Fair Work Commission
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7 February 2014

Subject: 2014 review of default fund terms

Dear Sir/Madam

The Financial Services Council (FSC) welcomes the opportunity to make submissions in relation to the 2014 review of default fund terms in modern awards.

The FSC represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, private and public trustees. The FSC has over 130 members who are responsible for investing over $2 trillion on behalf of more than 11 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

Please feel free to contact me on 02 9299 3022 if you have any further questions in relation to this submission.

Yours sincerely

ANDREW BRAGG
DIRECTOR, POLICY AND GLOBAL MARKETS

Contents

FSC submission to the review of default superannuation fund terms in modern awards

CONTEXT OF THE REVIEW

The Financial Services Council (FSC) recognises that the *Fair Work Act 2009* (FW Act) requires the Fair Work Commission (FWC) to review the default fund terms in modern awards as soon as practicable after 1 January 2014.

The FSC notes, however, that the Government also released its *Better regulation and governance, enhanced transparency and improved competition in superannuation* Discussion Paper on 28 November 2013 with submissions due 12 February 2014.

The Discussion Paper considers whether the current processes provided for in the FW Act is the most appropriate method to determine default funds in awards, whether the FWC is the appropriate body to assess which funds should be listed in modern awards and whether an employer should have the flexibility to choose any fund offering a MySuper product to be the default fund for their workplace.

If the Government chooses to reform the default fund model the FWC process currently underway may create significant disruption for employers, employees and superannuation funds after 1 January 2015. It would not be appropriate for the FWC to require employers and default fund employees to change their superannuation arrangements for short period of time as this would cause enormous dislocation in the market, poor consumer outcomes and significant cost for employers, employees and superannuation funds:

- New superannuation accounts would be created for potentially millions of employees, exacerbating the current industry wide problem of multiple accounts per Australian;
- Contributions likely in the billions of dollars would be made and invested on behalf of members, likely needing to be sold shortly afterwards if members act to consolidate their funds; and
- Employers would incur the cost of interacting with a new fund and establishing new payroll arrangements.

Recommendation: The FWC have regard to the possibility that the Government may reform the default fund selection model whilst the FWC is undertaking its review. As a result, the Full Bench should take a cautious approach when determining what is as soon as practicable so as to avoid causing unnecessary cost and complication for employers, employees and superannuation funds. The process should not commence until the policy review is concluded.

TIMING

ACCOMMODATING THE COMPLEXITY OF THE PROCESS

The current model requires already licensed funds that offer a 'standard MySuper product' and wish to receive default contributions to:

1. Apply to APRA for a default MySuper authorisation; and
2. Apply to the FWC in accordance with s156A(3) of the FW Act to be included in the default superannuation list, subject to an assessment by the Expert Panel; and

3. Liaise with those persons able to make submissions to the Full Bench of the FWC in accordance with s156G(2) of the FW Act to be listed in each individual modern award in which the fund seeks to be named.

The current model also requires superannuation funds that offer an 'Employer MySuper Product' that wish to be available to receive default contributions to:

1. Apply to APRA for a default MySuper authorisation;
2. Apply to APRA to authorise each individual tailored, large employer MySuper products;
3. Apply to the Fair Work Commission in accordance with s156A(5) of the FW Act to be included in the Schedule of Approved Employer MySuper Products.

The current model is clearly complex for those trustees who intend that their 'Standard MySuper product(s)' or 'Employer MySuper Product(s)' receive default contributions. This is particularly the case where a public offer fund may wish to be listed in multiple modern awards.

If superannuation funds are not afforded adequate time to prepare for each stage of the review there is an argument that due process is compromised and this fails all affected parties – the funds and their service provides, employers and the members of those funds..

Further, it would not be in the interests of fund members and the industry to exacerbate the default fund review process by reducing submission timeframes. This will create unnecessary costs for funds and ultimately its members.

Recommendation: The FWC consult at each stage of the review process to seek advice from superannuation funds on the time necessary to prepare applications and submission so as to improve the efficiency of the review.

FWC SHOULD NOT DISADVANTAGE FUNDS YET TO BE GRANTED A MYSUPER AUTHORISATION

It is not clear on the current, publicly available information as to whether there are outstanding MySuper applications being considered by APRA.

