

Super System Review
Phase 3
Structure and SMSFs

February 2010



**Industry
Super
Network**

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About Industry Super Network

Industry Super Network (ISN) is an umbrella organisation for the industry super movement. ISN coordinates collective projects on behalf of a number of industry super funds with the objective of maximizing the retirement savings of five million industry super members.

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1 The choice architecture

There are three sources of market failure in superannuation: member inertia and disengagement; product complexity and low consumer financial literacy; and conflicted remuneration structures within the financial planning industry.

The choice architecture as described in the Phase 1 preliminary report *Clearer Super Choices – Matching Governance Solutions* (The Review, 2009a) is a significant contribution to debate on superannuation policy and in particular to addressing the first two of these sources. However, to provide a sound basis for reform the choice architecture must also address the impact of conflicted remuneration practices within financial planning. (It is recognised that this in part is a matter of timing and the review panel is considering the recommendations of the Ripoll Inquiry into the collapse of Storm Financial.)

In its *Inquiry into financial products and services in Australia*, the Federal Parliamentary Joint Committee on Corporations and Financial Services noted that “The regulatory framework has not compelled the industry to shift from acting as a distribution network to providing a professional, unbiased service” (PJC 2009,70).

Moreover, while ISN agrees with much of the theoretical underpinnings of the choice architecture we are of the view that enhancements to the existing regulatory framework and further development of government initiatives could significantly improve the efficiency of the superannuation system. In our submission to Phase 2 of the review, ISN advocated the introduction of a Superannuation Safety Net (SSN) which we believe enhances the current regulatory system and achieves the underlying objectives of the review panel without the need to overhaul the fundamental architecture of the super system.

ISN proposes that improvements to the existing regulatory framework would effectively address the three causes of market failure and achieve the objectives of the review panel without a comprehensive restructuring of the superannuation industry (see Table 1, below).

Table 1. Market failure in superannuation

Cause	Effect	Solution
Member dis-engagement and inertia	<p>Many workers do not make active choices.</p> <p>Many workers are members of higher cost retail funds and are paying for advice and other services they do not need or receive.</p> <p>Many workers are 'flipped' from relatively cost effective corporate master trusts into high cost personal super products.</p> <p>Retirement savings are eroded. According to SuperRatings projections this could be in the order of \$77,888 for a member on average wages.¹</p>	<p>Governance of workplace default funds through the Fair Work Australia (FWA) modern awards.</p> <p>Enhancement through the introduction of objective criteria to review principles by which workplace default funds meet are determined by industrial parties. Such criteria would be extended to all workplaces and employment arrangements.</p> <p>Reform of the financial planning industry (see below).</p>
Conflicted remuneration structures in financial planning	<p>Planners are paid incentives to recommend retail funds.</p> <p>These incentives have a large negative impact on retirement savings. Trailing charges of 0.5% reduce accumulations by around 10% and upfront charges of 3% reduce accumulations by around 3%, reducing savings at retirement by for an average worker by around \$50-60,000, with further costs incurred in the post-retirement phase.</p> <p>Virtually no advisers include non-profit funds on recommended product lists, despite years of APRA data demonstrating outperformance.</p> <p>ISN estimates retail fund underperformance has cost the nation \$50 billion in the 13 years to 2009, with costs to compound to \$250 billion to 2020.</p>	<p>Introduction of a best interest test/fiduciary obligation.</p> <p>Prohibition of payments by product providers to planners, including commissions, soft dollar payments and other ongoing percentage based fees for advice.</p> <p>Advice should be provided on a transparent fee for service basis.</p>
Product complexity and low financial literacy	<p>Workers experience 'choice overload', and may be unable to make decisions because of the complexity of products and pricing.</p> <p>Fund members unable to understand effect of higher fees/lower net performance on their retirement income.</p>	<p>Improved disclosure (ISN notes and actively supports Financial Services Working Group initiatives to improve disclosure).</p> <p>Ongoing information and education by funds to members through written material, education seminars, on line information and advertising.</p> <p>General and intra-fund advice (Simple Advice) to assist members who need personal advice about their super.</p>

¹ **Disclaimer** - The amounts are not predictions of actual outcomes. The comparisons show projected outcomes, applying today's average fees of industry super funds and retail master trusts, over 40 years. Differences in fees may change in the future and this would alter the outcome. Current at 31 December 2009 and may be revised if further information becomes available.

Assumptions: starting account balance \$20,000, initial salary \$50,000; 2.5% inflation rate; 3.5% salary increase per annum; 9% superannuation guarantee contributions; no additional salary sacrifice or voluntary contributions; 15% contributions tax; employer asset sizes accumulated at 11.6% per annum; investment return of 7.225% as per ASIC model (gross of taxes and fees at 8.5%) but with taxes of 15% deducted; explicit costs deducted from members' accounts (eg member fee) subject to a 15% tax allowance; contribution fees, entry fees, exit fees, additional adviser fees are excluded from calculations; starting age 25 and retirement age 65; employer asset size \$150,000. All assumptions and disclaimers can be found at <http://industrysUPER.com/financial-disclaimer.aspx>

1.1 The conceptual framework

The choice architecture reflects the developing understanding among industry, regulators and the Government that policy in the superannuation market should appropriately extend beyond measures to improve disclosure. This represents a significant departure from the official consensus since the *Financial Services Inquiry* (Wallis Inquiry) in 1997.

The architecture explicitly recognises that there is a range of levels of engagement in the market, and in fact that many superannuation members are passive. This observation – especially when considered in combination with the complexity of financial products and pricing and the limited financial literacy of many members – implies that consumer sovereignty alone cannot be relied on to drive effective competition on price and performance, and therefore efficiency.

The architecture seeks to address two sources of market failure but does not address the third: conflicted remuneration structures in financial planning and the role of these in the distribution of retail fund and SMSF products. As noted, in making this comment, it is acknowledged that the review panel is considering the publication of the recommendations of the Ripoll Inquiry. These recommendations included: that financial planners be subject to a fiduciary obligation and act in the best interests of their clients; and that the government work with industry to remove payments by product providers to financial planners.

1.2 Interaction with Modern Awards

ISN notes that the system of workplace defaults with representative trustees determined through the industrial relations system ensures that the majority of workers are members of low cost super funds with strong medium to long term net returns (see section 2, below).

