of superannuation to tax revenue forgone – and these features remain prominent*".[102]

In the view of CPS, the FSI Report should have been guided by these principles expressed by APRA.

A fundamental problem with recommendation 13 is that its very basis is completely at odds with the approach consistently applied to other issues in the FSI Report, including recommendation 10.

Throughout the FSI Report the notion that market forces (such as the proposed application of full contestability to default fund selection in recommendation 10) is advocated as irrefutably the most effective way to achieve efficiency and appropriate outcomes. In other words, the FSI Report consistently applies the economic orthodoxy that the best outcomes occur when participants are free to choose them and make rational trade-offs, not when actions and approaches (like default funds in awards) are mandated.

However, the FSI Report only departs from its otherwise consistent set of principles in relation to superannuation Board governance. In the view of CPS, the FSI Report does not explain why this departure is critical to improve the outcomes for members of superannuation funds. For example the FSI Report does not discuss how mandating the make-up of public offer Boards will result in improved fund consideration and management of the acute risks, like involuntary retirement and sequencing, facing employees in some sectors.

In addition to this fundamental anomaly, the FSI Report's reasoning to support a mandated approach to Board governance is reckless in one critical respect.

[102] Australian Prudential Regulation Authority, Response to interim FSI Report, 2014; p6

Recommendation 13 rests on the view expressed in the FSI Report that in relation to industry funds, "*there is no evidence to suggest that the performance of these funds is driven by their equal representation model*"[103].

However, the FSI Report provides no evidence that the performance of these funds is not a result of their governance model. If the FSI Report is purporting to recommend good public policy, then it should at a minimum be applying the internationally accepted basis for the consideration and development of public policy and regulation – the precautionary principle. This principle is that an action should not be taken if the consequences are uncertain and potentially dangerous.

In the case of recommendation 13, the FSI Report provides no hard evidence to establish the certain effects or benefits of change to Board governance, nor does it provide evidence that the change will not create new risks for fund members.

In fact the FSI Report leads its discussion about recommendation 13 with the admission that "*there is little empirical evidence about the relationship between quality of governance in Australian superannuation funds and their performance*"[104]. Accordingly, CPS believes that the FSI Report has not established a case to support recommendation 13.

In the view of CPS, new standards should only be introduced if there is a compelling case for them to improve governance and address systemic failures. CPS considers that the FSI Report does not make this case.

3.2 The Inappropriateness of Mandated Boards

In the view of CPS, legislation or regulations that mandate the appointment of independent directors to superannuation trustee Boards is not consistent with the need to ensure an appropriate balance between standard rules of governance and the need for organisations to have flexibility to meet their own needs.

Recommendation 13 is not a defensible proposal as:
- current legislation governing directors duties in the superannuation industry is the most effective instrument for good corporate governance;
- there is no credible case for a mandated one size fits all approach to corporate governance;
- there is no evidence from previous reviews of superannuation corporate governance of the need for a mandated approach;
- current board structures demonstrate that self-regulation has been and can continue to be a success in improving corporate governance; and
- it provides no guarantee that it will lead to increased member security or outcomes of funds management.

3.2.1 Current Regulation is Effective

It is normal regulatory practice in Australia for the roles and responsibilities of Boards to be governed by general corporate law, and in some circumstances additional industry specific legislation. The financial services industry is no exception.

The *Superannuation Industry (Supervision) Act 1993* (SIS Act) creates and regulates the obligations for Boards of superannuation funds. These requirements include that directors must perform their powers and functions in the best interests of beneficiaries[105]. The Stronger Super reforms strengthened these obligations.

[103] FSI Report 2014; p135
[104] Ibid; p133
[105] Section 52A of the SIS Act

The duties of directors in the SIS Act override the Corporations Act duties. Industry specific legislation governing the obligations of directors of Boards in the insurance industry also overrides the Corporations Act[106].

The Corporations Act does not prescribe the number of independent directors a company must have, or that a chair must be independent. If this is the regulatory standard that applies to all companies regulated by corporation's law, it is not made clear in the FSI Report why the superannuation industry should be singled out for a different level of treatment. Particularly as the SIS Act already provides regulatory requirements in line with the nature of the superannuation sector's purpose and operation.