It would be prudent for the FWC to seek guidance from APRA as to whether there are outstanding applications. If outstanding applications exist, the FWC should not commence either the 'Standard MySuper' process or the 'Employer MySuper' process until it is confirmed that all outstanding applications have been finalised.

Commencing the process whilst a superannuation fund has an application with APRA that is not finalised would disadvantage that superannuation fund if it were seeking to apply for default listing. It would also deprive that superannuation fund procedural justice.

For example, as part of APRA's application process APRA can refuse to approve a MySuper product without changes to a range of product features that would impact on the merits of the fund's application to be listed as a default fund, such as its asset allocation, risk strategy and return target. Further, APRA can refuse an application simply because an attachment to an application was inadvertently left off the application, or not all pages of the application were signed by the correct individual.

It is impossible for a fund to complete the FWC application process until the APRA application has been finalised and the final design of the MySuper product is settled. Instigating the FWC process whilst a fund is in this position would be breaching basic procedural justice for that fund, likely through no fault of its own.

Recommendation: The FWC not issue the Notices provided for in Appendix B or Appendix E or issue the related application forms until such time as APRA has confirmed there are no outstanding applications before APRA for a 'Standard MySuper' or an 'Employer MySuper.'

DRAFT NOTICES AND DRAFT FORMS

WHO IS ENTITLED TO MAKE APPLICATIONS

Section 156C of the FW Act provides that 'superannuation funds' that offer a standard MySuper product may make an application to the FWC to have the product included on the list. The term 'superannuation fund' is not defined, and other than its common meaning, does not have a legal meaning in either the FW Act or the *Superannuation Industry (Supervision) Act 1993* (SIS Act).

As a result it is not clear who is entitled to make the application to the FWC, a critical issue considering that not compliance may invalidate all of a fund's applications. It is contingent on the FWC to provide further guidance on whether it is:

- the corporate entity or entities that own the trustee;
- the trustee (as defined in s10 of the SIS Act); or
- the CEO of the regulated superannuation fund (as defined in s19 of the FW Act).

Recommendation: The FWC provide further guidance on which person is entitled to make an application to the FWC before the application process opens.

The FSC notes that the FWC's statement also only covers FWC's process to include various MySuper funds to either the Default Superannuation List or the Schedule of Approved Employer MySuper Products.

The statement does not provide any information on the subsequent process of (once successfully being appointed to the Default Superannuation List) applying to be included as a default superannuation fund on an individual award. The legislation only provides for registered organisations to make applications in relation to the second stage. The FSC seeks further direction from the FWC on whether the Commission intends on allowing individual funds to make submissions in relation to individual awards in the interest of procedural fairness.

Recommendation: The FWC provide further guidance on the second stage process and, in particular, whether it will grant superannuation funds standing to make submissions in relation to specific modern awards.

FURTHER GUIDANCE ON FIRST STAGE CRITERIA

The FSC seeks further guidance in relation to the grounds on which the FWC and the Expert Panel will interpret meaning of 'best interests' of default fund employees. 'Best interests' is a subjective term and not defined in the FW Act.

The FSC also seeks further guidance on the first stage criteria that must be taken in account when considering an application. The first stage criteria outlined in s156F of the FW Act relate to complex financial services concepts. It is not clear that the FWC or Expert Panel have sought advice from APRA and the Treasury, who have specialist knowledge in relation to these concepts, to direct its interpretation of the criteria.

Recommendation: The FWC provide further guidance before it opens applications on the meaning of 'best interests' and how it will interpret the first stage criteria listed in s156F of the FW Act.

For example, s156F(e) of the FW Act requires consideration of "whether the superannuation fund's governance practices are consistent with meeting the best interests of members of the fund, including whether there are mechanisms in place to deal with conflicts of interest."

The FSC seeks directions from the FWC as to whether this indicates the Expert Panel will consider industry best practice, such as the standards set in the ASX Corporate Governance Principles[1] (ASX Principles) which have been determined as such by twenty one industry bodies, including the following experts on investment, superannuation and corporate governance:

- Association of Superannuation Funds of Australia Ltd
- Australian Council of Superannuation Investors
- Australian Institute of Company Directors
- Australian Institute of Superannuation Trustees
- Australian Shareholders' Association
- Business Council of Australia
- CPA Australia Ltd
- The Institute of Chartered Accountants in Australia
- Financial Services Council
- Law Council of Australia
- National Institute of Accountants

Recommendation 2.1 in the ASX Corporate Governance Principles provides that best governance practices require a majority of a board to be independent directors and Recommendation 2.2 provides that the chair of the board should be an independent director. Independence is the bedrock of good governance. Corporate governance is a well established, global discipline which is relies upon independence at board level.