Both unions and employer associations have invested considerable time and expense in the construction of these modern awards and have agreed the importance of included superannuation and the nomination of workplace default funds as an element of modern awards. Along with government, unions and employer associations – representing employees and employers – represent the major stakeholders in Australia's compulsory super system.

1.3 Defining member segments by behaviour

The architecture appropriately seeks to orientate regulation around members rather than industry segments. However, the proposed structure would require formal regulatory segmentation of the market, resulting in separate products for each segment.

Correct allotment of members to segments would therefore be critical. However, it is not apparent how regulators would differentiate between passive (genuinely disengaged) members and inactive members whose continued subscription to default funds and default investment options may be the result of some consideration. Recent research on enrolment in default investment options by a major industry fund indicates how difficult and important correct segmentation would be.

The fund surveyed members in its default investment option in late 2009 to investigate whether or not members were in this option entirely passively. The survey evidence suggests that members in the default investment option could be divided into three groups of close to equal size. One group was 'unknowingly' in the default option; having no awareness of what the default option was or that they had alternate investment options. The second group was aware they were in the default option and that there

were alternatives, but gave ‘apathetic’ reasons for being in that option (such as that they were unsure of how to change, that it would take too much time or that they were not interested in investment issues). The third group was aware they were in the default option and gave reasons for being in the default option that indicated they had given the question some consideration and thought it the appropriate investment option.

The research emphasises that the level of engagement varied dramatically across the fund membership, but also that an assumption that enrolment in a default option is synonymous with passivity would be inappropriate.

Similarly, the assumption implicit in the choice architecture that a switch or choice indicates a high level of engagement is misplaced. As Roy Morgan (2009) reports, many switches occur when people change jobs (52%) or under advice (10%), the majority of which is influenced by conflicted remuneration structures, rather than on the basis of an informed consideration of alternatives.

While not explicitly stated, the ‘Choice’ segment bears close resemblance to the existing retail sector. However, it can not be credibly argued that all retail fund members are engaged, or even that they are retail fund members by choice. Paying commissions to a financial planner may be evidence of disengagement rather than engagement, particularly for the approximately 60 per cent of retail fund members do not receive financial advice from a financial planner, despite paying for it (McNair–Ingenuity, 2008; Forethought, 2009). Similarly, members who are ‘flipped’ into a more expensive product with lesser insurance benefits simply because they have changed employer are unlikely to have made an active and informed choice.

It is not apparent that consideration has been given to the risk that regulatory segmentation would crystallise existing levels of engagement, introducing increased switching costs for members and potentially trapping members in products that become inappropriate for them as their level of engagement changes. It is not clear why the interests of ‘disconnected members’ are so different from ‘universal’ members that they should have a different (low risk/low return) investment allocation.

1.4 Implementation issues

The cost of establishing discrete fund structures to support the different market segments could prove prohibitive for a number of funds. Whether such a structure would strengthen or weaken economies of scale would be difficult to establish prospectively. An unintended consequence of the architecture might be an increase in costs. All costs incurred by not for profit funds are ultimately borne by members.

In terms of investment, the architecture apparently would involve guidance or a requirement for Universal sector funds to adopt lifecycle asset allocation strategies. There has been considerable debate over many years about both approaches and some funds have elected to introduce them to varying extent. There remains, however, insufficient evidence to support their mandatory introduction for funds. Further, it is not clear whether more sophisticated life cycle strategies (which make subtle and iterative asset allocation changes rather than ‘step’ changes) would in fact be low cost.

The material released also suggests guidance on investment for universal funds might extend to the requirement that use passive (as opposed to active) investment managers to reduce cost, and listed rather than unlisted investment vehicles. These suggestions raise broader issues around listed markets and the potential for super funds to act as a constructive force in nation building (in particular whether Universal funds could directly invest in assets). Were the bulk of workers super savings devoted purely to index or

tracker funds then the ability of the market to reward successful companies in different sectors could, over time, be diminished with unintended consequences on overall economic competitiveness.

1.5 Financial literacy and member engagement

One way to increase member engagement and literacy is to communicate with them through a range of channels. The architecture does not fully accommodate the reality of member behaviour, at least in the industry super fund sector, nor the efforts by all funds to increase member engagement and increase financial literacy.

Communication with members over time has demonstrable effect in increasing engagement and financial literacy, in particular targeted communications whether through advertising, mail-outs or in electronic form. The universal fund structure would appear to limit the capacity for funds to communicate their members and therefore encourage them to develop their interest and knowledge of superannuation.

1.6 An alternative framework

ISN agrees with much of the analysis behind the choice architecture and in the policy intention of the framework. However, we believe the implementation costs and arbitrary allocation to members to different categories based on a static assessment of their engagement is problematic.

In our submission to Phase Two of the review, ISN advocated for the introduction of a “superannuation safety net” to protect super members. An overview of this safety is included below, at section 1.7.

1.7 A Superannuation Safety Net

Given the compulsory nature of super and its importance not only to the quality of retirement to individual workers but also to the economic future of Australia, the regulation of the distribution of super needs to effectively accommodate the actual competitive dynamics of the market.

Critically, the industry – which benefits from \$61 billion in annual employer contributions (APRA 2009) and taxpayer funded concessions worth \$25 billion a year (Treasury, 2008) – should act in the best interests of working Australians and seek to protect their interests, rather than profit from consumer inertia. Indeed, there is an expectation from the Australian community that this should be the case.

The proposal to introduce a *Superannuation Safety Net* is based on the following:

- Superannuation is a creature of regulation and therefore regulatory change can have a substantial beneficial or deleterious effect on individual savings and aggregate national savings.
- The majority of consumers are passive and disengaged in their superannuation; for example nine in ten workers do not choose their own super fund and members excessively discount their future needs.
- The lack of consumer sovereignty has led to market failure that in the short to medium term can only be addressed through changing the regulatory settings.
- The regulatory framework can act as a proxy for consumer driven demand through simulating the behaviour of rational, informed and engaged consumers.
- The regulatory settings must ensure that the key driver of fund selection, whether for an individual or a workplace, is net performance, consistent with maximising final payouts for both engaged and disengaged consumers.

