CSRI
COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

Superannuation: Alternative Default Model Draft Report, March 2017

CSRI Submission to the Productivity Commission Consultation Process

28 April 2017

Contents

28 April 2017

Superannuation
Productivity Commission
Locked Bag 2 Collins St East
Melbourne
VIC 8003

Dear Ms Chester,

Superannuation: Alternative Default Models Submission

The Committee for Sustainable Retirement Income (**CSRI**) is an independent, non-partisan, non-profit think tank whose Mission is to progress the development and implementation of policies to further the goal of encouraging "adequate incomes through all the years of retirement for all Australians on a fair and fiscally sustainable basis".

The CSRI welcomes this opportunity to contribute to the development of alternative default models.

The Commission has identified four distinctive models that cover a broad spectrum of options that ought to be considered. The CSRI considers these models worthy of consideration, although the inclusion of the current default approach could have enhanced the assessment by permitting comparison against the status quo.

Within the limited time available, the CSRI has confined its submission to four interrelated issues.

First, the scope of the alternative default model should be extended to include the retirement phase. This would not seek to develop a default model that determines the members' retirement benefit on entering the workforce, although access to lifecycle funds could be available under this approach. Rather, it would require that a short-listed default fund would be capable of offering the member a suitable retirement solution in the transition to retirement, either sourced internally or through another super fund, consistent with the CIPRs framework. An integrated perspective across the alternative default models and the regulatory framework for comprehensive income products in retirement is needed to avoid potential inconsistencies and ensure that broader policy aims are achieved. Accompanying this submission is a paper that discusses options for addressing the contestability of the retirement benefits stage.

Second, the assessment framework for evaluating the models should include explicit consideration of the impact of each model on the empowerment of members to better plan for retirement as discussed in Section 2.

Third, an evaluation of the core components underlying the models (as discussed in Section 3) has led to the development of the following preferred hybrid model:

- New members would be encouraged to choose a superannuation product themselves with the assistance of a number of policy interventions, as follows.
- A shortlist of funds would be offered. This list would be developed through a primary mandatory screen applied by APRA followed by a voluntary screen applied through a competitive tender process.
- The tender would apply multiple criteria including the offer of retirement benefits and/or Comprehensive Income Products in Retirement.
- Where members do not make a choice, they would be assigned sequentially to the above shortlisted funds.

Finally, in Section 4, it addresses the suitability of the criteria for shortlisting funds. Multiple criteria are needed to avoid a singular focus on cost. With the Government seeking to enshrine the purpose of superannuation as to provide income in retirement, retirement benefits should be an important criterion for the shortlisting of default funds. Consideration should be given to the appropriateness of the product's long-term investment return target and risk profile. Given that past returns are not a good indicator of future returns, consideration is needed of the expected ability of the fund to deliver on the product's return target, given its risk profile. This will require examination of the fund's investment strategy, investment capability and performance relative to target return. To enable meaningful comparisons of net returns across funds, it is important to account for differences in underlying risk profiles resulting from underlying asset allocations. This may be done by creating a composite benchmark that replicates the underlying portfolio.

I would be pleased to discuss and elaborate on any of the points made in this submission and the accompanying paper.

Yours sincerely,

Patricia Pascuzzo
Founder and Executive Director
Committee for Sustainable Retirement Incomes

Superannuation: Alternative Default Model

1. Scope of the Alternative Default Model

With the Government seeking to enshrine the purpose of superannuation as to provide income in retirement, the contestability of the pension phase should be an integral part of the design of the alternative default model.

The Government is conducting two related superannuation inquiries concurrently namely: the review of alternative default super models and the development of a regulatory framework for comprehensive retirement income products (CIPRs). Looking across both of these policy processes, however, a gap exists in relation to competition ***for*** (contestability) the default retirement benefit market that has the potential to compromise broader policy outcomes.

The purpose of the Treasury discussion paper for CIPRs is to develop a regulatory framework to support members transitioning into retirement by facilitating trustees' preselecting a comprehensive income product in retirement for each member. This framework will require trustees to engage with members well before retirement and will, in effect, create the soft default for retirement. The issue of contestability of the default retirement accounts market is beyond the scope of the framework.

The retirement phase has also been carved out of the Productivity Commissions (PC) Inquiry into Alternative Super Default Models. That leaves open the question of how contestability of the default retirement benefit market will be achieved.