The FIS Report seeks to rely on the OECD to support its proposal in recommendation 13. However while the OECD may suggest that it is good practice for a Board to include independent directors, the OCED does not suggest that governments should mandate the number of independent directors, let alone mandate that they should be a majority[107].

The experienced APRA is comfortable that existing legislative arrangements encourage directors of superannuation funds to exercise the required levels of governance to the benefit of fund members, and that no change is warranted. APRA considers that the "*existence of the special director duties can be seen as consistent with the legal basis upon which the assets supporting beneficiaries' claims are held*" and that what the SIS Act already requires is "*fundamental to the integrity of the superannuation system*"[108]. In the view of APRA, these key requirements are that "*the trustee company - that is the RSE licensee - holds the assets in trust on behalf of members [and] the SIS Act makes clear as to whom trustee directors owe their duty of loyalty in relation to those assets*"[109].

While the FSI Report advocates that the use of independent directors in the super system does not compare favourably with conventional practices in Australian Securities Exchange (ASX) listed companies, such as banks, APRA takes a different view on the comparability of sectors.

The strong view of APRA is that unlike the super sector, banks and insurance companies "*are not required to segregate assets and liabilities referable to their customers*", and that the directors duties in the SIS Act reflect the fact that "*investment-based products offered by superannuation funds are not (or not always) defined by readily verifiable, quantitative obligations for a particular return or benefit*"[110]. In the case of banks, a deposit is offered at a specified rate of interest, whereas with respect to super, the "*objective is for the trustee to strive to maximise the rate of return (either generally, or in relation to a given class of investments), and this requires a greater emphasis on the best interest of members*"[111].

The view of APRA is important because it reflects the conclusions from available international empirical evidence that while mandating Board independence may establish a structural test to guide the selection of directors, it does not guarantee the capacity of Boards to make objective decisions and improve fund performance[112]. For example, a study of the United States mutual fund industry concluded that there is no consistent evidence that demonstrates that independent Chairs or Boards make any discernible contribution to the achievement of lower fees and/or higher returns for fund shareholders[113].

[106] Section 48 of the Life Insurance Act
[107] Organisation of Economic Co-operation and Development, Principles of corporate governance, 2004; p64-65
[108] Australian Prudential Regulation Authority, Response to interim FSI Report, 2014; p57
[109] Ibid
[110] Ibid
[111] Ibid
[112] McKell Institute, The success of representative governance on superannuation boards, June 2014; p24
[113] Spratt, C Literature Review on Independent Mutual Fund Chairs and Directors , Office of Economic Analysis, Securities and Exchange Commission, New York, December 2006.

Other evidence also suggests that it is sensible to apply the precautionary principle when considering mandating the nature of Boards. Recent research into the ASX rules requiring Boards to justify why they would not adopt a majority of independent directors "*concluded that companies with a majority of independent directors were less likely to replace poorly performing CEOs, and in addition were more likely to demand higher remuneration fees for decreased firm performance. Ultimately, these consequences of independence resulted in an estimated loss of $69 billion between 2003 and 2011*"[114].

3.2.2 No Case for a One Size Fits All Approach

To support recommendation 13, the FSI Report suggests that its proposal is consistent with the ASX Corporate Governance Principles which include a requirement for ASX listed entities to have a majority of independent directors[115].

However in its analysis the FSI Report appears to have ignored the actual context and overall approach of the ASX to Board governance which does <u>not</u> support a 'one size fits all' model.

Firstly the ASX makes clear that its recommended principles for corporate governance are guidelines only, and "*that different entities may legitimately adopt different governance practices, based on a range of factors, including their size, complexity, history and corporate culture. For that reason, the Principles and Recommendations are not mandatory and do not seek to prescribe the corporate governance practices that a listed entity must adopt*"[116].

In other words, the ASX does <u>not</u> support a mandatory approach to any aspect of corporate governance as proposed by the FSI Report.

Secondly, the application of the 'if not, why not' condition has a specific purpose for ASX listed entities. The ASX is clear that entities are entitled to choose whether or not to adopt its recommendations and principles, however considers that where entities do not apply them, the market must be informed about the reasons. The specific purpose of this is so that:

- "*security holders and other stakeholders in the investment community can have a meaningful dialogue with the board and management on governance matters;*
- *security holders can factor that information into their decision on how to vote on particular resolutions; and*
- *investors can factor that information into their decision on whether or not to invest in the entity's securities*"[117].