- Competition for informed consumers should be based on brand, performance, cost and/or other features typical of consumer markets.
- It is acknowledged disclosure is insufficient protection for consumers that are disengaged and tend to discount the future.

On this basis a *Superannuation safety net* is proposed consisting of:

- Default funds at all workplaces that meet objective criteria which protect workers retirement savings by providing minimum protections and delivering strong net benefits to members;
- A requirement that financial advisers act in the best interests of their clients.
- The capacity for super funds to provide low cost intra-fund financial advice to their members which is in their 'best interests'.
- A practical and equitable solution to lost super/inactive accounts.

2 Default funds and the industrial relations system (s14.1)

The Industry Super Network strongly supports the current process for determining default funds. The current arrangements have served both employers and employees well.

The use of the industrial relations system to set default funds is entirely consistent with the industrial origins of compulsory superannuation and the fact that a considerable component of Superannuation Guarantee contributions arise from wages deferred by either agreement or determination. An outline of the industrial relations origins of compulsory superannuation may be found at Attachment 2.

ISN has made extensive submissions to Phase 2 of the review regarding default funds and the benefits of the representative trustee model associated with industry and not for profit funds. It is not our intention to repeat these submissions. These comments should however be read in the context of ISN's earlier submissions.

The current process where default funds are named within modern awards as determined from time to time by Fair Work Australia is supported. The current arrangements reflect a level of agreement between employer and employees. ISN believes the process can be improved through the establishment of a set of minimum criteria that a fund must meet to enable that fund to be considered as a default fund within an industrial award or agreement or to be offered by an employer. This proposal was contained in Attachment 2 of ISN's submissions to Phase 2 of the review.

The continuation of a tri-partite and public process via Fair Work Australia (formerly the Australian Industrial Relations Commission) is highly desirable as it is a public and open process which can consider the needs of both employers and employees and public policy considerations.

The current arrangements do not impact on the capacity of funds to compete within the super sector as the Choice of Fund regime ensures that an individual worker can select his or her own super fund. In addition, if an employer and its workers wish to nominate a default fund different to that named in the award, they can do so within a workplace agreement.

The most appropriate mechanism for providing for a superannuation safety net is through the industrial relations system. Given the historic intersection of industrial

relations, the award and agreement making systems and superannuation, it is appropriate that employer and worker representative organisations participate in the determination of appropriate default funds.

Importantly the current arrangements provide a level of continuity between the safety net modern awards and industrial agreements. The award arrangements reflect a high level agreement as to what is the most appropriate superannuation arrangement, often across industries and occupations, whilst workplace agreement making facilitates local level arrangements directly between employers and employees.

The existing arrangements facilitate member portability and a level of responsiveness to the characteristics and needs of particular industries.

2.1 Suitability of existing arrangements reflected in enterprise agreements

The suitability of the existing arrangements for the determination of default funds at workplaces is reflected in the default fund arrangements within workplace agreements.

These agreements are freely entered into between employers and employees at a workplace level and override the arrangements within awards. In most instances the default arrangements found within awards are replicated.

If an employer believes there is a case for changing the default fund arrangements applying to a workplace, it is entirely appropriate that the employer make that case to employees rather than be placed in the invidious and paternalistic position of determining what the employer believes is best for employees. This potentially places a legal and moral liability and economic cost that most employers would seek to avoid.

Indeed some agreements change superannuation arrangements applying to workplaces, including the quantum paid, the relationship with salary sacrificing arrangements at the workplace, additional choice of fund and employee contributions.

To alter the existing arrangements would cause considerable cost confusion and uncertainty for both employers and employees. There is also considerable doubt that any change to existing arrangements for the establishment of default funds would not be possible without significant changes to industrial relations legislation.

2.2 Employer support for current arrangements

Appendix 2 of ISN's submissions to Phase two's issues paper dealt with employers and default superannuation funds. ISN commissioned research from Newfocus concerning employers' attitudes to default funds and included those findings in the paper. This research found a very high level of support for default funds at an industry wide level.

The establishment of default funds via an open and public system with the involvement of representatives of both employers and employees is preferable to effectively burdening an employer with the sole burden of choosing a default fund. This is an important consideration for employers, all the more so as it is recognised that many employees do not actively exercise choice. Individual employers can have some comfort that default funds nominated within awards have undergone a level of scrutiny and have the support of employee and employer representatives.

ISN is aware that a number of employer representatives have expressed their support for the current arrangements to the review.

2.3 Representative trustee model successful

The use of industrial awards to determine employer default funds has provided a strong backing for the representative trustee model used by industry and not for profit funds. In ISN submissions to Stage one of the review ISN outlined the demonstrated governance benefits of the representative trustee model and how such a model remains the best means of delivering the best outcomes for fund members.

Given that the primary responsibility of superannuation funds is to maximise the retirement benefits paid to members, the continued outperformance of industry super funds, together with their low fees demonstrate the effectiveness of representative trustees at meeting their overriding objective.

Industry super funds have equal representation from employers and employees with many employer and employee trustees continuing to work within the industries and occupations the fund derives many of its members. As a result the fund is more representative and responsive to its members needs.

2.4 Failure of choice

In reality there is very little active decision making regarding choice of fund. Research has found that the level of switching between super funds has reduced to only 2.5 per cent in the 12 months to June 2009, down from a high of 5.9 per cent apply immediately after the introduction of choice of fund (Roy Morgan, 2009). More than half² of those employees who did switch funds did so after changing jobs and choose the default fund nominated by their employer.

It should be noted that the Choice of Fund policy was intended to give consumers choice and control over their superannuation. It is not appropriate that employers alone be burdened with this decision. Where advice regarding the selection of appropriate default funds is sought, it is suggested it is often conflicted.

Choice of fund, either via bargaining or individual selection exists. However, with between 80 and 90% of individual's not exercising choice where it exists it is more appropriate that a default arrangement be in place rather than a product chosen by an individual employer.

A safety net of default funds is critical in a compulsory system. Until workers become more actively engaged in selecting their own super fund, it is important that there is some regulation of the funds which can act as default funds.