Clearly many superannuation funds operating under the 'equal representation' model do not comply with what is commonly agreed to be best practice. The FSC is seeking further direction from the FWC on whether this matter will be taken into account by the Expert Panel.

Recommendation: The FWC provide further guidance on how the Expert Panel will interpret s156F(e) of the FW Act.

Section 156F also requires consideration of the appropriateness of the long term investment return target (s156F(a)) and the appropriateness of the fees and costs of the product (s156F(c)).

The FSC submits that these assessments require a detailed understanding of:

- the investment markets and operating jurisdiction(s);
- data related to potential future market dynamics and global economic trends (local, regional, global);
- an explicit outline of the assumptions the FWC would use in assessing any investment return target or an expert assessment of the fund's assumptions.

[1] http://www.asx.com.au/regulation/corporate-governance-council.htm

- The current and changing nature of the employee and member demographic to which the MySuper product relates. For example, will the MySuper product continue to be available to individuals whose circumstances change (age, industry of employment etc) and will this affect other members' rights, entitlements and services?

An understanding of the demographic characteristics of to whom the award applies is critical for the Full Bench when determining MySuper products to be listed in the modern award.

For example, for a younger cohort of award covered employees it may be appropriate to have the fund invested more aggressively as they have the time to 'ride' through market cycles, and as a result the fund is more likely to be actively managed. This necessarily increases the costs of managing the portfolio but will generate higher returns over the longer term. Other funds, however, have strong data to suggest a single diversified arrangement generates the best returns and potentially at lower cost. Assessing these competing arguments will require both the Expert Panel and the Full Bench to have detailed technical knowledge of investment practices as well as the needs of the members to which the award relates.

It is not clear, however, the demographic characteristics of various groups of employees covered by each modern award or to whom the award applies, particularly given the long term nature of FWC reviews (four yearly cycles). It is therefore impossible for the Expert Panel or the Full Bench to accurately assess whether the long term investment return target suits the employees in question or whether the fees are appropriately set without additional externally gathered information.

In order to effectively discharge its duty it would be appropriate for the FWC to conduct research into the 122 modern awards being considered to determine the demographic characteristics of the employees covered by those awards so that the criteria in s156F(a) and (c) can be accurately applied.

Recommendation: The FWC provide further guidance on how the Expert Panel will interpret s156F(a) and (c) of the FW Act and conduct research to inform its assessments in relation to these criteria.

Recommendation: The FWC conduct research into the demographic characteristics of the employees to whom the award applies so that applications can be accurately assessed against the criteria in s156 of the FW Act.

DELAY IN COMMENCEMENT OF NEW AWARD TERMS

The FSC recognises that the FWC is required to continue to carry out the default fund process as required by the FW Act. As such, it is possible that the FWC will complete the process and determine new default fund listings for many awards by 1 January 2015. Contributions will therefore be required to be paid into those funds from 1 January 2015.

Existing MySuper funds that are currently listed in modern awards may not be listed following the completion of the FWC process. These funds are at risk of not being able to accept default superannuation contributions on behalf of award employees.

To the extent that an existing employer's fund is not listed in a modern award they can apply to have a specific corporate or tailored MySuper plan approved for 'default contributions' separately by the FWC, subject to the same two stage approval process. This concession is insufficient to protect many existing employers from the risk that they may at some point be contributing to MySuper products which may not be approved for default purposes.

If the Government chooses to reform the process as a result of the current consultations the Government's reforms may not have commenced prior to the 1 January 2015 deadline. As such, there may be a period of time between 1 January 2015 and the commencement of the new Government's regime where an employer is unable to pay contributions into a fund that it may otherwise wish to continue to do so, and may be able to do so again once the new regime commences.

The FSC submits that the FWC, as a contingency, provide in all default fund determinations that employers can continue to pay contributions into their current fund until the delayed date of 1 July 2015. This approach would avoid an unnecessary dislocation of current arrangements and, as a result, avoid:

- Employees being forced to create new accounts with a new superannuation fund, exacerbating the existing 'lost super' problem of where Australians have multiple accounts that become difficult to track;
- Employers unnecessarily incurring the expense of establishing a relationship with a newly listed fund;
- Superannuation funds incurring the expense of creating accounts and processing contributions for employers and fund members that may only be with the fund for a short period.