The need to inform the market about these issues has no application in the superannuation industry because the trustee nature and purpose of the industry is completely different to that of companies seeking institutional and retail investors through a securities exchange. The strict requirements in the SIS Act regulate the specific nature and purpose of superannuation including directors duties, and accordingly the 'if not, why not', notion applied to ASX listed entities has no relevance to the corporate governance of super funds.

However as a matter of principle, what the ASX corporate governance principles illustrate is a fundamental support for a flexible approach that does not seek to apply a 'one size fits all' model to the management of entities. In doing to the ASX principles recognise that improvements to corporate governance are best pursued via cultural change over time.

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114 McKell Institute, The success of representative governance on superannuation boards, June 2014; p25
115 FSI Report 2014; p134
116 Australian Securities Exchange Corporate Governance Council, Corporate governance principles and recommendations, 3rd Ed, 2014; p3
117 Ibid; p3

Independent stakeholders, such as the Governance Institute of Australia, support this flexible approach and oppose the notion that corporate governance standards can be mandated through legislation. In its view, "*governance arrangements applied in the corporate environment cannot be transposed in their entirety to other industries, for example, the superannuation industry*" and "*introducing further complex legislation is unlikely to achieve the change to practice and behaviour that lies at the heart of improving corporate governance*" [118].

Not only is recommendation 13 out of step with the ASX recommended approach to corporate governance, it is also inconsistent with the general public policy approach to implementing standard behavioural obligations.

For example, it is generally appropriate for legislation to create standards, however in order to provide organisations with flexibility and the capacity to determine the arrangements that suit them best, regulations/policies and/or guidelines usually enable organisations to seek exemptions or exceptions from legislative standards, where appropriate and justifiable, against set criteria.

There is ample precedent for provision of exemptions or exceptions to legislative standards where it is appropriate and meets the needs of organisations. For example key components of national competition policy and law that governs the behaviour of public and private organisations and their Boards across the economy includes the capacity of:

- governments to maintain anti-competitive legislation where they can prove the benefits outweigh the costs; and
- organisations to seek authorisations from the Australian Competition and Consumer Commission to maintain anti-competitive practices where justified.

In essence this approach creates a sensible balance between self-regulation and the application of standard rules governing organisational behaviour.

Achieving this balance is often important to the competitiveness and effectiveness of smaller organisations in markets, which may not have the resources or need to implement the same rules in every circumstance as larger organisations. As discussed elsewhere in this submission, the superannuation industry consists of a diverse range of funds, and smaller funds, like CPS play an important role in protecting the retirement incomes of employees in specific industries.

3.2.3 No Evidence of Need from Previous Reviews

It is widely recognised in relevant research that "*Board independence is not aimed at improved performance in terms of higher returns to shareholders, but rather the prevention of systematic underperformance due to managers optimising their own utility rather than their shareholders*"[119].

Therefore, legislation or regulations to mandate the appointment of independent directors may be justified if there is:

- majority support for this in the superannuation industry; and/or
- compelling evidence that this is necessary to improve the governance and performance of superannuation funds.

However it is clear from the work of the Super System Review and Productivity Commission[120] that neither of these conditions exists.

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[118] Governance Institute of Australia, Submission to the FSI, 2014; p7

[119] McKell Institute, The success of representative governance on superannuation boards, June 2014; p23

[120] Review of the Superannuation Industry (Supervision) Act 1993 (2001) and Default superannuation funds in modern awards 2012

(a) Super System Review

The Review recommended that the SIS Act be amended to[121]:

- enable equal representation Boards to appoint independent directors;
- require that at least one third of directors on equal representation Boards be independent; and
- require that for Boards that are not based on the equal representation model the majority of directors be independent.

These recommendations were based on the view of the Review that[122]:

- the equal representation model imposed rigidity on fund governance practices and reduced accountability, without ensuring the representation objective on which it was predicated; and
- best practice in corporate governance required the presence of independent directors.