2.5 Safety net required

Despite the extension of the award system it is estimated that approximately 9 percent of employees are in workplaces where the employer determines the default fund or there is no formal default fund in place. The available evidence shows that the majority of employers in these predominately small to micro businesses utilise the more expensive corporate master trusts as a default.³

The decision of the Australian Industrial Relations Commission on 12 September 2008 to recognise existing default funds utilised by employers ensures there will continue to be

² 52 per cent.

³ See Table 1 and Table 2 of Appendix 2 *Employers and Workplace Default Superannuation Funds* of ISN's submissions to Phase 2 of the Review. Pages 2 -3.

a significant, yet unquantifiable, number of employees who will continue to be allocated to default funds chosen by their employer.

Appropriate safety net arrangements should be in place to ensure the retirement incomes of these employees are the paramount concern when default arrangements are made on their behalf.

2.6 Current system has served the parties well

It is good public policy that encourages choice whilst simultaneously allowing the continuation of a default system which consistently provides higher returns to fund members at lower cost. It is appropriate that the status quo as reflected in the AIRC decision continue because it has consistently delivered higher returns for Australian workers at a low cost to employers.

The selection of default funds via the industrial relations system has provided a level of certainty to employees and practical benefits to employers. Industry funds with their representative trustee model have built confidence in the system. This confidence would be undermined in the event that the current process of establishing default funds is significantly altered and would be improved with the introduction of eligibility criteria as outlined above.

3 Participation (s13)

ISN endorses the AIST's submission on participation. In addition, we make the following observations on issues faced by indigenous Australians.

There are many aspects of superannuation that do not cater well for indigenous Australians.

With a lower life expectancy than Australians as a whole and a life expectancy of 59 for indigenous men, access to superannuation savings may not be available for many people who are no longer working and unlikely or unable to return to the workforce. Further, many indigenous Australians may not reach the preservation age and unless the life expectancies of indigenous Australians increase significantly, increasing the preservation age over time could disenfranchise greater numbers of indigenous Australians.

Many indigenous Australians have difficulty accessing the formal documentation required to join funds or make claims against life and disability insurance policies, particularly in remote communities. In these circumstances, it may be appropriate to use alternative arrangements to verify the identity and/or age of fund members, such as the systems used by Centrelink.

Financial literacy amongst indigenous Australians is often low. While ASIC and other organisations provide outreach programs and information targeted at indigenous communities, much of this material does not address superannuation. The focus is often on understanding contracts and avoiding debt. Also, material that is written in English may not be well understood in remote indigenous communities, where English is not widely spoken.

Indigenous Australians have higher rates of unemployment than Australians as a whole and are more likely to be employed in casual or temporary roles. This increases the likelihood of lost superannuation accounts and additional costs from having multiple accounts. Increasing awareness about superannuation entitlements and improving overall financial literacy would help to address these problems.

Recommendation: That financial literacy programs for indigenous communities run by ASIC and other organisations specifically address superannuation, including account proliferation; and access be facilitated within these programs for translation or interpreting services.

While programs such as the Community Development Employment Projects (CDEP) have provided useful skills for indigenous people looking for work, the income support payments they receive do not qualify for superannuation, even if participants earn over \$450 per month. Participants in CDEP projects work in their communities and are remunerated accordingly; however, CDEP organisations are exempt from contributing superannuation payments to participants in their programs. Since July 2009, new participants have received income support payments instead of a wage.

Neither the participants nor the CDEP organisations meet the definitions of an employee or employer under the *Superannuation Guarantee (Administration) Act 1992*, so participants are ineligible for the guarantee. This inequity should be addressed.

Recommendation: That SG contributions be made in respect of remuneration for work under the CDEP scheme.

4 Insurance (s10)

The provision of death, TPD and income protection insurance within super is a significant strength of Australia's superannuation system. The distribution of insurance through superannuation can be highly cost effective and reduces the risk that a premature exit or absence from the workforce due to serious injury or death will cause significant:

- Shortfall in benefits for those impacted,
- financial hardship for family,
- burden upon the taxpayer.

Industry superannuation funds in particular have led the way by providing affordable default cover that seeks to address the high levels of underinsurance in the community. Industry super funds have been able to negotiate highly cost effective group insurance which may take into account the particular demographics of their membership and providing access to cover for many members undertaking occupations that are regarded as too higher risk for to be covered under a retail policy. Additionally individuals have the choice to tailor their insurance to meet their specific circumstances.

Industry superannuation funds have demonstrated that such insurance can be provided at a fraction of the cost of comparable retail insurance purchased through a financial planner (see Table 1, below). The group policies of industry funds often pool risk between males and females and smokers and non-smokers. Apart from this feature the differences in premiums can be largely attributed to:

- The significant scale benefits in process and commercial bargaining capacity of large funds
- The application of commissions.

Table 2. Insurance – industry superannuation fund vs retail insurance markets administrative / office worker

Age Next Birthday	Industry Fund Annual Premium	Male Retail Rates		Female Retail Rates	
		Smoker	Non-smoker	Smoker	Non-smoker
25	\$137.73	\$505.50	\$339.60	\$360.60	\$261.90
30	\$137.65	\$448.80	\$278.70	\$360.60	\$250.00
35	\$156.83	\$486.60	\$287.10	\$411.00	\$274.50
40	\$211.33	\$652.50	\$343.80	\$558.00	\$339.60
45	\$302.74	\$978.00	\$509.70	\$839.40	\$509.70
50	\$449.81	\$1,750.80	\$858.30	\$1,486.20	\$833.10

Notes: 1. Comparison is based on a sum insured of \$200,000 for Death and TPD insurance cover. 2. Standard terms assumed. 3. Industry Fund premium is expressed on an annual cost basis using published monthly premiums and based on the underlying cost of cover offered by 4 major Industry Funds. 4. Retail Rates are based on the underlying cost of cover offered by major Life Offices with standard commission rates to financial advisers. Source: IFS Insurance Broking Pty Ltd (2008)

Clearly the provision of insurance within super is an efficient platform for addressing insurance needs of individuals in the context of protecting the capacity to fund retirement benefits during periods of temporary disability and provide appropriate benefits in the event of premature death or TPD.

However this is not the case across the entire superannuation sector.