This represents a significant gap as it is widely accepted that disclosure and competition **in** the market alone are insufficient to ensure that members' interests are met effectively in the superannuation market – competition ***for*** the market is critical.

It is important for the achievement of the government's objectives for superannuation that there be clarity as to the timing and process for addressing the contestability for the retirement benefits market. To try to broaden the alternative default system, or bolt on an extension of the system, at a later stage would likely prove much more difficult and impose greater regulatory costs than getting the scope right from the start.

One way to address this gap would be to extend the scope of the alternative default model inquiry to include the retirement phase. Under this approach, the model for injecting contestability would apply to all new default super members through both the accumulation and retirement phases. This would not seek to develop a default model that determines the members' retirement benefit on entering the workforce, although access to lifecycle funds could be available under this approach. Rather, it would require that a short listed default fund would be capable of offering the member a suitable retirement benefit in the transition to retirement, either sourced internally or through another super fund, consistent with the CIPRs framework. Under this approach, modification of the default fund selection criteria would be required to include retirement benefits (as discussed further in the Short List Criteria section).

The alternative approach would be to create a separate default model system for the retirement phase. This would allow funds to specialise in either the accumulation and retirement phases. However, funds specialising in accumulation would have difficulty in remaining viable as increasing numbers of members enter retirement would cause rising outflows. A separate process would also duplicate costs and inhibit the development of whole of life solutions that would enhance member benefits (eg life cycle funds).

Both of these options have merit and are superior to the status quo option of no contestability of retirement benefits. On balance, the single-integrated approach is considered a more effective way of achieving the objectives of superannuation and delivering superior member outcomes. The attachment to this submission details the evaluation of each option compared with the status quo.

The approach taken on this matter will have an important bearing on the evaluation of alternative default models, the criteria for evaluating default funds and the design of the CIPR framework. Clarifying the process would have the added benefit of supporting the government's policy of facilitating trustees' provision of CIPRs and furthering the objective of superannuation.

2. Assessment Framework

In developing the alternative default model, it is important to start with the end goal in mind. The model must be consistent and indeed support the overarching aim of the superannuation system "*to provide income in retirement to supplement and substitute the age pension"*.

The Commission has stated that it is seeking to ensure all employees can access competitive defaults and that benefits flow on to existing members. This expansive perspective of the default system is particularly important given the evidence that actual switching rates for superannuation are much lower when compared with other financial and utility products (Choice 2016). Further, according to Rice Warner research, fees charged for legacy retail products are a third higher than those charged for current superannuation products and that around one in three retail personal superannuation assets were held in these higher fee legacy products. If the default model is to have an appreciable effect on the system, it will need to influence existing products.

The Commission has put forward four alternative models and has identified criteria for assessing those models. It is difficult to determine, based on these criteria, which of the models is superior. An important factor that is under developed in the report, and indeed has received insufficient attention since superannuation was established, is member empowerment. While the establishment of superannuation has delivered many benefits, it has also transferred significant risks to individuals who are ill placed to manage those risks.

In seeking to make the purpose of superannuation a reality, there would be merit in envisaging the member experience that we are seeking and the nature of the super and regulatory system needed to deliver that outcome. Government can take a paternalistic approach towards members, or it can take a longer term perspective and seek to empower members to better plan for their retirement.

Looking into the future, are we to accept the status quo whereby members lack the motivation and necessary financial literacy to make choices on their own behalf? Or do we envisage a future that offers a streamlined set of appropriate options and members are empowered through effective communication and technology to make choices that take into account their needs and preferences?

Support for the first vision is provided by the complexity of the retirement income system, the existence of behavioural biases in decision making and evidence that members active choices have often resulted in inferior outcomes. The second vision accepts the above constraints while also recognising the potential for technology to be an enabler in financial decision making, the ease with which millennials adopt new technologies and that less complexity would encourage greater engagement.

The collective vision about these alternative futures has an important bearing on the assessment of alternative models and the role of the member. The first vision would place more reliance on defaults and the role of other agents in making decisions on members' behalf. This vision would not support a model that places a heavy onus on the member.

Under the second vision, however, members are encouraged to become more engaged and the system supports their ability to make choices through process design that recognises and counters behavioural biases in decision making. While this second vision is more aspirational, it is also more forward looking and sustainable in the longer term. This vision would also inform other policy processes including the development of CIPRs.