The Review recommended this approach even though[123]:

- in an overall sense, it did not find any significant evidence of systemic trustee governance failure;
- there was no consensus within the superannuation industry about the need for and value of independent directors; and
- there was strong evidence from submissions by participants, and the independent assessment of fund performance over many years, that industry funds governed by the equal representation model had delivered superior performance for the benefits of members, compared to other types of funds.

These recommendations of the Review do not form part of superannuation reforms to date. Unlike the FIS Report, the Review did not recommend legislative changes to mandate that a majority of the directors on Boards that are currently equal representation should be independent.

(b) Productivity Commission

In its 2001 review of the SIS Act, the Productivity Commission supported the equal representation of employer and employee representation on superannuation trustee Boards. It considered that equal representation rules[124]:

- provided a balanced representation of employer and employee interests;
- were conducive to active member interest in the prudent management of funds; and
- provided benefits that exceeded the cost of finding and appointing members who are capable of undertaking trustee duties.

During the 2012 Productivity Commission review of default funds in modern awards, there were wide ranging views about what constitutes good governance in the superannuation industry. In relation to the nature of Boards, many review participants preferred equal representation of employer and employee representatives, while others claimed that the appointment of independent directors would lead to better governance[125].

In essence there was no consensus amongst participants however key points that were made included the facts that:

[121] Australian Government, Review into the governance, efficiency, structure and operation of Australia's superannuation system, Final Report: Part Two: Recommendation Packages, 2010; p55-56
[122] Ibid; 53-56
[123] Ibid
[124] Productivity Commission, Review of the Superannuation Industry (Supervision) Act 1993 (2001); p113
[125] Productivity Commission, Default superannuation funds in modern awards 2012; p96

- the equal representation model is a representative governance structure which enables member interests to be prioritised and diversifies control of funds by shareholders and stakeholders[126];
- there is a substantial body of independent research that shows that the equal representation model has delivered superior performance and relevant products which meet the needs of employers, employees and the general public who join industry funds[127];
- the equal representation model was consistent with the OECD's governance guidelines for pension funds[128];and
- the notion of independence can vary to include independent of management, sponsoring organisations, and/or subject matter experts and there is minimal consensus about what it actually means[129].

More recently the Productivity Commission has determined that *"there is a lack of compelling evidence to suggest that any one model of board structure should be viewed as clearly preferable in all cases"* and does not consider that a particular structure should to be mandated and applied to all superannuation funds. It also considers that mandating board structures without a sufficient evidentiary basis may have an adverse impact on competition for default listing[130].

Instead the Productivity Commission is broadly supportive of APRA's approach which is not to mandate any particular structure for superannuation fund boards, but inform Boards of the potential benefits of having independent directors where appropriate[131].

Furthermore the Productivity Commission considers that the Stronger Super reforms have dealt with many of the most pressing governance issues (such as those relating to conflicted loyalties, remuneration and the competence of trustees), and accordingly there is no need to revisit many of these issues in the near future[132].

The practical experience of CPS affirms this view expressed by the Productivity Commission. The CPS Board has maintained equal representation of employer and employee representatives throughout its 25 year history and over this time has overseen strategies that have delivered fund growth, improved fund performance and continuously enhanced customer service and responsiveness. These results have been recognised in the market through a range of awards from independent rating agencies.

While achieving these outcomes, the Board has also considered the value of an independent director, but the cost of attracting a director with suitable experience has always exceeded the proposed benefits that person could bring. For example, CPS has been recognised as one of the best value funds due partly to its directors' fees being below the industry average. The salary demanded by an experienced independent director may alter this for no tangible improvement in Board governance.

An important reality for industry funds like CPS is that its Board appointments are controlled by its shareholders, which is not unusual for public and private companies. Arguably it would be an unwelcome precedent for government legislation to supersede the power of shareholders to control the appointments to Boards.