Analysis undertaken by ISN suggests the excessive cost of retail insurance purchased direct through a financial planner also extends to insurance bundled into retail superannuation.

The differences in the cost of premiums between sectors are significant enough to impact on retirement outcomes and the efficiency of taxpayer concessions extended to superannuation and warrants the attention of the review.

4.1.1 Sectoral differences in premiums

While it would not be unusual to see some variation in the cost of comparable insurance from fund to fund it is evident that there are large differences in the cost of comparable insurance across sectors. As well as providing poorer net returns on average, indicative analysis undertaken by ISN suggests retail superannuation funds offer much more costly insurance than industry funds.

ISN sought indicative data to compare the cost of insurance provided through a leading industry fund and a number of selected retail master trusts. This data is presented in Table 3 (below).

Table 3. Comparison of large industry fund and selected retail master trust insurance premiums

Sector	Industry	Retail								
Product Name	Australian Super	AMP Flexible Lifetime Personal Super	MLC MasterKey Super Fundamentals	MLC MasterKey Super	AXA Generations Personal Super	BT Lifetime Personal Super	Colonial First State FirstChoice Personal Super	Hillross PortfolioCare Super Service	Suncorp Easy Super Personal Super	Retail Fund Av.
White Collar Male N/S										
25	\$134	\$288	\$254	\$254	\$146	\$158	\$180	\$214	\$220	\$214
30	\$134	\$252	\$212	\$212	\$140	\$126	\$164	\$190	\$180	\$185
35	\$152	\$264	\$222	\$222	\$172	\$136	\$184	\$198	\$182	\$198
40	\$168	\$326	\$276	\$276	\$252	\$180	\$246	\$250	\$276	\$260
45	\$222	\$512	\$434	\$434	\$434	\$300	\$396	\$402	\$498	\$426
50	\$330	\$950	\$794	\$794	\$788	\$544	\$702	\$718	\$954	\$781
Female N/S										
25	\$134	\$222	\$222	\$222	\$118	\$108	\$144	\$160	\$64	\$158
30	\$134	\$220	\$198	\$198	\$112	\$114	\$148	\$152	\$76	\$152
35	\$152	\$236	\$206	\$206	\$138	\$120	\$176	\$166	\$136	\$173
40	\$168	\$288	\$256	\$256	\$202	\$164	\$236	\$218	\$250	\$234
45	\$222	\$462	\$384	\$384	\$348	\$270	\$392	\$340	\$444	\$378
50	\$330	\$846	\$722	\$722	\$630	\$484	\$708	\$532	\$810	\$682
Blue Collar Male N/S										
25	\$240	\$418	\$330	\$330	\$224	\$188	\$264	\$282	\$386	\$303
30	\$240	\$384	\$282	\$282	\$216	\$154	\$246	\$264	\$316	\$268
35	\$278	\$406	\$298	\$298	\$264	\$166	\$278	\$280	\$318	\$289
40	\$308	\$500	\$376	\$376	\$388	\$236	\$372	\$352	\$484	\$386
45	\$430	\$822	\$602	\$602	\$668	\$406	\$622	\$574	\$872	\$646
50	\$622	\$1,578	\$1,152	\$1,152	\$1,212	\$754	\$1,152	\$1,040	\$1,670	\$1,214
Female, N/S										
25	\$240	\$352	\$298	\$298	\$180	\$140	\$246	\$252	\$112	\$235
30	\$240	\$352	\$268	\$268	\$172	\$144	\$250	\$240	\$134	\$229
35	\$278	\$378	\$282	\$282	\$212	\$152	\$300	\$262	\$238	\$263
40	\$308	\$462	\$356	\$356	\$312	\$224	\$414	\$316	\$438	\$360
45	\$430	\$772	\$554	\$554	\$536	\$384	\$722	\$500	\$778	\$600
50	\$622	\$1,474	\$1,078	\$1,078	\$968	\$708	\$1,326	\$768	\$1,418	\$1,102

Source: Derived from Chant West Subscription Report. Insurance premiums \$ p.a for \$200,000 TPD cover. Insurance premiums include the maximum adviser commissions payable (which are about 20% for retail master trusts).

The differences revealed by ISN's analysis are significant enough to impact heavily on retirement outcomes of retail fund members.

In one instance (for a 50 year old blue collar male) the premium difference for \$200,000 of death and TPD cover could be as much as \$1,048 per year.

For a worker around average earnings (\$55,000) with a modest level of cover (\$200,000) this premium difference could reduce their available SG contributions for accumulation by as much as a quarter (24.9 percent).

An unweighted average of the selected funds reveals premium differences between industry and retail of around \$110 a year for females and just over \$160 a year for males.

These differences are significant enough to warrant the attention of the review. They represent a significant systemic cost to the superannuation system which is supported by generous taxpayer concessions and the safety net of the age pension.

For individuals the impact of these premium differences could significantly reduce their lifetime accumulation.

A good starting point for reform would be removing the impost of commissions on insurance premiums paid through retail super. These are typically 20 percent of the premium paid.

Industry funds have demonstrated there is no need for these retail distribution costs to be borne on super through the negotiation of appropriate group insurance.

Financial services reform which implements a fiduciary obligation and prohibits commissions would go some way to addressing premium differences.

It is often argued that commissions should remain in respect to risk based financial services products. However it is apparent that preserving this capacity could retain a back door channel for excessive costs to be drained from superannuation savings.

Additional pressure on premiums could be brought to borne through reporting individual fund insurance costs for a typical policy relative to industry averages in addition to including insurance in any assessment criteria adopted in the future for default fund approval.

4.1.2 Default coverage

The consultation document raises issues around the appropriateness of default insurance coverage and whether there should be additional regulation of default coverage.

Notwithstanding the sectoral specific issues identified above, trustees of individual funds should be given the flexibility to determine appropriate levels of default coverage consistent with the demographics of the fund. Individual members should have the right to opt out of cover if they wish or tailor insurance to more appropriately reflect their circumstances. ISN notes the important role intra fund advice can provide in this respect.

Among corporate master trusts for small employers, even though there may be insurance included by default with superannuation membership, there is often very limited cover available without underwriting. Typically only a minimum amount of death cover may be available.