The FSC notes that whilst the FW Act provides that determinations changing the default funds in modern awards cannot have effect before 1 July 2015, there is end date before which the determination must have effect. A six month delay is both a modest and suitable outcome to ensure there is legislative certainty around these proceedings.

The FSC's proposed approach would provide certainty for employers, employees and superannuation funds and, in the event that the current process remains undisturbed, not interfere with its final implementation.

Recommendation: FWC determinations should amend awards to delay the requirement that default contributions be paid to named MySuper products until 1 July 2015. Contributions can instead continue to be paid into existing named MySuper products, or other grandfathered superannuation funds.

OTHER PROCESS ISSUES

CONFLICTS OF INTEREST WITHIN THE EXPERT PANEL

The FSC is concerned that the Expert Panel appointments are not free of conflicts of interest in carrying out their duties.

Panel members who are currently on trustee boards of superannuation funds named in modern awards would likely apply for listing as on the Default Superannuation List. These are unacceptable conflicts of interest which compromises the Expert Panel. Panel members will be unable to consider applications due to their material conflicts of interest. Similarly, service providers to funds such as investment managers or administrators have a commercial interest in the outcome of the current process.

It is not clear from the Full Bench statement how the FWC intends to manage conflicts of interest. The FSC seeks further enunciated guidance from the Full Bench on this matter. The FSC notes that in relation to conflicts of interest the FW Act provides:

Subsection 633(3)

Expert Panel Members

(3) An Expert Panel Member must not engage in any paid work that, in the President's opinion, conflicts or may conflict with the proper performance of his or her duties.

Subsection 644(2)

Expert Panel Members

(2) The Governor-General must terminate the appointment of an Expert Panel Member if the Expert Panel Member engages in paid work that, in the President's opinion, conflicts or may conflict with the proper performance of his or her duties (see subsection 633(3)).

Recommendation: FWC suspend the current default fund process until such time as the immediate and material conflicts of interest in relation to multiple members of the Expert Panel have been addressed.

The FSC submits that it would be prudent for the FWC to have in place a process to:

- identify conflicts of interest;
- assess and evaluate those conflicts;
- decide upon and implement an appropriate response to those conflicts, to control, avoid or disclose such conflicts as appropriate in the circumstances.

As an example a trustee director on the Panel may have to excuse themselves from some or all of the deliberations around applications to be included on the Default Superannuation List or the Schedule of Approved Employer MySuper Products not just for the fund for which they are a trustee director, but by any fund that currently competes with their fund in the default market. We believe this example is likely to emerge immediately given the composition of the Expert Panel.

Particular regard must be had to situations where a trustee director of a fund on the panel:

- Is to consider and review both their own and other funds in contention; and
- Will have access to information in the application which is commercial in confidence and would not otherwise be made public under s156C(6) of the FW Act.

This is consistent with common corporate governance principles developed to comply with the *Corporations Act 2001* whereby conflicted directors excuse themselves from deliberations when a conflict arises.

For service providers, it is the case that they may benefit commercially from the listing of funds to which they provide services. For example, an investment manager may receive investment mandates from a range of funds applying to be listed. Prima facie this creates a conflict due to their relationship to some of the first stage criteria outlined in s156F of the FW Act being:

(a) The appropriateness of the MySuper product's long term investment return target and risk profile;
(b) The superannuation fund's expected ability to deliver on the MySuper product's long term investment return target, given its risk profile;
(c) The appropriateness of the fees and costs associated with the MySuper product, given:
    (i) Its stated long term investment return target and risk profile; and

(ii) The quality and timeliness of services provided;

(d) The net returns on contributions invested in the MySuper product;

Employees of service providers have knowledge of the commercial arrangements between the fund and the fund manager and this may impact on decisions, as may their desire to promote the interests of the funds that have issued a mandate to their employers to increase the sizes of those funds, and hence the mandates and fee income of those employers.

Recommendation: The FWC publish their processes for managing conflicts of interests (after appropriate consultation) in this instance.

On balance, the FSC believes that one key requirement should be that a trustee director or a service provider on the Panel excuses themselves from participating in deliberations where their fund, or a fund to which they provide services, is an applicant for the Default Superannuation List or the Schedule of Approved Employer MySuper Products.