[126] Industry Funds Forum submission to PC Review
[127] Industry Super Network submission to PC review
[128] Australian Council of Trade Unions submission to PC review
[129] Cbus submission to PC review
[130] Ibid; p102
[131] Ibid
[132] Ibid; 103

3.2.4 Current Board Structures Demonstrate Success of Self-Regulation

Superannuation entities are registered to offer the public access to their funds (public offer license) or not (non-public offer license). Prior to 2006, entities that were originally created for a particular employer or associated employers in industries were licensed as non-public. However with the removal of restrictions, almost 60 per cent of registered superannuation entities (RSE) licensees held public offer licenses by 2013. About 85 per cent of superannuation assets are held by RSEs with public offer licenses[133].

Table 5: Prevalence of Independent Directors on Boards of RSEs[134]

	Public offer licensee			**Non-public offer licensee**		
Employee and employer representation	**For profit entities**	**Not for profit entities**	**Total**	**For profit entities**	**Not for profit entities**	**Total**
Boards with equal representation	-	39 (21 of these have an independent director)	**39**	-	64 (14 of these have an independent director)	**64**
Boards without equal representation	45	3	**48**	-		
Total	**45**	**42**	**87**	**-**	**64**	**64**

Of the not for profit entities (industry funds) with equal representation which can offer products to the general public, 21 or about 54 per cent have Boards with an independent director. Accordingly, proposals by the Government to mandate the appointment of independent directors are not needed to shift industry funds towards good governance.

Of the not for profit entities with equal representation which are not able to offer products to the general public 14 or 21 per cent have Boards with an independent director. This could be regarded as a reasonably prevalent, given that these funds are limited to employees in particular industries and historically linked to employers in particular industries. The proportion of Boards that involve independent directors reflects the value of the current APRA approach which favours self-regulation and has led to a solid base of Boards with such directors.

In the view of CPS, any changes to government policy should build on and promote this model of self-regulation, given its success to date.

3.3 The Importance and Legitimacy of Equal Representation

The FSI Report suggests that the equal representation model for Boards is less relevant and appropriate for public offer funds compared to funds sponsored by a single employer[135]. There are some fundamental problems with this conclusion.

[133] Australian Prudential Regulation Authority, Annual Superannuation Bulletin for the Year to 30 June 2013, 5 February 2014; p11
[134] Ibid; p17
[135] FSI Report 2014; p135

3.3.1 Benefits of Aligned Board and Member Interests

In its conclusion about equal representation Boards, the FSI Report has demonstrated that it does not place any value on the affinity that such Boards can have with the fund members whose retirement incomes they are entrusted to protect. This is unfortunate and a significant oversight.

It is a fundamental matter of principle and law that super funds "*have stewardship of working Australians' mandatory retirement savings, and operate under a trust structure to protect the members and beneficiaries against the pursuit of interests outside of members' best interests*"[136].

There are two main kinds of trustee mechanisms in the superannuation system[137]:

- **Appointed trustee** – This is where Boards consist of appointed trustees. This occurs primarily in the retail superannuation sector where funds are run and administered by financial institutions for profit and therefore have a high sales and distribution focus; and
- **Representative governance** – This is where fund distribution occurs largely through the workplace and Boards therefore consist of member and employer representatives. Corporate, Public Sector, and Industry funds generally operate under representative governance structures.

The trustee nature of superannuation means that it is vitally important that Boards and fund members have interests that are as closely aligned as possible. This is consistent with the general purpose and challenge of corporate governance.

There is ample and diverse evidence that "*representation is without doubt the most powerful mechanism within corporate governance for aligning the interests of boards and shareholders, because having shareholders on the board helps to bring the interests of shareholders directly into the boardroom*"[138].

Where a Board has affinity or shared interests with shareholders there is an increased likelihood that the Board will exercise judgement to benefit shareholders. For example, an examination of the performance of Australia's top 100 companies from 2008 to 2013 found that companies whose directors held its stock delivered return on equity 13.7 per cent higher and a relative share price 8 per cent higher than companies where this was not the case[139].

In section 2.4.4 this submission discusses the consistently superior financial performance of industry funds compared to retail funds over the 10 years to 2013 and the higher average returns that industry funds have delivered for their members. One important factor contributing to this result may be the relative extent to which directors of industry and retail Boards have 'skin in the game' in the funds they govern.

Recent research demonstrates that about 80 per cent of directors of retail funds do <u>not</u> invest any of their superannuation in the funds they manage. In comparison between 36-58 per cent of industry fund trustees invest all their superannuation in the funds they oversee[140]. The equal representation model stimulates this level of affinity and common investment interest between trustee Boards and members they serve.