In this situation, an employee who does not actively engage with their super provider on the subject of insurance and go through an assessment (possibly including medical checks) may find it difficult to obtain additional coverage, and it is likely that any

additional coverage, if available, would be significantly more expensive than coverage available through funds where there is a non-underwritten standard level of cover, particularly industry funds.

Improved data collection could improve the tailoring of default coverage however this needs to be balanced with the additional administrative costs involved. ISN also notes the practices prevalent in the retail fund sector when individuals are flipped from a corporate to personal super plan and the default premium is typically the highest cost (blue collar smoker). Improved data collection, disclosure and engagement with members would help avoid individuals bearing unnecessary insurance costs.

Survey research undertaken by the Industry Funds Forum determined that of those members who want insurance greater than 80% of members nominated a premium of \$5 per week or more as appropriate and more than 56% nominated \$10 per week or more as appropriate. Approximately 12% of members indicated they did not require insurance.

Currently, among industry super funds, default premiums are generally under the range indicated by members as being appropriate.

4.1.3 Ratio of proceeds to premiums

ISN believes table 3 in the Phase 3 consultation document adopts a methodology which understates the ratio of insurance proceeds (claims) to premiums.

It appears the analysis is restricted to claims paid data only (that is cash flow) and does not include any claims reserves for 'open' claims and any incurred but not reported (IBNR) claims. As a consequence it would appear that the overall loss ratio is significantly understated. A different and more rigorous methodology is required that takes into consideration the full extent of claims (i.e. reserves and IBNR). Such an approach would result in a higher loss ratio.

Industry Fund Services Insurance Broking (IFSIB) is currently undertaking such an analysis for the various industry segments and should be in a position to provide this information to the review shortly.

4.1.4 Insurance and the SIS Act

The SIS act provides specific definition of benefits such as Total and Permanent disablement that are now out of date and not in line with Market progression that is better aligned to member needs. This in some cases such as TPD (Own profession definitions) has a potential impact on the deductibility of premiums. Conditions of release are also specifically defined to the extent that product types or modifications that can be beneficial to members and the industry in supporting and returning members to work and funding retirement or supporting members with post retirement long term care are potentially excluded. Review of the definitions and modification to define the purpose of the benefits may result in an improved capacity support members up to retirement and post retirement while also not compromising the current deductibility of premiums. In addition it may provide the capacity to improve efficiency and reduce costs through improved benefit design.

4.1.5 Self Insurance

Insurance premiums typically represent a small portion of assets (1% or less) in most funds. Furthermore some major Funds have total assets of similar size or greater than insurers. Given the insurance expertise within the market is equally available to Funds it is appropriate that major Funds be able to consider and utilise the benefits of self insurance or risk sharing structures on the basis that appropriate reserving for future liabilities can be demonstrated.

Should a Fund's insurer fail then a major Fund will incur a loss of benefits equivalent to a multiple (greater than 1) of its annual premium. However, the obligation will fall upon the Fund to assess and pay the claims in the interest of those members impacted. As such, the benefits of external insurance for a major fund can be questioned.

On the basis that efficiency of process can be maintained or improved then self insurance is the lowest cost form of insurance as it removes third party profit margins. However, there are likely benefits in managing total risk through maintenance of appropriate reinsurance structures to deal with unexpected volatility (eg. catastrophe).

4.1.6 Income Protection

Survey research undertaken by the Industry Funds Form has established that income protection is currently the benefit product of best fit in providing for both long term and short term disability and the funding of retirement benefits. The research determined that in relation to AustralianSuper's membership sample, 80% of members preferred to receive long term disability benefits either as an income stream or a combination of a lump sum benefit and an income stream.

AustralianSuper is currently in the process introducing income protection as a default benefit for insured members.

Income protection provides a capacity to rehabilitate and retain members who are disabled for their own occupation with a view to returning members to the workforce that will permit them to continue fund their own retirement benefits. Furthermore, income protection can insure the member's superannuation contributions during their period of disability thereby maintain the funding the accumulation of their retirement benefits.

Improving the capacity to develop products that better meet the needs of both short term and long term disability or that can meet multiple needs (death and disability) may provide further opportunity for process and cost efficiency for members.

4.1.7 Other Pooling Ideas

Our response is as detailed under the section – Self Insurance.

5 Capital requirements and operational reserves (s14.4)

Superannuation funds (or their external service providers) may suffer from procedural errors or systems failures that may have negative consequences for the fund's members.

Appropriate management strategies to deal with this risk include analysis of operations and measures to reduce the likelihood of such events, taking on insurance, and creating reserves – as well as requiring equivalent measures of service providers.

Such measures carry costs, and in non-profit funds, all costs are ultimately borne by members. The intensity of risk management and the level of insurance and reserving are therefore important policy matters for trustees.

In relation to reserves, issues for trustees to resolve include the size of the reserve, the timing of the build-up of reserves (if necessary), how the reserve is invested and how the cost of creating the reserve is spread across the membership (that is, on a per member basis or in proportion to assets).

The regulatory regime is not silent on these issues but the degree of uniform prescription is quite limited.

The SIS Act (Part 2A, s29DA) requires that a trustee or custodian needs net tangible assets of a prescribed amount (\$5 million), or a guarantee, or access to a guarantee of equivalent amount (APRA, 2004a). If a fund fulfils this requirement through a custodian APRA also requires that the fund hold \$100,000 in cash (or equivalent).

The SIS Act also provides for a system of standards applicable to the operation of regulated superannuation funds (Part 3). Included in the list of matters in relation to which standards may be prescribed are those relating to the adequacy of resources (including human resources, technical resources and financial resources) (APRA, 2004b).

In assessing compliance with the standard, APRA states that it applies 'objective criteria to determine whether the trustee has adequate resources in its own right or available to it', and also that it 'considers the nature, scale and complexity of the trustee's operations and of the superannuation entities of which it is trustee' (APRA, 2004b).

As the superannuation system matures, superannuation funds are becoming larger and more sophisticated. Risk management procedures are becoming more systematic and are increasingly being informed by best practice in other industries, including banking.

For example, one ISN member fund has a policy of holding 40 per cent of annual expenses as an operational reserve. Another has a policy to keep reserves low, with a management target of 25-30 basis points of fund assets. Both approaches imply an increasing reserve as the fund grows. Another fund is reviewing its policy with input from leading risk management consultants in this area.