As participants at the CSRI Roundtable in 2016 heard:

> *"If we want a retirement income system that wins the support of the community, we have to make it as accessible and as user-friendly as the simplest mobile phone app. By keeping the complexity under the hood and building a friendly consumer interface, we'll build confidence in the system and increase engagement." (Jim Parker, Dimensional, CSRI Roundtable, April 2016).*

Under this vision, the alternative default model would, first, empower the majority of members to make their own choices and, second, provide a backstop for a declining proportion of members who are unable to choose. Third, to achieve this vision requires the streamlining and standardisation of choices to make comparisons possible, recognising that complexity is the enemy of good decision making. This last element while not ignored in the report should arguably receive greater prominence.

Each of these three elements and their relation to the models is discussed below.

3. Evaluation of Alternative Models

This section evaluates the core components underlying the alternative default model before arriving at a preferred approach.

Employee Choice

It is true that employee choice has not been successful to date in driving competition and efficiency throughout the market. A range of factors limit demand side pressures and accentuate member passivity and disengagement. These include the compulsory nature of contributions, the availability of the age pension, the complexity of retirement income decisions, long time horizons, various behavioural and cognitive biases, and the costs of active involvement.

However, requiring members to make no choice at all may stifle engagement further. Experience in the United Kingdom with compulsory annuitisation provides some insight into the way members respond when they are not required to make a choice. In this case the default product provided by the individual's pension provider, resulted in consumer apathy and a disengagement from the process, and often resulted in consumers not getting the best product available to them.[1]

If the individual is forced to choose an option, they may be much less prone to the effects of inertia and are encouraged to actively consider the choices. This may be effective at increasing engagement in the decision as well as competitive incentives on product providers.

To be successful, employee choice requires commitment to a number of supportive strategies including:

- Encouraging standardisation of options across the industry to remove complexity and enable greater comparability
- Clear communication to the member about the outcomes that they will experience rather than the technical details of the products offered.
- To establish an independent source of retirement planning information, communicated through channels targetted at various population cohorts, to encourage member interest and motivation in managing their superannuation savings and taking charge of their retirement planning

The resources used to empower members are resources well spent to make the market work more effectively and improve member outcomes. To be clear, this doesn't mean turning every super member into a financial expert. On the contrary, it would mean removing unnecessary complexity in the system, focussing member communication on outcomes rather than technical product features and providing support for decision making.

Members who do not make a choice

Even with all of the above strategies, particularly in the period before they have time to take effect, there will remain a group of members who do not make a choice and require additional support. A permanent, rather than interim, safety net or backstop is needed.

The suggestion (under Model 1) that the Future Fund could play this role, even if only on an interim basis, is not supported. Requiring the Future Fund to manage the super accounts of new default members would represent a major strategic shift for a government owned long term investment vehicle with no capability or infrastructure for administering retail members. While the fund could no doubt acquire or build the capability (at considerable cost to the Commonwealth) it would take many years to develop the scale to justify the investment. Moreover, the rationale for doing so is unclear given that there are already an excessive number of retail and industry funds who have this capability, many of whom have considerable scale and would be able to provide a better service more cost effectively.

[1] Financial Conduct Authority, 2014; 2015.

While the Future Fund could outsource member administration and engagement to a third party, once again the rationale for doing so is unclear. The Future Fund's core capability lies in being a wholesale investment fund, and the scope of the Commission's inquiry is limited to the retail sector.

ERFs (eligible rollover funds) is the least-worse option of the two. In either case, however, it would seem somewhat incongruous to introduce a competitive default model only to then allocate default members to a fund that has not participated in the process and is not currently in the market.

A superior option is to allocate these members sequentially to a default fund shortlist established through either an administrative or a market based option, as discussed further below.

Market based models versus administrative models

The choice between market based or administrative models as the method for determining the shortlist of funds depends to some extent on how either system is specifically designed and implemented.

A number of features could be common across either approach and therefore would not represent points of differentiation. Good governance and transparency are critical under either approach. The government appointed independent panel charged with either process would need to be subjected to a high degree of probity to ensure it was able to carry its function with diligence and objectivity.

In either case, a modified version of APRA's criteria for MySuper would be suitable as a mandatory light filter. In relation to a heavy filter, both a market based approach and an administrative filter could adopt the same criteria. Under either a market based or administrative approach, there is always a risk that top down metrics acting as a proxy for consumer demand will not necessarily match demand under ideal market conditions. The panel will need to give specific attention to this matter to ensure consistency with members' best interests.