[136] Australian Institute of Superannuation Trustees, Initial submission to the FSI; 2014; p21
[137] McKell Institute, The success of representative governance on superannuation boards, June 2014; p18
[138] Ibid; p26
[139] Ibid; p30. This research was undertaken by Macquarie Equities.
[140] Ibid; p31

In this respect the effect of the equal representation model is similar to the reasons why corporate organisations link CEO and other executive salaries to share price performance. In both circumstances the governance model can incentivise decisions that deliver better outcomes for investors.

For smaller industry based funds, like CPS, it is the affinity of the equal representation Board with the employees in its industry that adds, not detracts, to the sense of responsibility that directors have to fulfil their statutory obligations and also ensure that fund members have the maximum opportunities for a dignified retirement income.

In the view of CPS, this intention and capacity of Boards can be best achieved and enhanced when regulation seeks an appropriate balance between various objectives, including:

- recognising that funds and their members benefit from funds being managed by directors with substantial experience in superannuation and the industry involved. This is particularly relevant because superannuation is a complex area, and corporate knowledge to properly understand its strategy, operation and impacts can only be accumulated over a long period of time;
- the need for Board renewal to promote innovation, new thinking, global connectivity and gender and ethnic diversity that reflects corporate Australia and the community;
- the right mix of independent and employer and employee sponsored directors where necessary to improve Board performance; and
- the flexibility of organisations to determine their own Board arrangements consistent with their respective needs and accepted corporate governance regulations and principles.

In the case of CPS, it is involvement of a majority of employee and employer representatives on the Board that enables it to inherently understand the specific risks facing employees in the accommodation and food industry (which includes clubs) which can affect their retirement incomes. This includes the risks of involuntary retirement and sequencing and their combination as discussed in detail in section 2.

A Board consisting of a majority of independent directors is unlikely to experience the same affinity with, and understanding of, these issues.

Of course affinity alone in the absence of strict director's duties would not be enough to safeguard member's interests. But the SIS Act provides a solid statutory basis upon which the affinity that equal representation Boards have with members can work to deliver optimal outcomes.

3.3.2 Problems with Non-Representation Models

If the FSI Report was properly focussed on risks to members of funds, it would have more concerns with the absence of independent directors governing single employer sponsored funds than industry based funds. This is because the risks of conflict of interest arising between the commercial priorities of a single employer and the best interests of its employees in retirement are far greater than any potential risk of an industry fund deprioritising the future retirement benefits of its members.

The ASX for example has clearly identified that one circumstance that may compromise the capacity of a director to act independently in the interests of security holders (or superannuation fund members for that matter) is where "*the director is, or has been, employed in an executive capacity by the entity or any of its child entities and there has not been a period of at least three years between ceasing such employment and serving on the board of a director*"[141]. This scenario is more likely to arise in relation to a single employer sponsored fund, but would rarely if at all arise for an industry fund.

[141] Australian Securities Exchange Corporate Governance Council, Corporate governance principles and recommendations, 3rd Ed, 2014; p16

This scenario outlined by the ASX is also more likely to arise in relation to retail funds, particularly where a fund is vertically integrated within a broader financial institution group and Directors may be drawn from within the groups of businesses. Vertically integrated funds are also likely to be particularly vulnerable to other problematic scenarios identified by the ASX. These include where directors' capacity to act independently is compromised because they have been employees, partners, or directors of entities that have had a material business relationship (supplying or purchasing goods or services) with the fund[142].

The for-profit nature of retail funds can make the potential for such conflicts of interest more acute. It is considered for example that "*the existence of a large number of customers who are compelled to participate in a market they often do not understand and are unable to influence has provided financial institutions with many opportunities to apply a raft of fees, charges and commissions at the expense of member benefits. This is evidenced by the fact that while retail funds on average underperform relative to industry funds in terms of net returns to members, they nevertheless charge significantly higher fees*"[143].