In recent months, some industry groups and commentators have suggested that all superannuation funds should be required to hold significant discrete capital in the same way that all entities do in certain sectors of the finance sector, such as banking, general and life insurance.

In fact, the comparison with these sectors is informative, but the conclusion that the same approach is required is unfounded. In common with superannuation, these industries face operational risks. But in contrast to (accumulation-style) superannuation, in these industries the operational risks are dwarfed by financial risks, including credit

risk, interest rate risk and market risk, which can result in large and rapid fluctuations in assets and liabilities, and therefore net tangible assets.⁴

In the absence of exposures of this kind, reserves or other capital held apart from the primary member holdings can be much smaller relative to total assets.

The perception of the ISN member funds of the regulatory regime as it pertains to operational risks and reserves is that while the \$100,000 cash holding and \$5 million minimum net tangible asset or guarantee requirements are almost certainly too low to cover the operational risks of a large fund, the wide range of factors which influence operational risks (and the fact that these might change over time) imply that it would be difficult for Government to prescribe a 'one-size-fits-all' amount or proportion of assets/expenses.

Current arrangements require discretion on the part of trustees and case-by-case assessment on the part of APRA. While such an approach may not be perfect, it is not obvious how these aspects of the current regulatory regime would constructively be improved by blanket policy settings. However, holding \$100,000 in a cash account separate from fund assets and having it audited does carry cost, with little perceived benefit in terms of security for members for large funds.

Reportedly, one option being considered by APRA is to require reserves that meet some specified confidence interval around a statistical analysis of prior events, as is employed in relation to the banking sector. This approach is theoretically sound though of course would depend on robust historical data. As the level of reserving under such a scheme would be very sensitive to the confidence interval chosen and all provisions and reserves are paid for by members in the non-profit sectors, the industry would reasonably expect careful public consultation on these key factors.

6 SMSFs (ss15-22)

It is appropriate that there be greater alignment of regulation of the SMSF sector and the APRA-regulated sectors of the superannuation industry, to protect both investors and the public interest, given the substantial tax concessions available to investors. While the members of SMSFs must also be trustees, advisers often take a leadership role in management of these funds, creating potential agency problems as with larger superannuation funds.

SMSFs are the largest sector by assets, holding around 31 per cent of assets at 30 June 2009 according to The Review (2009b). The average income levels of SMSF members are significantly higher than those of non-SMSF members (Graph 7) and SMSFs also received a disproportionate share of member contributions (Graph 1). Given the greater level of benefit from tax concessions for those on higher incomes, a disproportionate share of the estimated \$24 billion in tax concessions on superannuation (The Treasury, 2010) would be received by the SMSF sector.

6.1 Licensing and training

A primary dimension of the regulatory regime that needs to be equalised is the licensing and training of trustees and service providers. Administrators of SMSFs, who may also act as advisers, should be licensed to reduce the potential for inappropriate conduct.

⁴ Defined-benefit superannuation funds have some of these exposures, but have access to the balance sheet of the sponsoring employer, typically a large corporate or public sector entity.

Recommendation: Licensing of SMSF administrators and a requirement for ongoing training to ensure a minimum standard of financial competence for fund trustees.

6.2 Distribution and advisers

As discussed in the briefing at Attachment 1, conflicted remuneration structures can lead to biased financial advice that is not in the member's best interest. Conflicted advice is tremendously costly both for individuals and the nation.

This applies to the SMSF sector as much as it does to the APRA regulated sectors. Much SMSF activity is driven by advisers, mainly accountants, who promote and deliver SMSF products, including pro forma trust deeds, fund formation and ongoing administration and tax returns.

Recommendation: The government require that financial advice meet a best interest test and ban commissions and asset-based fees remuneration for advice.

6.3 Scale

Data published by The Review indicates possible mis-selling of SMSF products, particularly to the significant group of individuals and families that appear to have insufficient assets to affordably carry SMSF administration costs.

Around 25 per cent of SMSF funds had less than \$200,000 in assets at June 2008, a figure often quoted as the minimum level of assets to achieve reasonable economies of scale. Around 15 per cent of SMSF funds had less than \$100,000 in assets. Of SMSFs created during financial year 2008, the median fund balance was just over \$200,000 and median member balance was \$100,000. This suggests that around half the SMSFs created in 2008 were of an inefficient scale.

Economies of scale were reflected in widely variant return on assets by size of fund. Over the three years – 2006, 2007 and 2008 – returns in funds of over \$2 million were around 15 per cent higher than returns for funds of up to \$50,000 and around 8 per cent higher than returns for funds of \$100,000-200,000 (The Review, 2009).

Recommendation: That a minimum assets threshold for SMSFs be established of \$200,000 per member.

6.4 Asset allocation

Available data suggests diversification levels in many SMSFs may be lower than most regulated fund default options. However, beyond a requirement for training, which should help address poor asset allocation, it is difficult to conceive of an effective regulatory solution to selectively impose adequate diversification on SMSFs.

7 Public sector funds (s8.5)

The industrial relations framework is an effective and efficient model for determination of workplace default funds, as discussed above in section 2.

However, a minority of public sector workplaces represent an aberration to the system, as state legislation in some cases requires workplace contributions in specific workplaces to be made to a named public sector fund.

These arrangements have a number of disadvantages for workers, the most obvious being that these members are denied a choice of fund.

The impact is felt particularly by workers in industries such as health and education that may work for employers with restricted super arrangements *and* other employers either at the same time (ie. working on a part-time/casual basis for both employers) or over time.

Workers in these situations who wish to have consolidated superannuation holdings are compelled to consolidate into the legislated public sector account. Workers who wish to hold a non-public sector account are compelled to hold more than one account.

This is a source of inefficiency for members and effectively prevent choice and flexibility in superannuation arrangements.

Recommendation: That legislation on public sector superannuation arrangements not override choice of fund or the determination of defaults by industrial agreement.