It would be possible to calibrate the administrative filter to result in a predetermined number of qualifying products. Careful consideration would be needed to ensure the criteria for reducing the number of default options from the current 120 *MySuper* funds on offer to the shortlist of up to 10 funds lines up with member best interests without resorting to arbitrary criteria. This highlights the major weakness associated with the administrative approach.

Given the intention is to drive efficiency in the broader superannuation market, however, it is important that a market mechanism is used to guide this process. A properly run auction is likely to lead to better market-related outcomes through improved transparency, feedback loops and competitive bidding. A tender process places greater onus on the market participants to put forward superior products to meet members' best interests. Whereas, an administrative approach places a greater onus on the panel members, with market participants playing a more passive role. A competitive auction run by an independent panel would thus appear to strike an appropriate balance between encouraging competition while promoting standardisation and reducing complexity.

There are sufficient protections in the regulatory system to guard against collusion as evidenced by the success of the ACCC in prosecuting cases in other industries, the severity of the penalties imposed by the courts, and the strong incentives provided for whistleblowers to come forward. This suggests that reliance can be placed on existing legislation and regulatory action to mitigate the risk of collusion. A key risk in competitive tender process is to ensure that the scope for other gaming is avoided. Considerable research and experience is available on which the panel would be able to draw on in designing and executing the tender to mitigate this risk.

Guided Employer Choice

The role of the employer is critical in the case of defined benefit schemes as the employer bears the residual risk of the fund. In a defined contribution plan, however, residual risk is borne by the member, and in the case of the Australian system, ultimately by the Commonwealth given the provision of the age pension safety net.

To place responsibility for making choices on the employer would provide scope for additional agency risk that would be difficult and impractical to mitigate. CSRI shares the concerns of CHOICE around evidence of a lack of oversight and probity in corporate tender processes, which in some cases has led to employer interests being put ahead of members.[2] It would also place an unnecessary burden on the employers with vastly varying abilities to undertake this responsibility.

Preferred Alternative Default Model

Based on the foregoing considerations, a preferred hybrid model would constitute the following elements:

- New members would be encouraged to choose a superannuation product themselves with the assistance of a number of policy interventions, as follows.
- A shortlist of funds would be offered. This list would be developed through a primary mandatory screen applied by APRA followed by a voluntary screen applied through a competitive tender process.
- The tender would apply multiple criteria including the offer of retirement benefits and/or Comprehensive Income Products in Retirement.
- Where members do not make a choice, they would be assigned sequentially to the above shortlisted funds.

4. Shortlist Criteria

With the Government seeking to enshrine the purpose of superannuation as to provide income in retirement, it would be reasonable to expect that retirement benefits should be an important criterion for the shortlist of default funds.

The PC correctly notes

> *"the transition and retirement phases have not received as much policy or market attention as the accumulation phase of superannuation. And yet this is when members typically have the largest balances and the efficiency of the system comes to the fore." PC 2016*

Given that the alternative default model is intended to act as a driver of change across the whole market, excluding retirement benefits from the multi-criteria would serve to perpetuate the current focus on the accumulation phase. This approach assumes that funds are best to specialize in either accumulation or retirement benefit products. However, with population aging causing a rising number of members to transitioning into retirement, specialization in accumulation products is likely to be a non-viable strategy for most, if not all, funds.

Moreover, a focus on accumulation ignores the fact that the ultimate purpose of super is to provide income in retirement. Also, focusing the default model on accumulation only would hinder the development of whole of life products.

Certainly, including retirement benefits as a criterion in the default model doesn't mean that each and every default fund must necessarily include a pre-specified retirement benefit. Some members may prefer a life cycle and therefore shouldn't be precluded from receiving one. This would provide defined contribution members with an experience comparable to that faced by defined benefit members.

However, it does mean that default fund trustees must have a suitable retirement benefit to offer their members that meets the requirements of a comprehensive income product in retirement once these are developed. If the alternative default is implemented before the CIPR framework is legislated, the requirement could be lessened to simply having a retirement benefits strategy and income stream product.

A further issue with the proposed multi-criteria (PC 2017, p176) is that a heavy focus is seemingly placed on past performance of net returns. It is acknowledged that the system should encourage the removal of funds that perform poorly on more than a one off basis. At the same time, an excessive focus on returns may encourage a bias towards short term investment strategies. A narrower focus on fees would further bias investment strategies adversely.