It is peculiar that in its purported zest to improve outcomes for fund members, the FSI Report has not proposed mandating a majority of independent directors for single employer sponsored and retail funds, because the ASX corporate governance guidelines are aimed squarely at addressing governance risks in listed companies, which include all the major vertically integrated financial institutions in Australia, and many large corporate entities with their own sponsored super funds.

3.4 Definition of Independent Directors

The FIS Report does not provide any definition of an independent director. The Super System Review considered that independence on Boards could manifest through the appointment of what it termed 'non-associated trustee directors'[144]. It considered these directors to be "*people who general have no historic connection with the fund or the appointer*"[145].

The ASX believes that to "*describe a director as independent carries with it a particular connotation that the director is not allied with the interests of management, a substantial security holder or other relevant stakeholder and can and will bring an independent judgement to bear on issues before the board*"[146].

The ASX considers that the definition of an independent director is as follows – "*a director of a listed entity should only be characterised and described as an independent director if he or she is free of any interest, position, association or relationship that might influence, or reasonably be perceived to influence, in a material respect his or her capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally*"[147].

When these definitions are applied, the directors of the Board of CPS (and in all likelihood the Boards of other industry funds) would be classed as independent. This is because, while being representatives of employees or employers, these directors do not bring any interests or position or association or connection with the fund other than those directly related to ensuring that all employees in clubs industry have the opportunities to maximise their dignified retirement income.

[142] Ibid
[143] Australian Council of Trade Unions, Submission to the FSI, 2014; p5
[144] Australian Government, Review into the governance, efficiency, structure and operation of Australia's superannuation system, Final Report: Part Two: Recommendation Packages, 2010; p55
[145] Ibid
[146] Australian Securities Exchange Corporate Governance Council, Corporate governance principles and recommendations, 3rd Ed, 2014; p16
[147] Ibid

4. CONCLUSION

The FSI Report does not present the evidence needed to make a compelling case for recommendations 10 and 13. Neither of these recommendations have been proposed by the previous more comprehensive reviews of the default super system undertaken by the Super System Review and Productivity Commission. Issues raised by stakeholders from across the spectrum at that time persuaded those previous reviews to recommend against the very proposals made by the FSI Report. These same stakeholders raised the same issues with the FSI, but the FSI Report ignores them.

Based on the available evidence, there is no market failure that warrants further government intervention in relation to the competitiveness of default super in awards or the governance by equal representation Boards.

The historic barriers to entry for retail funds in relation to modern awards have not resulted in competitive disadvantages for retail funds in the overall superannuation market.

Ultimately the superannuation system exists for a social and workplace relations policy purpose to assist employees in their retirement and consistent with the principles underpinning National Competition Policy, this purpose should take precedence over the notion that competition should be pursued as an end in itself. This is particularly the case where a fully contestable model may reduce the competitiveness of funds that deliver the maximum benefits for employees.

The current FWC model to promote competition in the market for default funds has only recently been introduced and it is prudent to evaluate its impact over time, rather than impose new changes on the industry. The current model has widespread employer support because it avoids imposing the degree of costs on them that would occur in a fully contestable market. The current model is evidence based and intended to increase competition without disrupting the balance between employer and employee interests.

Recommendation 10 in the FSI Report undermines the appropriate balance between competition and system stability. The Super System Review and Productivity Commission considered this balance to be critical to safeguard member benefits over the long term.

It is not clear that the benefits to members of the proposals in relation to governance outweigh the costs to funds, or that a move away from the current self-regulation model that is supported by APRA, would deliver significantly better results than has and is being achieved by funds on a voluntary basis in keeping with their specific needs.

Imposing mandatory standards on smaller funds, like CPS, that add unnecessary costs and reduce flexibility but do not achieve any significant extra benefits for members, is likely to reduce the competitiveness of smaller funds.

The SIS Act already provides an effective statutory basis for Boards to perform their fiduciary duties in relation to benefits to members. It sets standards that are specific for the superannuation industry consistent with the general principles in corporation's law. The Stronger Super reforms strengthened the SIS Act in this regard.

There is no precedent for mandating the inclusion or a majority of independent directors on equal representation Boards.

Recommendation 13 is not supported by the previous assessments undertaken by the Super System Review and Productivity Commission. Compelling organisations to act in a one size fits all way is also firmly not supported by the OECD, ASX or APRA.