8 Legacy products (s14.6)

Legacy products are a significant institutional barrier to competition, causing inefficiency and cost in the superannuation system. While there is little publicly available research on the numbers of consumers in legacy products, IFSA reportedly estimates that up to 25% of all funds under management – hundreds of billions of dollars – are in legacy products. [Footnote: <http://www.smh.com.au/news/business/money/superannuation/legacy-of-plague-proportions/2009/11/17/1258219829651.html> (SMH, 18 November 2009).

The problem of legacy products is confined almost entirely to the retail sector. Except for some cases of closed corporate/public sector super funds, legacy products result from a commercial decision by a trustee to close a product to new applications. The frequency with which retail super funds are closed is illustrated by the very small number of super funds in the retail sector which can report long term (10 years+) investment returns. The result is that there are hundreds of funds with dwindling numbers of members and funds under management.

The SIS legislation provides a process for fund rationalisation in the absence of member consent, through successor fund transfers. In order to undertake a successor fund transfer, the original super fund and the successor super fund must agree that the transferred members will be provided with “equivalent rights”, which means that the successor fund must offer the member the same level of benefits as the original fund. In ISN’s view, this sets an appropriately rigorous obligation on trustees to ensure that members are not disadvantaged by fund rationalisation.

In attempting to frame a policy response to the problem of legacy product, ISN submits that:

- Any measures introduced to assist the rationalisation of super funds should not enable member’s accounts to be transferred without their consent or in circumstances where the transfer will result in a loss of benefit or rights for the member.
- It is important to consider, in framing any policy response to this issue, that the high incidence of legacy products is based on the commercial or economic imperatives of the product provider. The cost of rectifying any resultant inefficiency should not therefore be borne by the funds’ members.

Recommendations:
Superannuation funds should be prohibited from charging exit fees, other than a nominal fee which reflects the administrative cost of transferring an account. Due to the anti-competitive characteristics of legacy products, ISN submits that this reform should not be subject to grandfathering.

9 Security (s12.1)

ISN endorses the submission on AIST on security in superannuation.

Recommendations:
The Government commits to altering the relevant legislation to simplify the use of collective investment vehicles by multiple funds.
Broader TFN access is required for funds and use of the TFN as the primary identifier associated with superannuation should be progressed.
Tighter regulation of the SMSF sector, including requirement of written investment strategies and regulatory overview by APRA.

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Appendix A. Brief History of Award Superannuation

Prior to 1983 only 39% of the working population (and 25% of women and “blue collar” employees) had superannuation. Most of the existing schemes were not portable, had strict vesting rules and were generally restricted to public servants and senior management.

Industrial pressure grew to improve the retirement savings of ordinary working Australians and in September 1985 the Australian Council of Trade Unions (ACTU) sought a 3 per cent employer contribution to superannuation in the National Wage Case. This claim was supported by the Federal Government. In February 1986 the Australian Industrial Relations Commission (AIRC) allowed for approval of agreements that allowed for superannuation contribution of “up to” 3 per cent to approved superannuation funds. These funds were generally multi-employer industry funds jointly sponsored by trade unions and employer associations.

The 1986 Wage Case decision saw superannuation coverage dramatically increase from approximately 40 per cent of employees to 79 per cent in the four years following the AIRC’s decision. The percentage of employees in the private sector with some form of superannuation increased from 32 per cent in 1987 to 68 per cent in 1991.

In 1991 the AIRC rejected an ACTU claim (supported by the Federal Government) to increase compulsory superannuation from 3 to 6 per cent. The AIRC recommended a national superannuation conference to deal with what it perceived as fundamental structural problems. Not least of which was an acceptance between the parties that a 3 per cent contribution was insufficient to significantly improve retirement incomes. These problems included the non-application to one third of the private sector workforce, massive non-compliance, confusion and underpayments, the lack of portability and flexibility and the lack of application to part-time and casual employees.

In 2008 the AIRC confirmed the appropriateness of the inclusion of default superannuation funds within new consolidated modern awards which were to commence on 1 January 2010 and subsequently maintained by the AIRC’s successor Fair Work Australia.

The AIRC determined that the appropriate default fund is a matter for the relevant industrial parties.

Superannuation guarantee

Rather than hold a conference on superannuation the Federal Government, using its taxation powers, introduced the superannuation guarantee via the *Superannuation Guarantee (Administration) Act 1992*. The principle features of this significant legislation were:

From 1 July 1992 employers would be required to make tax-deductible superannuation contributions on behalf of their employees. Commencing 1992/3 with a 3 per cent employer contribution (4 per cent for employers with an annual payroll of over 1 million). Contributions increased until 9 per cent was reached in 2002/03.

Employers who did not provide the required amount of superannuation support would be liable for a non-deductible Superannuation Guarantee Charge, equivalent to the individual employee shortfall in contributions, an interest component and an administrative charge.

The guarantee extended superannuation coverage to the majority of employees (excluding employees earning less than \$450 per month, part-time employees under 18 years of age and employees aged 65 or over).⁵

Criteria for eligibility for selection as default fund

Where workers do not choose their own fund it is important that net performance (investment performance less fees) is prioritised in selection of the workplace default fund.

Fair Work Australia is expected to review the operation of modern awards in 2014. ISN believes this would be an ideal opportunity to insert criteria that funds should meet to be eligible to be named in awards and agreements as default superannuation funds.

Criteria could include that a nominated super fund:

- a. Not pay commissions or ongoing advice fees to intermediaries.
- b. Operates within specified regulated fee caps, including entry, exit and ongoing fees.
- c. When contributions cease the employee remains a member of the default fund until he/she consolidates into a new active fund or is rolled into a suitable ERF.
- d. The fund is of sufficient size and scale to effectively and efficiently provide services to members.
- e. The fund has procedures in place for following up arrears in payments.
- f. The fund has a representative trustee structure.
- g. The fund holds an APRA RSE Licence.

Where an employer and union/employees have negotiated an enterprise agreement, the award provisions should be deemed to apply unless the agreement deals specifically with the issue of naming a default fund or funds. In addition, the above criteria should also apply as part of the consideration in determining the 'no disadvantage' test during certification.

In instances where employees are outside award coverage, the default funds selected by their employers should also meet the same objective criteria applied to default funds approved through awards.

⁵ The contributions guarantee was extended from 65 to 70 from 1 July 1997 provided the employee was employed for ten hours or more each week.