[2] Choice Submission to PC Superannuation Alternative Default Model, 2016

Given that past returns provide little indication of future returns, the criteria should place a greater focus on investment strategy, investment capability and whether the fund meets its target return. A better articulation would be along the lines of Fair Work Act:

- *Appropriateness of the product's long-term investment return target and risk profile.*
- *The expected ability of the fund to deliver on the product's return target, given its risk profile*

To enable meaningful comparisons of net returns across funds, it is important to account for differences in underlying risk profiles resulting from underlying asset allocations. This may be achieved by creating a composite benchmark that replicates the underlying portfolio.

5. Summary of Conclusions

Scope of alternative default model.

- With the Government seeking to enshrine the purpose of superannuation as to provide income in retirement, the contestability of the pension phase should be an integral part of the design of the alternative default model.
- It is important for the achievement of the government's objectives of superannuation that there be clarity as to the timing and process for addressing the contestability of the retirement benefits market.
- While a separate system could be developed for the retirement phase, a single integrated process covering both accumulation and retirement benefits funds would be the most effective way of achieving the objectives of superannuation and delivering superior member outcomes.

Model Assessment Framework.

- To improve superannuation system outcomes, an important policy aim should be to empower members to better plan for retirement. This aim can be furthered by including member empowerment as part of the alternative default model assessment framework to achieve the following:
    - support and encourage the majority of members to make their own choices;
    - provide a backstop for a declining proportion of members who are unable to choose.
    - stimulate the streamlining of choices as complexity is the enemy of good decision making.
- To be successful, employee choice requires commitment to a number of supportive strategies including:
    - Encouraging standardisation of options across the industry to remove complexity and enable greater comparability
    - Clear communication to the member about the outcomes that they will experience rather than the technical details of the products offered.
    - To establish an independent source of retirement planning information, communicated through channels targetted at various population cohorts, to encourage interest and motivation in managing their superannuation savings and taking charge of their retirement planning.

Model Evaluation

- While members are encouraged to make a choice, there will always remain a group of members who do not make a choice. Additional support should be provided for these members, in the form a default that would also be suitable on a long term, rather than interim, basis.
- To introduce a competitive default model only to then allocate default members to a fund that has not participated in the process and is not currently in the market is not considered appropriate. Neither the Future Fund or eligible roll-over funds are considered suitable as a default fund.
- A preferred approach is to establish a default fund shortlist and then to allocate these members sequentially to these funds.
- A market based approach to developing the default fund shortlist is likely to achieve outcomes better aligned with members' interests than an administrative approach. A competitive auction undertaken by a government appointed independent panel of experts would thus appear to strike

an appropriate balance between encouraging competition while promoting standardisation and reducing complexity.
- To allow employers to make choices on members' behalf, where members have not exercised their right to make a choice, would provide scope for additional agency risk that would be impractical to mitigate.

Preferred Alternative Default Model

Based on the foregoing considerations, a preferred hybrid model would constitute the following elements:

- New members would be encouraged to choose a superannuation product themselves with the assistance of a number of policy interventions, as follows.
- A shortlist of funds would be offered. This list would be developed through a primary mandatory screen applied by APRA followed by a voluntary screen applied through a competitive tender process.
- The tender would apply multiple criteria including the offer of retirement benefits and/or Comprehensive Income Products in Retirement.
- Where members do not make a choice, they would be assigned sequentially to the above shortlisted funds.

Shortlist Criteria

- Multiple criteria are needed to avoid a singular focus on cost. The superannuation system arguably places excessive emphasis on returns, which tends to bias investment strategies towards the short term. A narrower focus on fees would further bias investment strategies adversely.
- With the Government seeking to enshrine the purpose of superannuation as to provide income in retirement, it would be reasonable to expect that retirement benefits should be an important criterion for the shortlisting of default funds.
- Consideration should be given to the appropriateness of the product's long-term investment return target and risk profile. Given that past returns are not a good indicator of future returns, consideration is needed of the expected ability of the fund to deliver on the product's return target, given its risk profile. This will require examination of the fund's investment strategy, investment capability and performance relative to target return.
- To enable meaningful comparisons of net returns across funds, it is important to account for differences in underlying risk profiles resulting from underlying asset allocations. This may be done by creating a composite benchmark that replicates the underlying portfolio.